



**Treasury Minutes on the
First and Second Reports from the
Committee of Public Accounts
2003-2004**

1st Report: Tackling Fraud against the Inland
Revenue

2nd Report: The new electricity trading arrangements
in England and Wales

**Presented to Parliament by the Financial Secretary
to the Treasury by Command of Her Majesty
March 2004**

TREASURY MINUTES DATED 22 MARCH 2004 ON
THE FIRST AND SECOND REPORTS FROM THE
COMMITTEE OF PUBLIC ACCOUNTS, SESSION
2003-2004.

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First Report

Inland Revenue

Tackling Fraud Against the Inland Revenue

PAC conclusion (i): The Revenue have not estimated the direct tax gap, which is the difference between full and actual compliance with the tax rules. While there are recognised methodological problems, overseas research and the Revenue’s random enquiry programmes now underway on individual taxes offer a way forward in producing for the first time estimates of the scale of losses from fraud and other non-compliance. The Revenue should focus their work on making a reasonable estimate of the tax gap so that they can judge the effort needed for a given reduction in losses.

1. As the Committee acknowledges, there are recognised methodological problems which make it extremely difficult to measure the ‘direct tax-gap’. For revenue authorities these difficulties are exacerbated by a fundamental problem, that measures of income and taxable income that fiscal authorities use invariably come from tax data. There is no independent source of income data that can be used to check income reported to tax departments. In line with other fiscal authorities the Inland Revenue (the Department) does not have a robust estimate of the overall tax gap.

2. The Department takes compliance measurement very seriously. It is committed to a substantial compliance measurement programme, and deploys significant resource from its network staff and its Analysis and Research Division. As a result of its random enquiry programmes, the Department has estimates for parts of the “tax-gap” and a comprehensive research programme to give better information on some of more complex areas of the ‘tax gap’ such as the shadow economy and artificial avoidance. The Department keeps up-to-date with the compliance measurement work undertaken by other fiscal authorities, for example, through membership of the Compliance sub- group of the OECD Forum for Tax Administration.

PAC conclusion (ii): The Revenue first set out their tax compliance strategy in the 1980s. Their business has since expanded significantly and the environment in which they operate has changed, with developments in the law, access to information and information technology. They should set a date for completing and publishing their revised compliance strategy including an explicit strategy for preventing, detecting, investigating and deterring fraud, and the performance measures by which they will assess achievement.

3. The Department welcomes the Committee’s acknowledgement of the work it has done to date on its tax compliance strategy. The Department is continuing the development of its compliance strategy and the performance measures which will support it.

PAC conclusion (iii): The low number of fraud investigations and prosecutions is not commensurate with the potential sums at stake in lost revenue. Nor has the overall scale of work kept pace with the expansion in the Revenue’s business. Investigation work on tax fraud appears to have reduced

as work on tax credit fraud has increased, despite additional resources being provided. The financial returns on investigations suggest that it would be cost-effective to do many more. The Revenue should increase the level of investigations and prosecutions sufficiently to permit a meaningful evaluation of the effects of doing so. They should also seek to increase the effectiveness of such work by greater publicity to heighten public awareness about the risk of detection and punishment for those who commit fraud.

4. The Department's general policy is to counter fraud primarily through investigations done with a view to a monetary settlement, rather than prosecution. Those who commit fraud generally have to pay back the monies defrauded, with an additional significant financial penalty and interest. The Department uses prosecution selectively to bolster its overall enforcement strategy. The focus is on cases where prosecution will do most to promote compliance with the law by deterring tax, contribution and tax credit fraud. As the Committee recognises this approach has provided very good value for money.

5. As a consequence of improved procedures introduced since the National Audit Office carried out its fieldwork, the number of prosecutions by the Inland Revenue is increasing, in both the number of tax and tax credit fraud cases. The department is also considering as part of the work on developing its compliance strategy the implications of doing significantly more prosecutions.

6. The Department accepts the need to seek greater publicity about the risks associated with defrauding the Exchequer. The Department's Media Relations team always issue prosecution News Releases following the outcome of a trial. These News Releases provide the media with details of the tax cheat and the nature of the fraud committed. In addition, the Department's Special Compliance Office has developed a nation-wide network of Local Press Liaison Officers to develop communication channels with the regional media.

PAC conclusion (iv): To date the results of work aimed at using the new offence of evading income tax, which is particularly relevant in tackling fraud in the shadow economy, have been limited. In increasing the level of prosecutions the Revenue should extend the coverage across all taxpayer groups, to include all sizes of business and lower value cases, so that deterrence is maintained across the entire taxpayer base.

7. The Department accepts that cases involving the relatively new statutory offence of "to be knowingly concerned in the fraudulent evasion of income tax" have yet to be brought to court in significant numbers. Cases that were in the pipeline are now being put through the courts using the new offence. Some cases have been concluded and many more new cases are under investigation. The Department notes the Committee's conclusion that its prosecution work needs to encompass all areas of the Department's work. The current prosecution policy covers all customer groups although investigations have tended to focus on larger or more serious cases. The Department is considering how it might extend prosecution work to cases of all sizes.

PAC conclusion (v): There is a difficult balance to be struck in offering those in the shadow economy the incentive to regularise their tax affairs while not giving them an unfair advantage over those who have complied fully. While it remains important to punish serious abuse, the Revenue should also examine opportunities to secure higher levels of voluntary compliance and payment of tax due, for example by improving arrangements for payment by instalment and interest on arrears of tax.

8. As the Committee recognises, there are tensions between maintaining a credible penalty deterrent to evasion on the one hand, and offering encouragement and incentive for those who want to put their affairs back on a proper footing to come forward. The Department recognises the importance of getting the optimum balance between these opposing factors. The Department's policy on penalties for evasion already gives incentive to those who want to come out of the shadow economy, whilst still providing a deterrent to serious evasion. The Department is looking carefully at what more might be done to encourage more people in the shadow economy to come 'on side'.

9. Provision already exists to make things easier for those who have tax arrears and who want to regularise their tax affairs, whether or not those arrears arose as a result of evasion, to bring their affairs up to date. Where people cannot pay all that they owe immediately, the Department is always prepared to talk to them about payment by instalments.

PAC conclusion (vi): The Revenue face a growing threat from fraud involving offshore accounts and structures. The Revenue should work closely with the banking and credit card industry and professional representative bodies to ensure the reporting requirements of recent legislation are fully understood and acted upon. If difficulties remain they will need other ways to obtain the information they require, such as a statutory duty for financial institutions who provide offshore accounts to disclose the identity of account holders.

10. The Department recognises the threat identified by the Committee and the National Audit Office from fraud involving offshore accounts and structures. The Department takes this very seriously and has taken active steps to tackle this threat. Additional resources have been deployed against this risk as part of the initiative announced by the Chancellor in his 2003 Budget.

11. The Department meets representatives of the financial sector regularly to support the development and implementation of new legislation. It works closely with the National Criminal Intelligence Service (NCIS) in working with the regulated sector on money laundering reporting requirements. The Department has taken several significant steps to support NCIS in this, including the secondment of seven Inland Revenue staff to NCIS, delivering joint presentations with them and liaising with the various representative bodies.

12. The Department has already put systems in place in order to maximise the usefulness of the large amount of directly relevant information expected under these reporting requirements. The Department also accepts that it should continue to monitor the usefulness of this information and whether further measures may be needed. But given that the new reporting requirements have yet to come into effect, it is not possible to say at this stage whether these difficulties will materialise in practice. The Department accepts the point made by the Committee about whether further measures may be needed if difficulties remain.

PAC conclusion (vii): The Revenue expect prosecutions for new tax credit fraud to rise as new powers take effect, but they see civil penalties as their primary weapon. The Department for Work and Pensions prosecute more than twenty times as many cases per £100 million spent. The Revenue should work with the Department for Work and Pensions to secure greater consistency in the scale and nature of sanctions applied.

13. The Department notes the Committee's conclusion and is considering how best to work with the Department for Work and Pensions (DWP) to secure greater consistency. There is already a joint fraud forum which meets regularly to discuss such issues and good progress is being made. The joint fraud forum will be a useful body to explore further scope for consistency and effectiveness, involving other departments and agencies as appropriate. The Department is aware that DWP is carrying out a review into the effectiveness of its sanctions policy. The Department has agreed with DWP that it will be involved in this work as it develops.

PAC conclusion (viii): To those involved in or contemplating fraud the chances of getting caught could appear minimal, since the Revenue only carry out 400 serious fraud investigations and 60 prosecutions a year on a customer base of more than 30 million. The 12:1 financial return achieved by the Special Compliance Office, which excludes the yield from criminal prosecution work and wider deterrent effects, suggests that a substantial increase in investigation activity would be cost-effective. More prosecutions should also bring opportunities to make greater use of the confiscation and restraint powers to deprive fraudsters of the wider proceeds of their crime.

14. The Department notes the Committee's conclusion. In addition to the activities of Special Compliance Office (SCO), the Department's network of Area Offices carried out over 300,000 enquiries in 2002/03, producing a yield in excess of £1.3 billion. Enquiry work in the Department's specialist offices, including SCO, contributed yield of a further £3 billion.

15. As the Committee recognises, the Department's performance in using confiscation and restraint powers is very good. The Department has secured significant additional resources from the Home Office's Recovered Assets Incentivisation Fund to expand the Department's ability to deal with restraint and confiscation work arising out of Revenue prosecutions. This will enable the use of confiscation in all appropriate cases, with particular focus on those tax credit and shadow economy cases where confiscation is appropriate.

16. Those considering whether to evade their taxes, or defraud the Department of tax credits, can be assured that the Department will take the matter very seriously. This year, like other years, many thousand people will be caught and will have to pay the tax back, plus the interest due and severe financial penalties, and in appropriate cases the Department will prosecute.

PAC conclusion (ix): The enforcement of fines imposed by the courts for convicted fraudsters is important in building an effective deterrence. Although it is not the Revenue's role to collect the fines, they should nevertheless work with the Department for Constitutional Affairs to find out the level of fines actually paid. Without that knowledge they can hardly judge the effectiveness of prosecutions as a deterrent, or strike the right balance between prosecution and civil penalties.

17. The Department agrees with the Committee about the need for effective punishment. The Department has already set in train some work with the Department for Constitutional Affairs (DCA) to look at the level of court fines paid as recommended by the Committee. Further, the Department will consider how best to work with DCA in order to improve the process by which information is provided to the courts to assist them in the collection of fines.

PAC conclusion (x): The Revenue have not followed the examples of the Department for Work and Pensions and HM Customs and Excise in undertaking national campaigns to raise public awareness about the unacceptability of fraud and the consequences of getting caught. A pilot project could test the cost-effectiveness of such a campaign and show whether there is a case for a wider exercise. The Revenue should also publicise their awareness of new forms of fraud and evasion schemes, as a deterrent to further use, and the results of their compliance activities, drawing on the experience of their overseas counterparts such as the US Internal Revenue Service.

18. The Committee's recommendations are being actively studied by the Revenue's Marketing and Communications team with the intention of taking them forward where possible.

Second Report

Office of Gas and Electricity Markets (OFGEM)

The New Electricity Trading Arrangements in England and Wales

PAC conclusion (i): Electricity prices have fallen, but by much less for domestic customers than for industrial and commercial customers. Wholesale prices have fallen by around 40 per cent since 1998 and reductions for industrial and commercial customers have been consistent with this fall. But domestic reductions have been much smaller and only one to three per cent since NETA was implemented in 2001.

1. Comparisons between domestic and industrial/commercial (I&C) markets need to recognise the different structures of these markets. In particular, over 70 per cent of an I&C bill represents the costs of wholesale energy, while for a domestic bill this is only around 40 per cent. Domestic bills are also much more affected by changes in other supplier costs (for instance, back-office costs, transmission and distribution charges, environmental levies). For these reasons, Ofgem would not have expected wholesale price changes to be passed through to domestic customers at the same rate as to I&C customers. While wholesale prices were falling (which was the case in the period up to the NAO report to the Committee), the benefit to domestic customers was therefore dampened. More recently, wholesale prices have risen, and the impact on domestic customers has similarly been dampened.

2. In December 2002 Ofgem published its analysis of these factors so as to assist the NAO. At that time, wholesale costs comprised 39 per cent of a domestic electricity customer's bill. Ofgem's published analysis showed that during 1998-02 there had been a decrease in a supplier's cost base of between 8-17 per cent. While some costs (such as wholesale costs and the cost of transmission and distribution) had decreased over that period, other costs (such as environmental costs and supply and infrastructure costs) had increased. The analysis showed that price savings made by domestic customers reflect the overall change to the supplier's cost basis.

3. However, since January 2003, there has been a substantial increase in wholesale prices (base load prices have increased by 30-31 per cent), which has been cited by suppliers as leading to a five or six per cent increase in domestic electricity prices. These price increases appear to have occurred more promptly than price decreases following falls in wholesale prices. Ofgem is analysing these changes in more detail and aims to publish its initial findings at the end of March 2004 in its review of competition in the domestic gas and electricity sectors. It is worth noting that the most recent market analysis (October 2003) by John Hall Associates estimates cost increases for industrial and commercial customers to be 18-25 per cent, which is significantly more than those being incurred by domestic consumers.

PAC conclusion (ii): Customer loyalty is penalised. Since the market was opened to competition in 1998, only some 40 per cent of domestic consumers have switched supplier, with a lower proportion for the elderly and those who live in rural areas. Customers who have stayed loyal have benefited much less from competition and pay much more than those who have switched.

4. Ofgem agrees that customer loyalty is penalised. Domestic customers with average consumption could save up to £122 if they switched to a competitor. Ofgem wishes to emphasise that suppliers' decisions to keep charging these customers is a commercial one. Some researchers have argued that at a certain point, the loss of customers will provide incumbents with an incentive to reduce the differential between switchers and non-switchers. However, Ofgem would not expect market share erosion to result in one price for all but, like other markets, in price differentials based on brand equity, marketing and product innovation. Suppliers are already offering a wider range of tariffs and incentives (for instance dual fuel provision discounts and tariffs with no standing charge).

5. In Ofgem's view, competition is continuing to develop. The latest information that Ofgem has is that 51 per cent of domestic customers have now switched their electricity supplier, which is a significant increase from 38 per cent in April 2003 when the NAO published its report. Ofgem has been working with Age Concern and countryside bodies to raise those groups' awareness of the benefits of switching. Overall switching rates in the domestic electricity sector remain higher than in almost any comparable sector. For example, in March 2003 the telecom sector the incumbent's share was 82 per cent whereas incumbent share of the electricity markets was 63 per cent and is eroding at five per cent per annum.

PAC Conclusion (iii): Some customers who might have liked to switch supplier have not done so because they have not had the necessary information. Others may always be resistant to the idea of "shopping around" for a service where their interests have traditionally been protected in other ways – for instance switching rates are lower amongst the elderly. Ofgem, working with *energywatch*, should increase consumer awareness of the information already available to assist the switching process including price and quality comparison services, for instance by requiring these to be signposted more visibly on customer bills.

6. Ofgem agrees with the Committee that the information available to customers could be improved. For example, Ofgem have recently consulted on requiring price claims by doorstep sales agents to be provided in writing.

7. Ofgem and *energywatch* are working together to maximise the usefulness of customer information, using results from customer research to target such information effectively. However, in using bills to provide information, care will need to be taken to ensure that customers do not become "swamped" in the detail. Ofgem is intending carry out some research during 2004 about how information can be presented most helpfully.

PAC conclusion (iv): The domestic retail market has been less competitive than that for industrial and commercial consumers, who have seen much greater price reductions since NETA was implemented. Ofgem should carry out a review to determine whether the suppliers are acting in an anti-competitive manner to the detriment of domestic consumers and Ofgem should take action such as fines or price caps as appropriate.

8. As noted above, comparisons between the domestic and I&C sectors need to take account of their differing market structures, for instance their different levels of exposure to wholesale price changes. Ofgem notes that the proportion of customers that have switched supplier is broadly as high in the domestic sector (51 per cent) as for I&C (53 per cent) electricity customers.

9. Nevertheless, Ofgem agrees with the Committee's emphasis on vigorous regulatory action if suppliers are acting in an anti-competitive manner. Ofgem monitors closely suppliers' compliance with licence conditions and competition law. Where appropriate is ready to propose financial penalties, and indeed Ofgem has imposed financial penalties on several suppliers that it has found to be in breach of their licence conditions by inhibiting customers from switching supplier. It has also carried out a range of investigations using its concurrent powers under the Competition Act 1998.

10. However Ofgem does not consider that price caps would be an effective way to protect domestic gas and electricity customers in current market conditions. When we removed price controls in 2002, Ofgem considered that the level of competition then present in the market would be a better protection. Since then, competition has continued to develop with increasing numbers of customers switching their supplier. Ofgem, therefore believes that its powers to enforce competition law and suppliers licence conditions are the most appropriate focus of its activity.

11. In the meantime, Ofgem is taking forward a wide work-programme to remove rigidities that might reduce domestic benefits from competition. For instance, we have reformed the objections rules, have challenged the industry to improve the transfer process, tackled misselling (and are now looking to simplify and clarify the rules governing direct selling to domestic customers) and challenged the industry to pay compensation when it fails to sort out erroneous transfers.

PAC conclusion (v): Ofgem has very limited information on suppliers' profit margins, an important indicator of market conditions. To enable Ofgem to form a clearer judgement of the competitiveness of the market Ofgem should start to collect information from the suppliers on their profit margins from domestic supply.

12. Ofgem considers that analysis of suppliers' margins provides a complement to other competitive indicators. For a number of years Ofgem has monitored profit-levels available to existing or new-entrant suppliers. However, this work has not been allowed to grow so as to absorb the resources that would be required to conduct detailed analysis of the economics of each main supplier.

13. Ofgem has taken the view that supplier profitability is not, of itself, the only or indeed necessarily the main indicator of the success of competition. Other indicators include market share, switching rates, the extent of price and non-price competition, customer experience and satisfaction, as well as market entry and exit.

14. Various methodological issues arise that make analysing companies' published margins complex: in particular the fact that they are likely to reflect profits over a wide range of activities and domestic supply is rarely identified separately. In its review of competition in the domestic gas and electricity domestic sectors (which it aims to publish towards the end of March 2004), Ofgem intends to initiate a discussion of the issues raised by profitability analysis.

PAC conclusion (vi): Over recent years, the level of vertical integration has increased in the electricity market. In Ofgem's view vertical integration in the industry should not be a problem so long as both the wholesale and retail markets are competitive. Nevertheless, Ofgem should take seriously the risk that vertically integrated companies may exploit their position and Ofgem should adapt its competition analysis of the wholesale market and retail markets to reflect the new reality of the market.

15. Ofgem takes seriously any behaviour that may be anti-competitive; its competition analysis follows the Office of Fair Trading's published guidelines and recent case law. Our assessment of the effect of company behaviour on competition takes into account the structure of the market. Ofgem recently published a document¹, which considered one aspect of the behaviour of some vertically integrated suppliers and generators. In that paper, Ofgem recognises that there is potential for competitive abuses to emerge from the widespread vertical integration between generation and supply, and gave a commitment to effective regulation in this area. Ofgem will therefore continue to devote resources to monitoring the evidence available to us and will act where distortions arise. We also consider market participants aware of anti-competitive actions have a financial interest in bringing evidence to Ofgem.

PAC conclusion (vii): Whether the system can meet future increases in electricity demand in severe weather is uncertain Ofgem appears confident that market mechanisms will ensure that companies have sufficient generating plants to produce enough electricity to meet all reasonable demands. But the margin of spare capacity over expected demand has been falling continuously since the introduction of NETA when it was nearly 30 per cent, and currently stands at around 17 per cent. Ofgem takes confidence from the potential for "mothballed" power stations (those taken out of service by their owners) to meet rising electricity demand. Ofgem has, however, no formal powers to ensure that, if a power station is mothballed or a generating company goes into receivership, these assets are kept in a serviceable condition for future needs.

16. Ofgem is confident that the market will produce enough electricity to meet all reasonable demands and market failure will only occur in extremely rare circumstances. An example of the market working is in the events leading up to the increase in electricity demand during winter 2003. Falling electricity prices in 2001-02 contributed to a "mothballing" of generating capacity and a postponement of construction of new power plants. Forward prices indicated a rise for winter 2003 (electricity prices have risen by 60 per cent since August 2002) which led to an increase in generation capacity. Since Ofgem gave evidence to the Committee in June 2003, the return of a number of mothballed units has been announced (two 650MW units at Gain, 250MW at Deeside as well as units at AES Fifoots Point and Dinorwig) and work commenced on the construction of new power plants (both CCGT and renewables). Overall the margin of spare generating capacity over demand has risen from 17 per cent to 20 per cent.

17. Ofgem facilitates the ability of energy generators and investors to respond to market signals and balance long-term supply and demand by producing regular information on market developments. Ofgem jointly chairs with DTI the Joint Energy Security of Supply working group (JESS), which monitors medium-to long term security of supply.

¹ Restriction on self-supply: Final proposals, Ofgem October 2003.

18. Ofgem believes that generation capacity would be offered to the market where it is economic. Should a company enter administration, market prices would rise, to reflect the extent that their assets are needed in order to balance supply and demand market and capacity would return to the system. Should there be any barriers to the market returning generation capacity that was needed in the short-term, National Grid Company NGC, in its role as system operator, would act to ensure that the system remains in balance. Therefore Ofgem does not believe that it requires formal powers to ensure, that, if a generating company goes into receivership, assets are kept in a serviceable condition for future needs.

PAC conclusion (viii): The system operator (National Grid Company) may not know the condition of generating capacity that is taken out of service. We recommend that Ofgem, with the Department, introduce obligations on administrators of generating companies, and owners of mothballed plant, to ensure that the condition of generating capacity is clearly communicated to enable the National Grid Company to understand better the availability of power stations to meet demand.

19. Ofgem notes the Committee's recommendation for greater transparency of information on mothballed plants. NGC has consulted on changing the "Grid Code", (sets out obligations for all licensed generators) to oblige generators to estimate times for returning mothballed generating units to service. This would give NGC information on the time scales (accounting for the time required to carry out the necessary technical work to make plant fit for service using Good Industry Practice, reflecting normal working arrangements and procurement lead times) of potential reserve capacity. The proposed changes to the grid codes will be sent to Ofgem for approval.



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