

Mr Bob Fletcher  
Secretary, Modification Panel  
Joint Office of Gas Transporters  
51 Homer Road  
Solihull  
B91 3LT

14<sup>th</sup> February 2011

Dear Bob

**RE: UNC Modification Proposals 0339, 0339A & 0340 – “Clarification of the AUG Year in respect of UNC Modification 0229” and alternatives.**

1. British Gas believe that each of these proposals facilitate the Relevant Objectives of the Uniform Network Code (UNC) although we consider that Modification Proposal 0340 achieves this best, followed by Modification Proposal 0339A and then Modification Proposal 0339 in that order. Our detailed reasoning is given below.
2. Since 2005 it has been widely accepted that the allocation of unidentified gas costs is unfair, yet despite spending over five years attempting to secure reform these costs are still being incorrectly allocated to the Small Supply Point (SSP) sector today. British Gas believe that the industry must take this opportunity to finalise reform arrangements in this area and argue that industry arrangements must fulfil two fundamental needs; a primary need to ensure that the reallocation of costs occurs from a fixed date which all Shippers can work towards, and a secondary need to ensure that the date chosen is the earliest point possible point where LSP cost certainty and SSP cost accuracy are balanced.
3. We welcome the fact that each of these Modification Proposals fulfils the first of these fundamental needs by ensuring that the reallocation of costs occurs from a fixed point in the future. We believe this will mean all Shippers, regardless of which sector they operate in, will see reduced uncertainty associated with not knowing when the reallocation will take place from, and that SSP Shippers in particular will gain the certainty they need over when they will lose responsibility for covering costs generated from the LSP sector over which they have no control. This in turn will reduce risk to the SSP sector. On this basis, our preference between the three Modification Proposals at hand is driven from an assessment over how well each of them

meet the second fundamental need, that of balancing cost certainty and accuracy.

4. On this point, we have for some time been concerned that insufficient weight is being placed on the need for an urgent correction to these inaccurate costs, and that this is distorting competition in the Large Supply Point (LSP) sector by disadvantaging those Shippers who are active in both the SSP and LSP sector in favour of those who operate exclusively in the LSP sector.
5. In their recent decision on Modification Proposals 0317, 0317A and 0327<sup>1</sup> for example, Ofgem stated that a reallocation of unidentified gas costs from 1<sup>st</sup> April 2011 would create “*significant uncertainty*” and may therefore “*have a detrimental impact on competition*”<sup>2</sup> because it did not strike the right balance between the SSP Shipper’s need for cost accuracy and the LSP Shipper’s need for cost certainty. We continue to argue that the scale of misallocated costs is so significant that the fixed date chosen for any reallocation should be as early as possible, preferably 1<sup>st</sup> April 2011. We have however taken in to account the comments made by Ofgem in their decision on Modification Proposals 0317, 0317A and 0327 regarding the need to go further in balancing the competing needs for cost accuracy and cost certainty and on this basis have raised Modification Proposal 0339A in an attempt to find a more appropriate balance.
6. We believe this is achieved by ensuring the reallocation of unidentified gas costs SSP Shippers urgently need occurs from the earliest point at which LSP Shippers can be deemed to have a reasonable level of certainty over the amount of cost they will face, and are therefore able to provision accordingly. As the industry will have approved the Allocation of Unidentified Gas Statement (AUGS) on or around 1<sup>st</sup> September, the 1<sup>st</sup> October date proposed by Modification Proposal 0339A is appropriate. Thus, if Ofgem maintain that the risk posed to the LSP sector by a reallocation of costs from 1<sup>st</sup> April 2011, we consider that MOD0339A is a suitable alternative.
7. Modification Proposal 0339A also gives the LSP Shippers five months notice of the charges they will face, starting from 1<sup>st</sup> May each year when the draft methodology is produced through to the effective from date for any reallocation itself, 1<sup>st</sup> October. This notice period aligns with the five month period Shippers receive for any changes in gas Distribution prices. We also note that the decision by Ofgem to allow a significant increase in Electricity Network charges set a precedent that certainty of costs can be provided with four months notice. By aligning Modification Proposal 0339A with these examples of current industry practice we consider that we have found a solution which is fair, reasonable and successful in balancing risk between the two competing sectors.
8. Finally, we also believe that Modification Proposal 0339A resolves the conflict which exists between Modification Proposals 0339 and 0340 and the interim

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<sup>1</sup> Link [here](#)

<sup>2</sup> Ofgem Decision Letter on MODs 0317, 0317A and 0327, page 6

reallocation of unidentified gas costs introduced by Modification Proposal 0317. Under both Modification Proposal 0339 and 0340 the £2.75m interim payment from the LSP to SSP communities would not be reconciled against the final Allocation of Unidentified Gas Statement (AUGS), exposing the LSP community to a potential “double reconciliation”. Modification Proposal 0339A however expressly provides for the initial AUGS to discount any interim payment made under Modification Proposal 0317, improving cost accuracy to the market as a whole and therefore facilitating competition between Shippers. Whilst we therefore continue prefer the 1<sup>st</sup> April 2011 date set by Modification Proposal 0340, we therefore consider that Modification Proposal 0339A provides a real alternative which should be implemented if Ofgem consider that significant risk continues to exist with alternative dates.

9. We have set out our view on how each of these Modification Proposals meets or does not meet each of the relevant objectives below, and then gone on to provide a more detailed assessment of each Modification Proposal within Appendix One.

***Standard Special Condition A11.1 (d): so far as is consistent with subparagraphs***

***(a) to (c) the securing of effective competition:***

***(i) between relevant shippers;***

***(ii) between relevant suppliers; and/or***

***(iii) between DN operators (who have entered into transportation arrangements with other relevant gas transporters) and relevant shippers;***

10. Modification Proposal 0339 proposes to delay the reallocation of unidentified gas costs until 1<sup>st</sup> April 2012, despite the AUGS being approved by the Uniform Network Code Committee (UNCC) some seven months earlier. Whilst we consider that this has the benefit of providing with all Shippers with certainty that the reallocation of costs will happen from a fixed point in time, and provides LSP Shippers with *absolute* certainty of the costs they will face, we consider this is the absolute minimum requirement for any reform in this area. We are concerned that Modification Proposal 0339 does nothing to ensure these improvements in cost certainty are balanced with the SSP Shipper’s need for cost accuracy. We therefore consider it does meet the relevant objectives of the UNC, but that both Modification Proposals 0339A and 0340 provide more balanced solutions.
11. Modification Proposal 0340 for example ensures that the reallocation of inaccurate costs to the SSP sector is fixed from the earliest possible date. Given our view that the scale of inaccurate charges the SSP sector face is approximately £121m per annum, we believe there is a greater distortion of competition associated with delaying this correction than that from ensuring LSP Shippers have absolute cost certainty.
12. Whilst we therefore consider that MOD0340 best facilitates this relevant objective we recognise this point was not accepted by Ofgem in their decision on Modification Proposals 0317, 0317A and 0327 and that therefore more

was needed to ensure that the balance between cost certainty and cost accuracy was achieved.

13. Modification Proposal 0339A therefore retains the important benefit of reallocating costs from a fixed date in the future and then goes on to ensure that the reallocation is effective from the first point at which LSP Shippers will have a reasonable degree of certainty over the amount of cost they will incur and, by extension, provides an earlier correction to the inaccurate costs which the SSP Shippers incur than that proposed in Modification Proposal 0339. This balancing of the competing needs for cost certainty and cost accuracy ensures that all Shippers can compete fairly, thus facilitating this relevant objective.

***Standard Special Condition A11.1 (f): so far as is consistent with subparagraphs***

***(a) to (e), the promotion of efficiency in the implementation and administration of the network code and/or the uniform network code;***

14. We note some have argued the UNC is currently unclear about the effective from date for the AUGS and that, in clearing up this ambiguity, each of these proposals therefore meet this relevant objective. We contend however that the UNC is already clear that the AUGS will be effective from 1<sup>st</sup> April 2011 and that none of these proposals therefore add any clarity.
15. We do however believe that it is efficient administration of the UNC to ensure parties are adequately incentivised to ensure the AUGE process is delivered on time. We consider that the whilst each of these proposals do this by making it clear that any delay to the AUGE implementation timeline will not effect the point when SSP Shippers will benefit from accurate charges, the incentive on LSP Shippers to avoid delay is increased as the effective from date for the initial AUGS is brought forward. This is an important point considering the level of potential benefit which LSP Shippers could if there was an indefinite delay in the effective date of the initial AUGS, as some LSP Shippers are now arguing for<sup>3</sup>. We therefore consider that Modification Proposal 0340 best facilitates this relevant objective, followed by Modification Proposal 0339A and Modification Proposal 0339 in that order.
16. Our detailed reasoning on each of the Modification Proposals is set out below in Appendix One. If you have any queries relating to this representation, please do not hesitate to telephone me on (07789) 570501.

Yours sincerely

David Watson  
Regulatory Manager, British Gas

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<sup>3</sup> Modification Proposal 0366, raised by Total Gas and Power. Link [here](#).

Appendix One – Detailed Comments on Modification Proposals 0339, 0339A and 0340

*The Need to Balance Accuracy and Certainty of Costs*

17. Modification Proposal 0229 introduced legal text which, after over three years of debate, ensured both that an independent expert would be appointed to establish a methodology to correctly apportionment unidentified gas between the SSP and LSP sectors, and that this methodology would be applied with effect from 1<sup>st</sup> April 2011 regardless of when the methodology was actually first published. This provided the SSP sector with the certainty that they there would be a fair reallocation of costs to the LSP sector based on the findings of an independent expert (AUGE), and ensured that this reallocation would not be delayed any longer than was necessary; minimising the risk SSP Shippers faced with continued exposure to unfair charges.
18. A number of modifications have been raised since the implementation of Modification Proposal 0229 with the aim of either changing or clarifying the date from which the AUGE's methodology would become effective. In particular Modification Proposal 0317, raised by Shell Gas Direct, sought to provide the SSP sector with £2.75m for each year until the AUGE's methodology was delivered and Modification Proposal 0317A, raised by British Gas, sought to clarify that the AUGE's methodology would still apply from 1<sup>st</sup> April 2011 and that the £2.75m was merely a "payment on account" until the methodology was delivered. A further proposal, Modification Proposal 0327, again raised by us, sought to establish that the actual amount of cost reallocation required was £121m for each year until the AUGE's methodology was delivered with a provision for the eventual amount of cost reallocation to be reconciled once known.
19. In their decision on Modification Proposals 0317, 0317A and 0327 Ofgem reaffirmed their view that "*the arrangements for the allocation of Unidentified Gas should be reformed such that each market segment makes an appropriate contribution to these costs*"<sup>4</sup> but went on to say that the reconciliation provisions in both Modification Proposals 0317A and 0327 meant that LSP shippers needed to "*take a view on the level of charges to pass through to customers in their contracts based on their requirement to make a contribution toward the £2.75m and their view of any adjustments likely from the future AUGS*"<sup>5</sup> and that this created "*significant uncertainty for small shippers and LSP shippers [which] may have a detrimental impact on competition, in particular in relation to shippers operating only or predominantly in the LSP sector*"<sup>6</sup>.
20. We consider that this was not in itself a rejection of the principle of specifying a fixed date from when the AUGS would apply from, but was instead a statement on the need to ensure that the effective from date arrived at properly balanced the competing risks associated with lack of cost accuracy

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<sup>4</sup> Ofgem Decision Letter on MODs 0317, 0317A and 0327, page 5.

<sup>5</sup> Ofgem Decision Letter on MODs 0317, 0317A and 0327, page 6.

<sup>6</sup> Ofgem Decision Letter on MODs 0317, 0317A and 0327, page 6

for SSP Shippers and lack of cost certainty for LSP Shippers. Indeed, we argue that without a fixed date from which the AUGS will be effective from, there can be no certainty of costs for any party, nor ability for SSP Shippers to remove the risk associated with being unfairly charged costs over which they have no ability to control.

21. We therefore accept Ofgem's argument that effective competition relies on this balance being maintained, and believe the key decision at hand is to decide at which point in the AUGS creation process, as set out in the AUGE Guidelines Document<sup>7</sup>, this balance is achieved. This is explored further below.

#### *Modification Proposal 0339*

22. Modification Proposal 0339 seeks to change the effective from date of the AUGE's methodology to April 2012, although it is not entirely clear to us why this date is the most appropriate. The Proposer says that "*there is a mismatch between the intention of [Modification Proposal 0229] and the legal text currently contained within the UNC*"<sup>8</sup> which the Proposal seeks to resolve, yet it is apparent to us that the original intent of Modification Proposal 0229 was to ensure that the AUGE's methodology would apply from the first April after the methodology was produced, whenever that may be. This fact is acknowledged by Total Gas and Power in Modification Proposal 0366<sup>9</sup>.
23. Whilst we welcome the moves in Modification Proposal 0339 to ensure that SSP Shippers will have a fixed date from which they will get relief from the inaccurate costs they currently face, we consider that an effective from date of 1<sup>st</sup> April 2012 does not strike the right balance between cost certainty for LSP Shippers and cost accuracy for SSP Shippers. The effect is an advantage for those LSP only shippers over those who operate in both the SSP and LSP sectors, distorting competition in the process.
24. The AUGE Guidelines Document created by Modification Proposal 0229 obligates the Network Owners to finalise the process by calculating the specific volumes to be reallocated on 1<sup>st</sup> March each year<sup>10</sup> but also obligates the UNC Committee (UNCC) to have signed off the AUGS "*on or around the 1<sup>st</sup> September*"<sup>11</sup> in the previous year. This is all subsequent to the draft AUGS being published on the previous 1<sup>st</sup> May, and a three month query and challenge process where issues can be flagged and taken in to account by the AUGE.

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<sup>7</sup> AUGE Guidelines Document, section 6

<http://www.gasgovernance.co.uk/sites/default/files/AUGE%20Guidelines%20v2%20approved.pdf>

<sup>8</sup> UNC MOD0339, page 1.

<sup>9</sup> "*The implementation of UNC Modification 0229 would not reflect the intention of the modification if it were to create the possibility of retrospective charges. Modifications 0339 and 0340, which purportedly seek to clarify the situation, will not do so appropriately as both modifications seek to create a fixed date to which charges may be back-dated*". Total Gas and Power, MOD0366, page 3.

<sup>10</sup> The final query process where the AUGS can be challenged ends on the "last day of February", AUGE Guidelines Document, paragraph 7.2.

<sup>11</sup> AUGE Guidelines Document, paragraph 6.1.8.

25. We consider that, whilst any new “*material*”<sup>12</sup> issues not addressed in previous query process can be accommodated between September and the end of February, the process between May and September ensures that Shippers will have a reasonable degree of certainty about the charges they will face following the UNCC meeting on or around 1<sup>st</sup> September. The need to delay the reallocation of unidentified gas costs until 1<sup>st</sup> April the following year, a further seven months, is therefore unwarranted in our opinion and therefore liable to unnecessarily expose SSP Shippers to inaccurate costs for longer than is necessary.

#### *Modification Proposal 0339A*

26. Modification Proposal 0339A retains the benefit of a fixed date from when cost reallocation will occur and goes on to address the issues detailed above by acknowledging that Shippers will have a reasonable level of certainty about the costs they will incur in the following April and thus are able to make informed decisions about the amount of money they need to provision for. This resolves the “*significant uncertainty*” associated with a provisioning exercise which Ofgem identified in their decision letter on Modification Proposals 0317, 0317A and 0327 and thus does not in our view distort competition.
27. The effect of applying the AUGS from 1<sup>st</sup> October 2011, some six months ahead of the 1<sup>st</sup> April 2012 date considered in Modification Proposal 0340, represents a material improvement in the accuracy of costs to all sectors. As we have mentioned above, there is universal acknowledgement that the current allocation of unidentified gas costs is inaccurate and this will in turn distort competition. In Modification Proposal 0327 British Gas set out its view that the scale of misallocation could be as much as £121m per annum. We still subscribe to this view and consider that the early reallocation of costs proposed by Modification Proposal 0339A would therefore prevent approximately £60m of costs being misallocated from the LSP to SSP sectors than would be under Modification Proposal 0339. This represents a significant improvement on Shippers’ ability to compete based on the actual costs they should incur, thus meeting the UNC Relevant Objectives.
28. We consider there are precedents for this approach. When Network Owners announce changes to Distribution prices, an initial indication of proposed changes is made not less than five months prior to the implementation with a final notification of the changes not less than two months prior to implementation. The precedent created is that an acceptable level of cost certainty will be afforded to Shippers if they receive at least five months notice of indicative changes to their costs. As the draft AUGS will have been provided by 1<sup>st</sup> May and then approved by the UNCC on or around 1<sup>st</sup> September, we consider that Modification Proposal 0339A provides adequate notice to parties of the charges which they will incur.

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<sup>12</sup> AUGE Guidelines Document, paragraph 7.5 sets out that any amendments to the AUGS after the UNCC have approved the methodology must have a “*material impact, and can be implemented in time for the creation of the final Unidentified Gas volumes*”. Even after this, the UNCC retains the final decision over whether or not to reconsider its original decision to approve the AUGS.

29. We also note the precedent set by recent changes in electricity Network charges where, following an Ofgem review of the impact of settlement data adjustments on the Network Owners losses incentive schemes, Suppliers in the electricity market have been given four months notice of significant changes to their Electricity Network Charges. In light of this, we consider that the five months notice afforded under Modification Proposal 0339A is again more than adequate.
30. Furthermore, we believe that there will be consequential benefits associated with aligning the reallocation of unidentified gas costs with the start of the new gas year. In particular we consider it good financial practice to align the annual reallocation of unidentified gas costs with the point in time which Annual Quantity (AQ) data, from which the reallocation of costs will be largely calculated, is effective from. The benefits here will not simply be to the Network Owners who are required to make the calculation but also to those Shippers whose internal processes align to the gas year.
31. Finally, we recognise that both Modification Proposal 0339 and Modification Proposal 0340 potentially leave the LSP sector liable to a double reconciliation through a conflict with the mechanism introduced under MOD0317. For example, if Modification Proposal 0340 is implemented and the AUGS is produced in time for an April 2012 reallocation of costs then the LSP sector will be liable to pay £2.75m to the SSP sector<sup>13</sup> for unidentified gas in the period April 2011 to April 2012 and a second reallocation of cost, value of which to be defined by the AUGS themselves, for the same period. This would have the effect of providing the SSP sector with a windfall of £2.75m, leaving them open to charges that competition is distorted in its favour. Likewise, if Modification Proposal 0339 is implemented and the first AUGS is produced after April 2012, the LSP sector would be liable for £2.75m for each year until the AUGS was finally produced, to an unlimited value, plus the eventual reallocation of unidentified gas costs from April 2012. Again, it may be argued that this double repayment would distort competition in favour of SSP Shippers.
32. Modification Proposal 0339A resolves both of these issues by ensuring that any reallocation of unidentified gas will be adjusted to take account of any payments made under the Modification Proposal 0317 process, ensuring that LSP Shippers only pay for the unidentified gas that can be attributed to them. This will ensure costs are accurately apportioned in the market, improving Shippers' ability to compete fairly against one another.
33. We understand that some may attempt to argue that as the AUGS Guidelines Document provides a mechanism for Shippers to make requests for the AUGS to be amended after 1<sup>st</sup> October each year, a reallocation of unidentified gas costs from this date still presents LSP Shippers with the risk of uncertain costs. We believe however that the level of risk associated with a provisioning exercise for LSP Shippers at this point is almost entirely

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<sup>13</sup> As per MOD0317.

mitigated by the fact that a draft methodology will have been known for some five months, that the industry will have engaged and completed in a full query and challenge process with the AUGE, that the AUGE will have revised the methodology accordingly and that the final methodology will have been agreed and signed off by the UNCC themselves. Again, any residual risk must be balanced with the risk to the SSP sector associated with a deliberate extension of the period for which they are responsible for financing inaccurate costs.

34. Furthermore, we also note that the criteria for any challenge from this point is quite onerous in that it must “*have a material impact, and can be implemented in time for the creation of the final Unidentified Gas volumes*”<sup>14</sup>. Whilst there is therefore a theoretical risk that any provision made before 1<sup>st</sup> October may be subsequently amended, we consider that the test for such amendments has been set appropriately high that the consequential risk of amendment is therefore very low. When set against the benefit an earlier reallocation of unidentified gas costs would have on competition in the market, we believe that the right balance of risks between the need for cost certainty and accuracy would therefore be met.
35. We are also aware that some may argue that as the AUGE’s final methodology will be approved on or around 1<sup>st</sup> September 2011, an effective from date for the reallocation of unidentified gas costs of 1<sup>st</sup> October 2011 does not afford Shippers with sufficient time to take the necessary actions to provision against the costs they will face. We reject this argument in its entirety and point out that the draft methodology will have been published on 1<sup>st</sup> May 2011, some five months before. As we mention above, this is considered adequate notice in other areas of the industry, and thus is adequate here.

#### *Modification Proposal 0340*

36. We recognise the many similarities between Modification Proposal 0340 and 0317A, which Ofgem rejected in November 2011 and in particular the provision that the effective date of the initial AUGS should be defined as 1<sup>st</sup> April 2011. We are also mindful that Ofgem have already said such a provision would cause “*significant uncertainty for small shippers and LSP shippers*” which in turn may “*have a detrimental impact on competition*”<sup>15</sup> and therefore believe that that on this basis there may be grounds to argue that Modification Proposal 0340 does not meet any of the UNC relevant objectives.
37. We continue to believe however that the impact on competition of the inaccurate costs currently being misallocated between the LSP and SSP sectors far outweighs any the impact on competition caused by a lack of certainty over precisely how much LSP Shippers should provision for against any future reallocation. Primarily this is because we consider that the true

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<sup>14</sup> AUGE Guidelines Document, paragraph 7.5

<sup>15</sup> Ofgem Decision Letter on MODs 0317, 0317A and 0327, page 6.

amount of unidentified gas to be approximately £121m per annum<sup>16</sup>, an amount which significantly impairs SSP Shippers ability to compete and increases costs to customers, but also because we consider that parties can adequately assess the likely costs they may face and provision accordingly<sup>17</sup>. Consequentially we believe the risk assessment associated with backdating the reallocation of unidentified gas costs to 1<sup>st</sup> April 2011 Modification Proposal 0340 should be reappraised.

38. Were Ofgem to continue to believe however that the provisions to backdate the reallocation of unidentified gas costs to 1<sup>st</sup> April 2011 presented an unacceptable level of risk to LSP Shippers then we consider that Modification Proposal 0339A would be the next best solution, as this would balance this risk by allocating costs from the 1<sup>st</sup> October 2011, a point in time when Shippers will have a reasonable level of certainty about the costs they need to provision for.

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<sup>16</sup> As per MOD0327.

<sup>17</sup> These arguments were explored further in our response to MODs 0317, 0317A and 0327.