<u>Thames Water Proposed Penalties:</u>
<u>GSS standards and Conditions of Appointment</u>
<u>Section 22A(5) variation notices dated 9 January 2008</u>

<u>Representations of Thames Water Utilities Limited ("Thames")</u>

1. Executive summary

1.1 It was not within the powers of the Water Services Regulation Authority ("**Ofwat**") to issue the GSS Notice (as defined in section 2), given that it is founded on a notice of 19 July 2006 (the "**July Notice**") which purported to impose a nominal penalty of £1, only as an artificial device to extend the statutory limitation period.

1.2 In addition, or alternatively, the July Notice breached sub-sections 22A(4)(a) and (c) of the Water Industry Act 1991 (as amended) ("**WIA 91**"); these breaches caused substantial prejudice to Thames – both in terms of unfair procedure and in consequence, as Ofwat is seeking to impose a penalty in respect of a period outside the statutory limit.

1.3 Ofwat's explanations for its choice of a nominal, unrealistic penalty in the July Notice are unsustainable; indeed Ofwat's asserted inability to make use of section 203 WIA 91 leads to the conclusion which supports Thames's contention that Ofwat had no power to issue a notice as a deliberate strategy to extend a limitation period in circumstances where Parliament did not permit Ofwat to do so.

1.4 Ofwat has acted in breach of the statutory regime by refusing to attribute the perceived contraventions to Thames's particular business – water or sewerage – and accordingly, by assessing the penalty by reference to Thames's combined turnover, Ofwat has wrongly inflated the penalty proposed.

1.5 While abandoning certain grounds previously advanced in support of its proposed penalties, Ofwat has, illogically, failed to make a corresponding reduction in the penalties themselves.

1.6 Ofwat has failed to address certain arguments previously advanced by Thames sufficiently or at all.

1.7 Ofwat has failed to provide adequate reasons for the level of penalties proposed. In particular, Ofwat has failed to explain why it is proposing to impose a penalty on Thames, whose performance, when compared to that of others in the industry, is not egregious.

1.8 Ofwat's response with respect to regulatory precedents does not withstand scrutiny. In comparing the proposed penalties in Thames's case to those imposed by itself and other regulators, Ofwat takes account of irrelevant factors and disregards relevant ones. In particular, Ofwat's consideration and dismissal of the Ofgem precedent, which is almost an exact parallel to Thames's case, is cursory.

2. Background

2.1 On 27 September 2007, Thames received, pursuant to sections 22A(5) and 22A(4) WIA 91, notices from Ofwat proposing to impose penalties of £1.4m (the "**GSS Notice**") and £11.1m (the "**J/M Notice**") for, respectively:

(i) its failure to meet standards of service prescribed under the Guaranteed Standards Scheme Regulations ("**GSS Regulations**"); and

(ii) its failure to comply with Conditions J and/or M of Thames's Instrument of Appointment (the "**Licence**").

Written representations in response to these formal notices were made by Thames to Ofwat on 29 October 2007.

2.2 On 9 January 2008, Ofwat issued further section 22A(5) Notices with respect to the GSS Notice and the J/M Notice (the "**GSS Variation Notice**" and the "**J/M Variation Notice**", respectively), which respond "to particular representations and provides further evidence of Ofwat's reasoning in arriving at its proposal to fine".[1]

2.3 This is an assessment of Ofwat's responses to Thames's main arguments. Thames reserves the right to rely on all previous relevant documents in any further proceedings.

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[1] Paragraph (vi) of the preamble to the GSS Variation Notice; paragraph (v) of the preamble to the J/M Variation Notice.

3. Validity of the GSS Notice

3.1 In its written representations, Thames argued that, by proposing a nominal penalty of £1 in the July Notice, Ofwat had failed to comply with the statutory requirements, thus rendering it, and consequently the GSS Notice, invalid.[2]

3.2 Ofwat now claims that Thames's argument of invalidity falls outside the grounds for challenge in the Court as set out in section 22E(4) WIA 91.[3]

3.3 Thames responds that, for the reasons developed below, firstly the imposition of the penalty of £1.4 million is not within Ofwat's powers and, secondly, Thames's interests have been substantially prejudiced by Ofwat's non-compliance.

Section 22E(4)(a)

3.4 Thames contends that, by issuing the July Notice with the £1 nominal penalty, Ofwat committed an abuse of process, deliberately subverting the statutory scheme; and this brings it within section 22E(4)(a).

3.5 Section 22C(1) WIA 91 imposes a twelve-month limitation period on Ofwat. It expressly provides that Ofwat may not impose a penalty with respect of any contravention or failure later than the end of the twelve-month period from the time of the contravention or failure unless a section 22A(4) Notice or section 203 Notice is served.

3.6 A section 22A(4) Notice is one that complies with sub-sections 22A(4)(a)–(d). The July Notice did not do so because:-

(i) the penalty was a nominal one that Ofwat never intended to be the penalty that it would impose; so that sub-section 22A(4)(a) was not complied with.

(ii) it did not specify the "other facts" which, in Ofwat's opinion, justify the imposition of the penalty. Ofwat failed to specify in the July Notice what evidence or information it was relying on to justify the imposition of a penalty. Thus, it also failed to satisfy sub-section 22A(4)(c).

3.7 Accordingly, whatever it purported to be, it was not a section 22A(4) Notice; and this mechanism for extending the limitation period under section 22C was not available to Ofwat.

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[2] Paragraphs 1.5 and 2.3 of Thames's representations dated 29 October 2007.

[3] Note 1 of the table in paragraph 137 of the GSS Variation Notice.

3.8 Ofwat positively asserts that it had no power to serve a section 203 Notice in relation to the alleged GSS contraventions and seeks to justify its use of the July Notice on the grounds that it did not have the option of issuing a section 203 Notice for contravention of the GSS Regulations.

3.9 However, on the assumption that Ofwat's powers in respect of contravention of those Regulations was limited to the imposition of penalties rather than the obtaining of enforcement orders under section 18, this provides of itself no justification for the issue of a notice, purporting to be a section 22A(4) Notice, which does not comply with the requirements for such notices in an attempt artificially to extend the limitation period.

3.10 Parliament made no alternative provision for Ofwat to extend the limitation period in the case of contravention of these GSS Regulations on the grounds of lack of information or otherwise. It would appear, again on the assumption that Ofwat's analysis of the limits of section 203 and section 18 is correct, that the statutory scheme differentiated between contraventions enforceable under section 18 and contraventions that are not so enforceable – for example, because they were contraventions of standards that the Secretary of State has chosen not to designate as breaches of section 37: see section 38(1) WIA 91. Parliament evidently:

(i) regarded contravention of the GSS Regulations as being of a different character or degree than breaches of licence conditions and certain other requirements of WIA 91 or regulations made thereunder; and

(ii) accordingly, devised a strictly defined period for a regulatory response to alleged contraventions of GSS Regulations – no exemptions exist in the legislation for uncertainty or lack of information on the extent of such contravention or failure, indicating that Parliament did not intend that Ofwat should be able to extend the limitation period at all.

3.11 The remaining question is whether Parliament intended to allow this scheme and this distinction to be subverted by the use of a device such as the issuing of a notice as a strategic device, purporting to be issued under section 22A(4) but in fact not complying with the statutory requirements for such a notice.

3.12 Thames's submission is that there can be only one answer to this question: Parliament plainly did not so intend. To hold otherwise would be to undermine entirely the statutory scheme. That is in particular because Ofwat's actions not merely involve deliberately ignoring requirements that Parliament has laid down in section 22A(4), but also removing, in doing so, the distinction referred to above.

3.13 Ofwat positively asserts that it had no power to issue a section 203 Notice, that it was aware of that absence of power at the time and that it therefore devised a strategy to circumvent the limitation period set by Parliament. That deliberate strategy involved purporting to issue a section 22A(4) Notice, knowing full well that the "notice" did not comply with the statutory requirements for valid notices under that section.

3.14 Thames submits that this amounts to deliberate subversion of the statutory scheme, and the purported use of powers for a purpose plainly not intended by Parliament. As such, it constitutes a plain abuse of process. That is more than sufficient to bring the case within section 22E(4)(a).

Section 22E(4)(b)

3.15 In addition, or alternatively, Thames relies on section 22E(4)(b). This provides as one of the grounds for challenge:

> *"that any of the requirements of subsections (4) to (6) or (8) of section 22A above have not been complied with in relation to the imposition of the penalty and the interests of the company have been substantially prejudiced by non-compliance".*

3.16 As discussed above, the invalidity of the July Notice and non-compliance with sections 22A(4)(a) and 22A(4)(c) satisfy the first limb of section 22E(4)(b).

3.17 Section 22E(4)(b) also requires that the interests of the company have been substantially prejudiced by non-compliance.

3.18 In this case, Ofwat's non-compliance with sections 22A(4)(a)–(d) has caused substantial prejudice to Thames. This is because it is intended to, and if implemented would, cause Thames to be penalised £1.4m for matters occurring in a time period in respect of which, in these circumstances, Parliament did not intend Ofwat to be able to impose a penalty.

3.19 Ofwat states that:

> *"The choice of £1 was made to avoid any substantial prejudice to the interests of Thames Water."*[4]

This statement is irrelevant, and fails to explain how a nominal penalty of £1 serves to avoid any substantial prejudice to the interests of Thames.

3.20 Therefore, both sub-sections 22E(4)(a) and 22E(4)(b) are satisfied and Thames has two grounds upon which it would be entitled to bring, should it choose to do so, a statutory appeal before the Court.

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[4] Note 1 of the table in paragraph 137 of the GSS Variation Notice.

4. Use of applicable turnover

4.1 In neither the GSS Variation Notice nor the J/M Variation Notice does Ofwat address the requirement imposed by the legislation to attribute the perceived contraventions to the relevant business. It states that it considers that the most appropriate approach is to proceed by reference to the combined turnover of Thames as the alleged failings prejudice the regulatory regime as a whole.[5] However, section 22A(11) WIA 91 stipulates that, for the purposes of determining the maximum penalty which can be imposed on an undertaker, the applicable turnover is to be determined by subordinate legislation. As discussed in paragraphs 4.22–4.30 of Thames's representations dated 29 October 2007, the Water Industry (Determination of Turnover for Penalties) Order 2005[6] (the "**Order**") requires the applicable turnover for the purposes of section 22A WIA 91 to be derived from the provision of goods and services in the course of the company's "regulated activities", which is defined as the company's functions as a water or sewerage undertaker, as appropriate. The legislation clearly separates these functions and does not allow for the use of combined turnover at will.

4.2 Thames contends that, in construing the Order both literally and purposively, Ofwat should have attributed the alleged failures to the relevant water or sewerage function, as appropriate, in determining the level of the penalties. Not only is this compelled by the legislative language, it is also the just and equitable approach. For example, consider two undertakers of equal size and total combined turnover: one has 10% water and 90% sewerage functions; the other has 90% water and 10% sewerage functions. If both companies committed precisely the same breach with respect to its water functions, it would be unjust to impose the same penalty on both companies, given the different proportions of their business accounted for by their water and sewerage functions. Or consider an undertaker who has 10% water and 90% sewerage functions, but whose breaches are 100% as to its water functions and 0% as to its sewerage functions. It would be unjust to impose a penalty for those breaches by reference to the turnover of its combined functions rather than its water functions.

4.3 Annex 1 illustrates how the failures should have been attributed to the separate water and sewerage functions and gives an example of how the penalties may have been calculated, without prejudice to any other appropriate methods. In this illustration, the proportions have been calculated by reference to "value" of the GSS failure, i.e. taking into account the value of the GSS payments, in order to reflect the gravity attached to the failures by the regulations. There are several points to note.

- GSS Regulation 6 (interruption of supply) and Regulation 7B (flooding from sewers) relate solely to water and sewerage services respectively. In considering the

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[5] Paragraph 83 of the GSS Variation Notice; paragraph 140 of the J/M Variation Notice.

[6] SI 2005 No. 477

regulatory regime as a whole, Ofwat has failed to recognise that these failures relate only to part of Thames's business and it has thus exaggerated the penalty.

- The proportion of the failures which relates to both the water and sewerage businesses accounts for less than 14% of the total. Ofwat's broad approach in simply stating that the regulatory regime as a whole has been prejudiced is unjustified and unlawful.

- The data in Annex 1 are derived from Thames's compensation payment quantification exercise, which was completed in December 2007 and reviewed by Ernst & Young LLP ("**E&Y**").

4.4 Ofwat states that Thames "in fact acknowledged that the separate attribution of failings to the water and sewerage businesses respectively was problematic".[7] This refers to the letter sent from Peter Antolik to Regina Finn dated 9 August 2007 discussing the breakdown of turnover of the water and sewerage businesses (further to the oral hearing on 18 July 2007):

> *"The application of a turnover-related approach to this draft [s22A(4)] Notice is more problematic, given the lack of evidence of misreporting specific data to relate to the water, wastewater or both turnovers."*

4.5 In making this statement, Thames was clearly referring only to the specific misreporting notice and not, as suggested by Ofwat, to the concept of separate attribution of failings in general. It is therefore misleading for Ofwat to include this in the GSS Variation Notice. In any event, the fact that something is "more problematic" does not justify circumvention of the legislation. Nor is it impossible, as Thames has already amply shown.

4.6 It appears that in the light of Thames's written representations, Ofwat has abandoned its previous justification that "the penalties do not come close to the statutory maximum".

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[7] Paragraph 83 of the GSS Variation Notice; paragraph 140 of the J/M Variation Notice.

5. Changes in Ofwat's approach and reasoning

DG indicators

5.1 In the written representations in response to the J/M Notice, Thames argued that Ofwat had failed to produce evidence of misreporting of the DG indicator data, as conceded in the text of the J/M Notice:

> *"Although there is no evidence of misreporting of the performance data under the DG indicators […]'*[8]

5.2 In the J/M Variation Notice, however, Ofwat has now deleted this sentence.

5.3 More importantly, when specifying the contravention in question, Ofwat has removed references to the alleged misreporting of performance under the DG indicators:-

> *"The specific contravention in this case is the misreporting of compliance with the GSS Regulations by Thames Water when the 2005 June return was submitted […]",*[9]

compared to the equivalent paragraph in the J/M Notice:

> *"the specific contravention in this case is misreporting of performance against DG indicators and misreporting of compliance with GSS Regulations by Thames Water when its 2005 June return was submitted […]"*[10] [Emphasis added].

5.4 A further example of Ofwat having changed its reasoning in the light of Thames's representations is provided by the deletion in the same section of another reference to the misreporting of information on Thames's performance under the DG indicators:-

> *"This led directly to the misreporting of information of its compliance with the GSS Regulations and misreported confidence grades."*[11]

and

[8] Paragraph 130 of the J/M Notice.

[9] Paragraph 153 of the J/M Variation Notice.

[10] Paragraph 193 of the J/M Notice.

[11] Paragraph 155 of the J/M Variation Notice.

> *"This led directly to the misreporting of information on its performance under the DG indicators and of its compliance with the GSS Regulations."*[12] [Emphasis added]

5.5 The removal of these references to alleged misreporting of performance under the DG indicators has clearly reduced the grounds upon which Ofwat proposed a penalty of £11.1m.

5.6 In particular, Thames notes that the DG Indicators are published by Ofwat for comparative purposes, whereas the GSS data in Table 6 of the June Return are not. Therefore, any misreporting of the DG Indicators will have a much more significant effect on customers' and Ofwat's ability to make comparisons between water companies, and it is precisely this aspect of the alleged misreporting that Ofwat has now conceded.

5.7 However, while in these several ways Ofwat no longer seeks to justify the amount of the penalty in the J/M Variation Notice on grounds as ample as those set out in the J/M Notice, it has illogically and counter-intuitively made no corresponding reduction in the penalty itself.

Contravention of Condition J2

5.8 Similarly, Ofwat has – in the light of Thames's representations[13] – abandoned its case against Thames that it contravened Condition J2 in materially misstating the methods used in monitoring, assessing and reporting on matters in the June Return.

5.9 In order to justify not reducing the penalty in the light of this particular abandonment, Ofwat states in paragraph 198 of the J/M Variation Notice that:

> *"this does not affect the seriousness of the contravention."*[14]

5.10 This unelaborated statement is unsustainable. The £11.1m penalty was proposed after taking into account all the alleged contraventions of the Licence; now that Ofwat has reduced the scope of the contraventions, the penalty must also sensibly decrease.

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[12] Paragraph 197 of the J/M Notice.

[13] Paragraph 4.20 of Thames's representations dated 29 October 2007.

[14] Note 3 of paragraph 198 of the J/M Variation Notice.

The level of the penalty

5.11 Ofwat has corrected its argument with respect to the "sliding scale" it used in its informal penalty notices. It states that any penalty it decides to impose:

> *"must lie in the range between a nominal sum and 10% of the applicable turnover of the company".*[15]

5.12 Ofwat's mention of a "nominal sum" presumably is a reference to the £1 penalty in the July Notice. However, Ofwat has not provided any reasons for the level of the proposed penalties. On that basis, Ofwat's use of this range and its determination that the penalty should lie towards the lower end of the range, instead of applying the sliding scale, is a difference without a meaning.

5.13 Ofwat has, moreover, removed from the body of the notice its argument that the:

> *"[a]ssessment of the existence, nature and extent of that harm is essentially a qualitative exercise and a matter of judgment",*[16]

and only mentions it as the final point in the table in paragraph 198, focussing instead on the unquantifiable nature of the harm:

> *"Ofwat has not attempted to quantify harm which is non-quantifiable; this has necessitated an element of judgment by Ofwat".*

5.14 This does not absolve Ofwat from its obligation to justify how it arrived at the proposed penalties. Simply stating that the harm is unquantifiable and that Ofwat's judgment is required is insufficient. The judgment must be capable of explanation. It is otherwise of an arbitrary character.

Results of MD220 letter

5.15 Ofwat admits that the costs of the MD220:

> *"cannot be directly attributed to Thames Water alone";*[17]

but continues to state that Thames's (and others') alleged misreporting led Ofwat to question the trust it can place on the information reported on customer service.

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[15] Paragraph 86 of the GSS Variation Notice; paragraph 143 of the J/M Variation Notice.

[16] Paragraph 155 of the J/M Notice.

[17] Paragraph 168 of the J/M Variation Notice.

5.16 This does not change the fact that Ofwat cannot use the MD220 letter as evidence of damage to other undertakers when the requirement for additional quality assurance checks is provided for in accordance with Condition M of each undertaker's Instrument of Appointment. Ofwat clearly intended, even before the problems with Thames (and the other two undertakers referred to in the MD220) were identified, for each undertaker to perform such checks when necessary. These additional checks were therefore requested by Ofwat in its role as a prudent regulator, and Ofwat cannot attribute them to Thames's alleged misreporting.

5.17 The results of the MD220 letter revealed weaknesses across the whole sector:

> *"It was disappointing that every company identified weaknesses or areas of risk and improvements which could and should be made to its processes. For example most companies found parts of their business where they were not properly tracking appointments to ensure that GSS failures were avoided or identified".*[18] [Emphasis added]

This highlights the fact that the MD220 was necessary for Ofwat to discover weaknesses which may prejudice its ability to make comparisons between companies and thus determine whether it should require any particular undertaker to improve its systems and service. Ofwat itself states in the MD227 letter that it "may, from time to time, look more closely at the methodologies of individual companies, groups of companies or all companies". The costs of MD220 for other undertakers therefore cannot be attributed to Thames, whether directly or indirectly.

5.18 In any event, as pointed out in Thames's previous representations, the impact of these additional quality assurance measures could be objectively assessed, but Ofwat has still chosen not to do so.

Failure to provide adequate reasons

5.19 As set out in Thames's previous representations, this is the first occasion that Ofwat has proposed a financial penalty on an undertaker for failure to meet guaranteed standards of performance, which has allegedly damaged the interests of customers, even though all companies have fallen short of the GSS standards to a greater or lesser extent; indeed some by more than Thames. This is shown in Figure 1 below, which shows the GSS payments (and other compensation payments) made by Thames and nine other undertakers.

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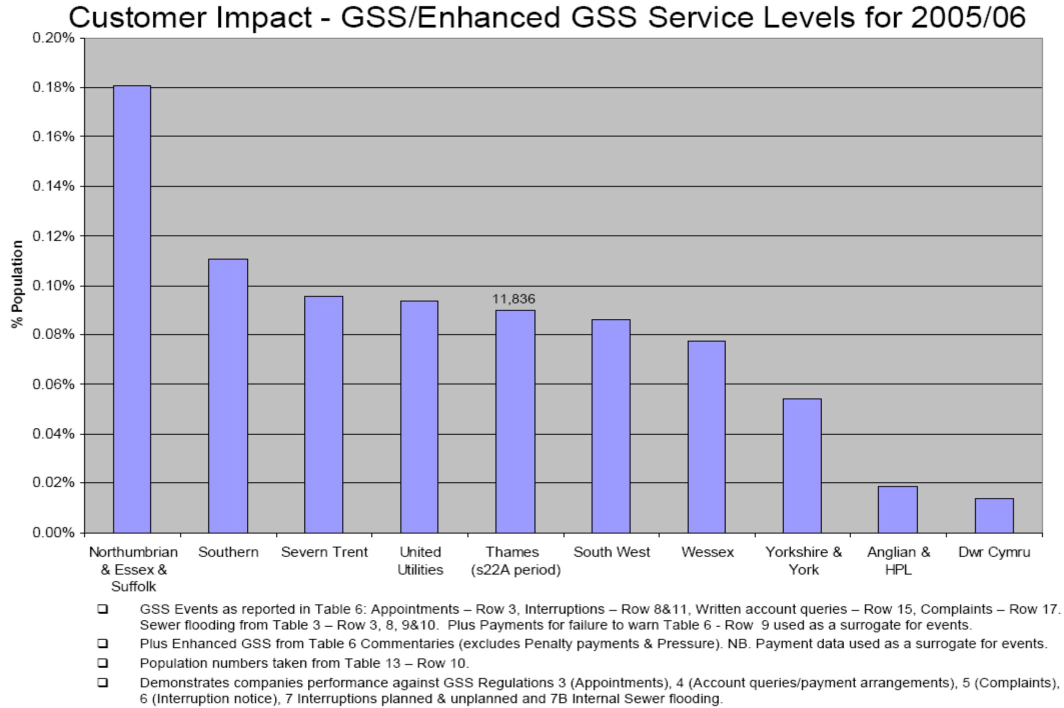
[18] MD227 letter to Managing Directors of all water and sewerage companies and water only companies, dated 13 November 2007.

Figure 1: GSS/Enhanced GSS service levels for 2005/2006



5.20 Whilst Thames does not seek to excuse any particular level of failings, Ofwat has nonetheless failed to justify its approach in proposing to impose a penalty on Thames in the GSS Variation Notice without reference or evidence as to how the proposed penalty for Thames's failures to meet GSS standards (and alleged damage to customers) relates to any coherent monitoring and enforcement policy of Ofwat. This makes the regulatory action now envisaged unpredictable and unjustified.

5.21 Ofwat attempts to address this issue simply by downplaying its previous argument that the assessment of the existence, nature and extent of harm is essentially a qualitative exercise: see paragraph 5.13 above. This is insufficient to absolve Ofwat of the need to provide adequate reasons for the proposed penalties. Thames accepts that there is an inevitable area of judgment for Ofwat in setting penalty levels. However, the variation notices fail to provide any explanation for the proposed penalties. The onus to provide such an explanation is all the greater given both the scale of the penalties proposed and the inconsistencies identified above.

5.22 Figure 1, together with the results of the MD220, demonstrate that Ofwat has failed adequately to justify the penalties proposed in both the GSS and the J/M Variation Notices. Not only has Thames presented Ofwat (on several occasions) evidence that its performance, when compared to that of other undertakers, is not egregious, this has also been confirmed by Ofwat's own MD227 letter. And yet Ofwat continues to insist that Thames's alleged failures justify the imposition of financial penalties whereas those of others do not. This highlights the inconsistency and unreasonableness of Ofwat's approach, and violates the public law principle of consistency.

6. Incentive to comply / no financial gain

6.1 Ofwat has failed to address Thames's arguments raised in its representations that it needs no further incentive to comply and that it made no financial gain arising from the alleged contraventions. These include, *inter alia*:

- The problems were identified by Thames, immediately investigated by Thames and the necessary reforms and remedial measures then pursued by Thames.
- Thames co-operated fully in disclosing the discrepancies to Ofwat as soon as they were identified by the independent consulting engineer and Thames continued to co-operate in the investigative process.
- Thames has taken extensive measures and given an undertaking to compensate all affected customers. Thames has in fact compensated customers over and above what was statutorily required by £1.4 million, an exercise which amounted to £5.0 million in total.
- Thames has made substantial investments in improvements to its processes and systems to ensure future GSS compliance and prompt identification of potential issues.

6.2 These actions demonstrate Thames's recognition of the importance of a transparent and proactive relationship with the regulator, and it therefore needs no further incentive to comply with the regulations. Thames has not taken this matter lightly and its conduct throughout the process is proof that it is also committed to preventing future failures.

6.3 At the time of Thames's response to Ofwat's section 203 Notice in November 2006, it had incurred costs of £1,192,000 with respect to internal and external investigations. To date, this has now increased to £1,935,000. Thames also completed its compensation payment quantification exercise in December 2007.[19]

6.4 The substantial costs incurred not only more than outweigh any potential financial gain as a result of the alleged contraventions, but also provide every incentive to others in the sector not to breach those requirements. Thames repeats paragraphs 3.4–3.25 of its representations dated 29 October 2007.

6.5 Whilst Ofwat accepts in both variation notices that Thames voluntarily reported the failures and co-operated with the independent investigation, it states in both notices:

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[19] As a result of the quantification exercise, which was reviewed by E&Y, there are some immaterial changes to the payments and misreporting data in the Variation Notices. These changes can be derived from the data provided to Ofwat in the E&Y letter dated 21 December 2007.

> *"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 such as misreporting can be remedied by co-operation with any investigation".*[20] [Emphasis added]

6.6 Ofwat has erred in its assessment in two ways. First, it has failed to pay sufficient regard to the extent of Thames's actions. Thames went far beyond merely reporting the matter to Ofwat and co-operating with the investigation; it initiated its own investigations, invested substantially in improvements to its systems and processes and undertook to compensate affected customers with a generous compensation package.

6.7 Second, Thames is not seeking to be absolved of accountability for its failures or to remedy the alleged contraventions wholly by its co-operation. It is willing to be held accountable to a reasonable and proportionate extent. Ofwat has, however, failed to take relevant factors into account and has consequently proposed penalties that are unjustified and arbitrary. It is to this that Thames objects; it cannot be open to a regulator to propose financial penalties that are inadequately reasoned or justified.

6.8 It is also curious that the GSS Variation Notice includes the phrase "a contravention such as misreporting", as Ofwat insists throughout the document that the proposed £1.4m penalty relates only to the failure to meet the GSS standards and not to the misreporting of GSS events. Ofwat continues to treat the two cases as fungible.

6.9 Ofwat has also introduced a new argument in the variation notices:

> *"Ofwat considers that the deterrent effect of the fine on the industry is significantly greater than the quantum of the fine that is proposed in this case. The fine on Thames Water will deter it from [failing / misreporting] in future, but will also deter the industry more widely […]"*[21]

6.10 However, given that Ofwat has claimed that the deterrent effect is greater than the sums proposed, Ofwat has failed to justify the need for penalties as great as £1.4m and £11.1m. This underlines the fragility of its approach in continuing to propose the same penalties despite the substantive differences in the arguments now used to justify them compared to those used to justify them before.

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[20] Paragraph 67 of the GSS Variation Notice; paragraph 123 of the J/M Variation Notice.

[21] Paragraph 90 of the GSS Variation Notice; paragraph 148 of the J/M Variation Notice.

7. Regulatory precedents

7.1 In relation to other regulatory penalties cases considered by Ofwat to be relevant, Thames makes the following response.

The GSS Variation Notice

7.2 As discussed below, Thames finds it logically inconsistent for Ofwat to compare the Thames penalty with that for United Utilities Water ("**UUW**") in the J/M Variation Notice, while dismissing it as "different" in the GSS Variation Notice. In those circumstances, it is difficult to see in what way Ofwat has "had regard" to it in relation to either penalty.

7.3 In relation to Southern Water, Ofwat says that the proposed penalty is the same as that for Thames.[22] But it does not explain how it arrived at that decision given the finding that Southern Water's senior management were implicated in devising, implementing and concealing, by a number of methods, performance standards and payments non-compliance.

7.4 Further analysis is confined to stating that fines by other regulators demonstrate the gravity with which they view failures to provide required standards of customer service. How Ofwat arrived at a figure of £1.4 million in part having regard to these cases is therefore a mystery.

The J/M Variation Notice

7.5 In relation to the Ofwat cases, Thames remains at a loss to understand how its inadvertent misreporting is "in some respects […] more serious"[23] than the UUW case; and, in particular, how it reaches the judgment that a long-standing breach knowingly maintained for a number of years is less serious because Ofwat was able to take pre-emptive action to minimise prejudice to customer and regulatory reporting interests. In fact Ofwat explicitly said in that case that "non-compliant trading arrangements fundamentally undermine the regulatory regime for water pricing" also, and that it could not fully compensate for customer detriment.[24] It is also logically inconsistent to make this comparison when in the GSS Variation Notice Ofwat describes the case as "different from and not directly comparable to" the Thames case.[25] The fact is that there is no coherent comparison of the level of the two penalties.

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[22] Paragraph 122 of the GSS Variation Notice.

[23] Paragraph 176 of the J/M Variation Notice.

[24] Notice of Ofwat's Imposition of a Penalty on United Utilities Water Plc, Ofwat, 22 June 2007, page 92.

[25] Paragraph 121 of the GSS Variation Notice.

7.6 At the time when Ofwat decided the level of the penalties for Thames (which have remained unchanged), it had published no notice in respect of the penalty for Southern Water's deliberate misreporting, so it is unclear how Ofwat had regard to its "current" proposal in respect of the latter.

7.7 Ofwat asserts that the financial penalty of £250,000, or 0.01% of annual turnover, imposed by the Office of Rail Regulation ("**ORR**") on Network Rail for failure to provide information in respect of the capability of its infrastructure related to information required "for quite different purposes" from that applying in this case, being "important for participants in downstream markets".[26]

7.8 Ofwat describes this case as reflecting the importance attached to accurate reporting of data by other regulators, yet Ofwat does not explain why it considers it appropriate to impose on Thames a financial penalty far greater than that imposed by ORR for a breach of a fundamental licence condition affecting the business plans of a number of train operators and their customers which had "a number of serious implications for the industry",[27] remained unresolved for three years, and constituted a second licence breach which "indicates a failure proactively to address its licence obligations".[28]

7.9 In relation to the Ofgem case, Ofwat's only observation is that Ofgem decided not to impose a penalty under the directly equivalent powers, but nonetheless "sought" to impose a sanction on Yorkshire Electricity Distribution plc ("**YEDL**") and Northern Electric Distribution Limited ("**NEDL**") for their failures to comply with their reporting obligations in relation to customer service performance. It is unclear whether this observation is intended to mean that the case does not fall under the first criterion above; or what the significance is of the word "sought".

7.10 The case was clearly considered under the equivalent provision – Ofgem refers to the revenue reduction imposed on YEDL and NEDL as one that "has the effect of a financial sanction", and as "in lieu of a financial penalty […] which […] is beneficial to CE's customers".[29] In the light of that statement, not only does Thames assert the relevance of the case, but also finds it perverse that Ofwat has repeatedly declined Thames's offer of making some form of payment that would benefit customers, and in favour of a financial penalty which benefits Government only.

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[26] Paragraph 181 of the J/M Variation Notice.

[27] Paragraph 25 of the Notice in Accordance with Section 57C of the Railways Act 1993 as Amended, of the Office of Rail Regulation's Decision to Impose a Penalty on Network Rail Infrastructure Ltd, ORR, April 2006.

[28] Ibid, paragraph 34.

[29] Paragraphs 8-9 of the Statement by the Gas and Electricity Markets Authority of Yorkshire Electricity Distribution plc's and Northern Electric Distribution Limited's non-compliance with Standard Condition 49 of their Electricity Distribution Licences, Ofgem, 6 June 2007 (the "**Ofgem Statement**").

7.11 Ofwat says that the seriousness of Thames's contravention "is of a wholly different order of magnitude", giving its reasons as follows.

- "[M]isreporting fundamentally prejudices the regulatory regime that Ofwat operates, which is based on comparative competition".[30] Ofwat does not explain how this differs in substance, as distinct from name, from the incentives regime for electricity distribution operated by Ofgem.

- "[T]he information misreported by Thames Water affected individual consumers."[31] While the Thames data concerned individual payments and customer service levels, the information in the Ofgem case also led to each customer paying too much for a service level higher than that which was received.

7.12 The Ofgem case, in fact, yields an almost exact parallel, for the reasons set out in Thames's previous representations:

- the misreporting by YEDL and NEDL was "a serious matter especially where it would have affected the charges paid by consumers"[32] (moreover, it appeared to involve actions taken to classify wrongly or "filter out" some data);

- the breach was due to a "failure to maintain appropriate systems, processes and procedures accurately to reserve and record specified information"[33] in two reporting years; and

- "if uncorrected the companies' customers would have paid up to £5.5 million more […]"[34] than they should have paid.

7.13 Ofgem nonetheless considered the appropriate response was limited to ensuring that the potential gain was repaid to customers, and to a financial sanction equivalent to 0.45% of the companies' combined turnover of £471.6m in 2006/7.

7.14 Thames maintains its view that, in the light of identical considerations in its case, Ofwat should have:

- accepted Thames's actions, going beyond what was necessary to ensure that customers were not disadvantaged; and

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[30] Paragraph 183 of the J/M Variation Notice.

[31] Ibid.

[32] Paragraph 6 of the Ofgem Statement.

[33] Paragraph 14 of the Ofgem Statement.

[34] Paragraph 16 of the Ofgem Statement.

- accepted Thames's offer of a payment to benefit customers, and

accordingly, that its decision in the present case is both disproportionate and misdirected.

7.15 In relation to incentivising compliance, Ofwat says that Postcomm's June 2006 decision "in particular […] considered the minimum amount" that would provide this.[35] It is unclear whether by this Ofwat means anything more than that the Postcomm financial penalty was at a level similar to that proposed for Thames, which is devoid of impact.

[35] Paragraph 186 of the J/M Variation Notice.

8. Alternative of payments for benefit of customers

8.1 In response to representations from third parties that the penalties should be used for the benefit of customers, Ofwat has pointed out that the legislation requires that all penalties are paid into the Consolidated Fund. That is true in the narrow sense. But, as evidenced by the Ofgem case, it does not preclude a regulator determining that a just response to a contravention may encompass acceptance of an offer by a licensee to make financial provision which will be to the benefit of customers, accompanied by no, or a correspondingly lower, financial penalty. Instead, Ofwat clings solely to the imposition of a large penalty which benefits only Government.

8.2 Ofwat's case rests heavily on the impact of the GSS failures on customers and of the misreporting on customers in general; there is therefore no reason to preclude measures to benefit these customers directly, especially as this approach has the support of CCWater and two Members of Parliament. Thames urges Ofwat, even now, to reconsider its position.

Slaughter and May (CJCW / NZY)
20 February 2008

EC080150001

Annex 1

Apportionment of the applicable turnover by value of the relevant penalties[1]

GSS Variation Notice	Total no. of GSS events	Penalty per event[1] (£)	Total value of GSS events (£)	Proportion of GSS events by value	Relevant 2005/06 turnover (£m)	Proportion of 0.1%	Penalty (£m)
Interruptions to supply[2]	7,814			40.3%	664.4 [3]	0.040%	0.27
Domestic	7,189	20	143,780				
Commercial	625	50	31,250				
Flooding from sewers[3]	1,121			46.3%	686.9 [4]	0.046%	0.32
Domestic	796	104	79,600				
Commercial	325	374	121,550				
Account queries	110	20	2,200	0.5%	1,351.3	0.001%	0.01
Written complaints	137	20	2,740	0.6%	1,351.3	0.001%	0.01
Missed appointments	2,654	20	53,080	12.3%	1,351.3	0.012%	0.16
Total	**11,836**		**434,200**	**100.0%**		**0.100%**	**0.77**

Notes:

1. We assume for the purposes of this example that no late payment penalty is payable.
2. Based on the assumption of 92% domestic customers to 8% business customers (percentages reviewed by E&Y).
3. Legislation states penalty as the lesser of the wastewater charges payable by the customer for the financial year and £1000. For these purposes we have used 71% domestic at £104 and 29% commercial at £374 (both percentages and average bill values reviewed by E&Y).
4. This is the turnover attributable to Thames's water business.
5. This is the turnover attributable to Thames's sewerage business.

J/M Variation Notice	Proportion of GSS events by value[1]	Relevant 2006/07 turnover (£m)	Proportion of 0.8%	Penalty (£m)
Interruptions to supply[2]	40.3%	697.3 [4]	0.322%	2.25
Domestic				
Commercial				
Flooding from sewers[3]	46.3%	688.5 [5]	0.370%	2.55
Domestic				
Commercial				
Account queries	0.5%	1,385.8	0.004%	0.06
Written complaints	0.6%	1,385.8	0.005%	0.07
Missed appointments	12.3%	1,385.8	0.099%	1.37
Total			**0.800%**	**6.30**

Notes:

1. The J/M Variation Notice now relates only to the GSS data and therefore the same proportions are adopted as for the GSS Variation Notice.
2. Based on the assumption of 92% domestic customers to 8% business customers (percentages reviewed by E&Y).
3. Legislation states penalty as the lesser of the wastewater charges payable by the customer for the financial year and £1000. For these purposes we have used 71% domestic at £104 and 29% commercial at £374 (both percentages and average bill values reviewed by E&Y).
4. This is the turnover attributable to Thames’s water business.
5. This is the turnover attributable to Thames’s sewerage business.