

Northern Ireland Authority for Utility Regulation

Notice given pursuant to Article 45(4) of the Energy (Northern Ireland) Order 2003 of intention to impose a financial penalty on Gas Networks Ireland (UK) Limited

1 Summary

- 1.1 We (the Northern Ireland Authority for Utility Regulation) propose to impose a financial penalty on Gas Networks Ireland (UK) Limited (**GNIUK**) following an investigation into GNI's failure to comply with Condition 2.2.2(c)(ii)(ab) of the gas conveyance licence (the **Licence**) granted to it under Article 8(1)(a) of the Gas (Northern Ireland) Order 1996 (the **Gas Order**).
- 1.2 Our investigation followed a 'whistleblower' complaint received by us from an ex-employee of GNIUK alleging the improper allocation of costs between construction projects undertaken by companies within the same group as GNIUK.
- 1.3 GNIUK is a wholly owned subsidiary of Gas Networks Ireland which in turn is a wholly owned subsidiary of Ervia.
- 1.4 At around the same time, GNIUK's ultimate parent company (Ervia) also received the same 'whistleblower' complaint and initiated its own investigation into the matter. That investigation substantiated the allegation and found that there had been an improper allocation of costs.
- 1.5 Ervia (previously known as Bord Gáis Eireann) is a commercial semi-state company – it is a commercial company but its Chief Executive and non-executive members are appointed by the Minister for Communications, Energy and Natural Resources - with responsibility for the delivery of gas and water infrastructure and services in the Republic of Ireland. Gas Networks Ireland owns and operates the gas network in the Republic of Ireland.
- 1.6 We are satisfied and find that GNIUK breached Condition 2.2.2(c)(ii)(ab) of the Licence.
- 1.7 This provision requires GNIUK to provide us with details of the capital expenditure actually incurred by it in respect of each of the pipeline projects specified. The purpose of this provision is to ensure that the licence holder provides accurate details of capital expenditure for which it will be recompensed through the applicable price control condition of the Licence.
- 1.8 However, the information provided by GNIUK to us included details of capital expenditure that had not been incurred in respect of any of the specified pipelines. This was due to the improper allocation of costs between construction projects within the Ervia group.
- 1.9 We take these provisions seriously. The purpose of the reporting of actual costs is to ensure that the licence holder is appropriately recompensed for expenditure actually incurred and

ensure that any such expenditure which is ultimately paid for by Northern Ireland consumers reflects the actual costs incurred by the licence holder.

- 1.10 GNIUK accepts that there had been an improper allocation of costs and that it breached the relevant condition. It has also acknowledged that its internal systems and procedures failed to prevent the circumstances which led to the breach taking place. It has since made improvements to its internal systems and procedures.
- 1.11 We have taken into account GNIUK's offer to settle the investigation and make consumer redress payments but does not consider in the circumstances of this case that a consumer redress payment in lieu of a financial penalty is adequate or appropriate.
- 1.12 Accordingly, the Authority considers it appropriate in the circumstances of this case to impose a financial penalty and hereby gives notice under Article 45(4) of the Energy (Northern Ireland) Order 2003 (the **Energy Order**) of its proposal to impose a financial penalty of £0.5m.
- 1.13 Any representations on the proposed penalty may be made in writing to Elaine Cassidy at the Utility Regulator, Queens House, 14 Queen Street, Belfast BT1 6ED by Thursday 31 March 2016.
- 1.14 Any representations received may be published on our website. Should you wish for your response or part of your response to remain confidential please indicate this clearly, together with supporting reasons, and we will consider any such request on a case by case basis.

2 Background

- 2.1 In September 2014, we received correspondence (dated 30 September 2014) from a former employee of GNIUK (the '**complainant**').
- 2.2 The correspondence was a letter (with attachments) addressed to the Chair of Ervia which made certain allegations of historical impropriety in the allocation of costs between construction projects undertaken by companies within the same group as GNIUK.
- 2.3 In particular the complainant alleged that an overrun of approximately €576,000 on a capital project in the Republic of Ireland was concealed by way of allocation of certain costs of that capital project to the North West Pipeline (**NWP**) in Northern Ireland.
- 2.4 The allegation related to the construction of the Barnakyle to Coonagh pipe-line in the Republic of Ireland (the **BC Pipeline**) during the period 2000 to 2004.
- 2.5 More particularly the complainant alleged that –
 - (a) there was a cost overrun during the construction phase of the BC Pipeline;

- (b) insufficient money had been approved by the Board of GNI to pay the construction contractor – Murphy International Limited (**MIL**) – in respect of the BC Pipeline;
- (c) instead of seeking approval (from the Board) for further spend on the BC Pipeline, because MIL was also the construction contractor for a number of other construction projects for other companies in the Ervia/GNI group, the cost overrun was concealed by allocating it across a number of such other MIL contracts; and
- (d) one of these other MIL contracts was in respect of the NWP¹ and £200,000 of the cost overrun of the BC Pipeline was allocated as spend on this contract (when in fact it had not actually been spent under the contract).

2.6 In support of the allegation, the complainant also enclosed the following documents –

- (a) A letter from MIL, dated 16 February 2007, which confirmed how the outstanding monies due on the BC Pipeline account had been settled by way of payments made in respect of other contracts and listed £200,000 against the NWP contract.
- (b) A paper to the GNI Board seeking approval for additional expenditure on the BC Pipeline.
- (c) An e-mail from GNI UK's consulting engineer – who were contracted by GNIUK to provide consultancy services, including in relation to design, project management and quantity surveyor services, during the construction phase of the NWP and the NWPSP – to the complainant (as then employee of GNI/GNI(UK)) confirming a telephone conversation about the final account on these contracts and noting that the NWPSP account "includes £200,000 payable to MIL on previous project" .
- (d) A construction cost report for the NWPSP.

2.7 We acknowledged the complainant's correspondence on 25 November 2014 and on the same date sent a letter to the Chief Executive of Ervia requesting information about the alleged events and the steps that Ervia proposed to take having received the complainant's letter.

Ervia's Investigation

2.8 Ervia commissioned KPMG to investigate the allegations made by the complainant.

2.9 KPMG's investigation focused on six projects, including the NWPSP, and its key phases included –

¹ The complainant referred to the contract as relating to the construction of the NWP but it was confirmed through Ervia's (and subsequently the Authority's) investigation that the contract in question related to the North West Pipeline Spurs Project (NWPSP).

- (a) Comparing the Final Project Spend to the Board approved expenditure for each project;
 - (b) Agreeing Project Spend reports to invoices and supporting documentation, including quantity surveyor (QS) certificates;
 - (c) Verifying that the invoice and QS certificates related to the relevant project;
 - (d) Seeking additional information to assess the substance of the complaint; and
 - (e) Assessing whether other parties were overcharged and if yes, the impact of this.
- 2.10 As part of its investigation KPMG also held discussions with a number of key individuals, including the complainant, senior GNI/GNIUK employees and MIL employees, about their involvement in each of the six projects. It also received information from other senior employees of GNI and Ervia.
- 2.11 KPMG submitted a report of its investigation and findings to Ervia on 26 March 2015.
- 2.12 The report noted that the KPMG investigation had established the following –
- (a) The total unapproved overrun on the BC Pipeline project was €200,000 (that is the final approved budget was €5.1 million and the final spend was €5.3 million).
 - (b) Approval by the Board for the excess spend was not sought. The overrun on the MIL contract was paid even though it was not approved by the Board.
 - (c) Although the overruns were not paid exactly as set out in the complainant's letter, there were payments for the BC Pipeline paid through other projects, including in particular the NWPSP.
 - (d) There was evidence that a number of senior GNI/GNIUK employees were aware of the improper allocation of the BC Pipeline overrun across other projects and, while no such individual made any personal financial gain from this improper allocation, they did not elevate the issue to an appropriate level within GNI/GNIUK/Ervia.
 - (e) The scope of its work of GNI/GNI (UK)'s consulting engineers included routing and feasibility studies for the pipeline, liaison with all relevant statutory and public bodies, submission of planning applications including environmental statements, safety studies, material procurement, tender appraisals, appointment of a construction contractor and supervision of construction, testing and commissioning (including quantity survey work and certification of invoicing).

- (f) FMA had certified £200,000 of work relating to the BC Pipeline as part of their certification of the NWPSP and documentation from MIL confirmed a payment of £200,000 was allocated to the NWPSP in respect of the BC Pipeline.

2.13 The KPMG report concluded that £200,000 was incorrectly paid through the NWPSP for work performed on the BC Pipeline. It also concluded that, as a consequence of this incorrect allocation and payment, the regulatory asset base (**RAB**) for the Network was overstated by £200,000 in respect of the NWPSP. The report also noted that, as at October 2015, GNI had over-recovered (in respect of the NI RAB) by an estimated £160,000.

Our Investigation

2.14 On 15 April 2015, we were provided with a copy of the KPMG report by GNIUK.

2.15 Having considered the KPMG report, on 29 June 2015, we decided to launch a formal investigation into the case in order to determine whether GNIUK had contravened or was contravening any condition of the Licence.

2.16 As part of our investigation we sought and received further information from GNIUK. This included –

- (a) The invoices that GNIUK had received (from MIL) and paid in respect of the NWPSP. On a detailed scrutiny the invoices disclosed that the additional £200,000 was invoiced and recovered by way of two instalments, namely £60,000 in July 2005 and £140,000 in August 2005; and
- (b) details about the role of FMA in the NWPSP and the level of internal quantity surveyor costs associated with the NWPSP. The information received by the Authority confirmed that there was minimal input on the NWPSP by internal quantity surveyors and that FMA had a wide role in relation to contract administration for NWPSP.

3 Relevant Licence Obligations

3.1 GNIUK is authorised under the Licence to convey gas through its network in Northern Ireland which network comprises of the North West Pipeline (between Carrickfergus and Londonderry) and the South North Pipeline (which in Northern Ireland starts at Ballyclare (but which continues to Gormanston in the Republic of Ireland), and in each case associated 'spurs' that are owned and/or operated by it.

3.2 The Licence includes, among others, conditions which regulate the amount of revenue that may be recovered by GNIUK in respect of costs relating to the construction, development maintenance and operation development of the Network.

- 3.3 In brief, the amount of revenue that GNIUK is permitted to recover in each year (the Total Allowed Conveyance Revenue - **TACV**) is calculated by reference to a formula that is set out in Annex 1 of Condition 2.2 of the Licence.
- 3.4 A key variable in this formula (and therefore the TACV) is the Capital Revenue Requirement (**CRR**). The calculation of the CRR is dependent on information submitted by GNIUK to the Authority under and in accordance with certain obligations imposed on it under Condition 2.2.
- 3.5 More particularly, there is an obligation on GNIUK to provide certain information prior to the final completion of the relevant pipeline or spur (i.e. during its construction phase). This obligation is set out in Condition 2.2.2(c)(ii)(ab).
- 3.6 Condition 2.2.2(c)(ii)(ab) requires that not later than 3 months after the end of each Gas Year GNIUK shall provide the Authority with:

‘...details of the amount and timing of Capital Expenditure the Licensee has actually incurred in respect of (to the extent applicable) the North West Pipeline, the South North Pipeline, each of the spurs and any associated Postalised Distribution Pipelines..’

4 Our Decision on Breach

- 4.1 In reporting its actual costs of the NWPSP to us in respect of Gas Year 2005, which GNIUK was obliged to do under Condition 2.2.2(c)(ii)(ab), GNIUK included the figure of £200,000 that had been improperly allocated to the NWPSP.
- 4.2 We are satisfied that GNIUK had been in breach of Condition 2.2.2(c)(ii)(ab) for the period July 2005 - 14 April 2015 (the end date being the date on which GNIUK informed us (by way of providing the KPMG report) of the actual costs incurred in respect of the NWPSP).
- 4.3 We accept that GNIUK is not continuing to breach the licence condition and that there is no evidence that it is likely to breach any licence condition in the future. The making of an enforcement order (whether provisional and/or final) is not therefore required.
- 4.4 The breach is a historic breach and therefore one in respect of which a financial penalty can be imposed under Article 45 of the Energy Order.
- 4.5 Article 45(1) of the Energy Order provides that where we are satisfied that a company has contravened or is contravening any relevant condition or requirement, or any provision of a Community Regulation, we can impose on the company a penalty of such amount as is reasonable in all the circumstances of the case.

- 4.6 Article 45(3) and 45(3A) respectively provide that before imposing a financial penalty we are required to consider whether it would be more appropriate to proceed under the Competition Act 1998 and not to impose a financial penalty if we consider that it would be appropriate to so proceed.
- 4.7 In this case we do not consider that it would be more appropriate to proceed under the Competition Act 1998.
- 4.8 Article 45(4)(a) provides that before imposing a financial penalty we shall give notice stating that it proposes to impose a penalty and the amount of the penalty proposed.
- 4.9 Accordingly, having considered all of the relevant factors, we hereby give notice that:
- (a) we propose to impose a financial penalty on GNIUK; and
 - (b) the amount of the financial penalty which would be reasonable in all the circumstances is £0.5m

5 Decision on whether to impose a financial penalty

- 5.1 We considered whether a financial penalty is appropriate in accordance with the requirements of the applicable legislation² and having regard to its published 'Statement of Policy with respect to Financial Penalties'³ (the **Policy**).
- 5.2 We have taken full account of the particular facts and circumstances of the breach of the relevant condition and also GNIUK's written submissions made in the course of our investigation process.
- 5.3 We also considered the indicators that make it more likely and the indicators that make it less likely (in each case as set out in the Policy) that a financial penalty will be imposed.

Penalty More Likely

- 5.4 By reference to the Policy, all of the indicators that make it more likely for a penalty to be imposed are present in this case. That is –
- (a) the breach of the relevant condition has damaged the interests of consumers;
 - (b) the imposition of a financial penalty is likely to create an incentive to comply and deter future breaches; and

² The Gas Order and the Energy Order.

³ Prepared and published (on 18 April 2008) under Article 46 of the Energy Order and available at http://www.uregni.gov.uk/news/view/utility_regulator_publishes_financial_penalties_policy_statements/

- (c) the circumstances from which the breach arose were substantially within the control of GNIUK.

Interest of Consumers

- 5.5 It is clear to us that the breach of the relevant condition has damaged the interests of consumers.
- 5.6 The breach of the relevant condition resulted in the Licensee benefitting from an over-recovery in revenue that it was otherwise entitled to recover. This over-recovery resulted in GNIUK being able to over-charge gas suppliers for the use of GNIUK's system.
- 5.7 Gas suppliers pass these costs on to their customers which means that Northern Ireland gas consumers have funded, through their gas bills, expenditure that was not actually incurred by GNIUK in respect of its network in Northern Ireland. This has damaged the interests of consumers as they have ultimately paid higher gas bills than should have been the case.

Incentive and Deterrence

- 5.8 Our view is that the imposition of a financial penalty will create a strong incentive on GNIUK to future compliance and deter contraventions by others. Moreover, it considers that this deterrence effect is of particular importance in the circumstances of this case.
- 5.9 The circumstances leading to the breach were serious. Inaccurate information was not provided to the Authority by mere inadvertence, but by deliberate choice. A number of relatively senior employees of GNIUK were involved in a deception and knew that the effect of what they did would be to charge costs to customers in Northern Ireland that did not relate to the development or maintenance of the gas network in Northern Ireland. As a direct result of that deception, the Authority was provided with inaccurate information that was intended to be, and was, misleading.
- 5.10 The system of energy regulation in Northern Ireland relies on all regulated companies behaving with honesty and integrity. It is essential to the proper functioning of the regulatory system that the Authority should be able to rely on the quality of the information that is provided to it, and in particular to operate on the basis that it is provided in good faith. It is also essential for public confidence in regulation, and therefore the health of the energy market, that this is seen to be the case.
- 5.11 We consider it an important function of a financial penalty in this case to send a clear signal to GNIUK and to the wider industry that the provision of inaccurate and misleading information – in particular as the result of deliberate deception – is unacceptable and will not be tolerated.

- 5.12 We are satisfied that a penalty will act as a strong incentive on GNIUK to ensure that similar breaches do not take place in the future, and will act to deter others from engaging in conduct of the same nature.

Within Licensee's Control

- 5.13 In the context of its regulatory legal obligations GNIUK is responsible for the actions of its employees. It is responsible for engendering a culture of honesty and responsibility and for ensuring that there are adequate checks and balances in place to prevent, or at the very least detect, the type of wrongdoings that were carried out by its employees in this case.
- 5.14 The deception (and thereby improper allocation of costs) was able to take place because GNIUK's internal systems and procedures were not sufficiently robust either to prevent the improper allocation of costs in the first instance or to detect that improper allocation after it had occurred.
- 5.15 The circumstances from which the breach arose were therefore within the control of GNIUK. It could and should have had adopted such systems and procedures as would have prevented or at the very least detected the improper allocation of costs. A duly diligent licence holder would have adopted such robust systems and procedures.

Penalty Less Likely

- 5.16 We also considered the indicators which would make the imposition of a financial penalty less likely and are satisfied that, with one exception, none of the indicators is present in this case.
- 5.17 More particularly we are satisfied that –
- (a) The breach was not of a trivial nature. On the contrary, for the reasons noted above, the circumstances leading to the breach, the breach itself, and the effects of the breach are all serious matters.
 - (b) The breach or possibility of breach would have been apparent to a diligent licence holder. Again as noted above, a diligent licence holder would have adopted robust systems and procedures to prevent or detect the actions of its employees.
 - (c) Our principal objective and/or general duties do not weigh against the imposition of a financial penalty. On the contrary, our principal objective is to promote the development and maintenance of an efficient, economic and co-ordinated gas industry (Article 14(1) of the Energy Order). We also have a duty to do so having regard to the need to protect the interests of gas licence holders in respect of the prices at which any services are provided by one gas licence holder to another (in Article 14(2)(d) of the Energy Order). Our objective and duties point in favour of a

financial penalty in this case. We note in particular that the continuing development of the gas industry requires a high measure of public confidence in the integrity of the gas industry and the effectiveness of its system of regulation, which the actions of GNIUK would, if unchecked, undermine.

(d) The circumstances from which the breach arose were not outside the control of GNIUK, as already noted above.

(e) The same breach has not already been the subject of a fine by any concurrent enforcement authority.

5.18 The one exception is by reference to the guidance in the Policy which provides that a penalty will be less likely where *'the [Authority] is satisfied that in lieu of a financial penalty the Licensee agrees in writing that any indicative value of a proposed financial penalty should be applied exclusively and verifiably to the benefit [of] customers (through requiring higher investment without higher prices to consumers)'*.

5.19 We note that GNIUK has, in its written submissions to date said that it is *'willing to make an appropriate contribution, agreed between us, for the benefit of customers in NI'*.

5.20 However, in the circumstances of this case, given the nature and seriousness of the breach and the circumstances in which it arose (as outlined above), and given that none of the other indicators which might make the imposition of a penalty less likely are present, We do not consider that this fact alone should lead it to the conclusion that a financial penalty should not be imposed.

5.21 Our decision that the imposition of a financial penalty is to be proposed is also informed by the realities that the breach continued for a period of nearly 10 years and that, had the complainant not 'blown the whistle', the improper allocation may never have been detected by GNIUK or notified to us..

6 Quantum of Financial Penalty

6.1 Having made the decision that it would be appropriate to propose the imposition of a financial penalty, we have considered the appropriate level of the financial penalty, again by reference to the matters referred to in the Policy.

6.2 In accordance with the Policy, the starting point was to consider the broad band for an appropriate financial penalty.

6.3 We considered that, given the breach –

(a) was a serious breach involving intended and actual deception on the part of relatively senior staff of GNIUK;

- (b) enabled GNIUK to benefit from an over-recovery of costs for almost a decade;
- (c) meant that gas customers in Northern Ireland have incurred higher charges than they would otherwise have done;
- (d) only came to light because of a whistleblower's complaint (and not through any due diligence on the part of GNIUK),

the broad banding of the financial penalty is £0.4m- £1.0m.

6.4 We then considered, again in line with the Policy, whether there were –

- (a) any particular aggravating factors which would tend to lead to the financial penalty being at the higher end of the band; and
- (b) any particular mitigating factors which would tend to lead to the financial penalty being at the lower end of the band.

Aggravating Factors

6.5 In terms of aggravating factors, we consider these to be –

- (a) the involvement of relatively senior employees in the improper allocation of costs to the NWPSP;
- (b) the deceitful submission of false and misleading information to the Authority – the employees in question (the actions of whom GNIUK must take responsibility for in its capacity as employer) knew that the costs had not been incurred on the NWPSP and knew that the costs of NWPSP were subject to regulatory approval;
- (c) the lack of robustness of GNIUK's internal mechanisms and procedures in preventing or detecting the improper allocation of costs to the NWPSP; and
- (d) the absence of effective oversight or management by GNIUK of its external contractors and consultants.

Mitigating Factors

6.6 In terms of mitigating factors, we consider that the following are relevant –

- (a) it is the first time that GNIUK has been investigated for and found in breach of the Licence;
- (b) GNIUK accepts all of the findings of its external investigation and accepts that it was in breach of Condition 2.2.2(c)(ii)(ab) up until 14 April 2015;

- (c) Eirvia (on behalf of GNIUK) took an immediate decision to investigate the 'whistleblowing' complaint, did so of its own accord (i.e. without the need for the Authority to request it) and rightly decided that the matter was sufficiently serious to appoint external auditors to undertake the investigation;
- (d) GNIUK has fully co-operated with the Authority's investigation, provided all information requested of it in a timely manner, and is actively looking at how the adjustment necessary to unwind the consequences of its actions can and will be made (irrespective of any financial penalty imposed on it);
- (e) GNIUK is taking all reasonable steps, by way of implementing sufficiently robust mechanisms, systems and procedures and ensuring that there are proper checks and balances in place, to ensure that lessons are learned from the circumstances of this case.

6.7 Accordingly, having taken into consideration the above aggravating factors and mitigating factors, it is our view that a financial penalty towards the lower end of the band, namely £0.5m is reasonable in all the circumstances of the case.

6.8 We have noted that the amount of the financial penalty may not exceed 10% of the turnover of GNIUK in the financial year ending 31 December 2015 – as determined in accordance with provisions specified in the Electricity and Gas (Determination of Turnover for Penalties) Order (Northern Ireland) 2005 (the **2005 Order**).

6.9 We do not at present have details of GNIUK's applicable turnover for the financial year ending 31 December 2015.

6.10 However, we have no reason to believe that GNIUK's applicable turnover for the period ending 31 December 2015 either should or will be substantially different (in terms of amount) from the applicable turnover for the year ending 31 December 2014.

6.11 On that basis we are confident that the proposed amount of the financial penalty will be approximately 0.9% of GNIUK's turnover and therefore well below the permitted 10% maximum.