



Mr J. Majdanski
Secretary, Modification Panel
Joint Office
National Grid Gas

Centrica Energy
Millstream East
Maidenhead Road
Windsor
Berkshire
SL4 5GD

Tel. (01753) 431059
Fax (01753) 431150
Our Ref.
Your Ref.

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Dear Julian,

RE: MODIFICATION PROPOSAL 0136V – ‘Reconciliation following AQ Amendment where an SSP becomes an LSP prior to calculation of Provisional Annual Quantity’

Thank you for the opportunity to comment on the above modification proposal.

British Gas Trading (BGT), as the proposer of this modification proposal, fully supports its implementation.

We have set out in detail under the following headings, why we believe that this modification proposal better facilitates the achievement of the relevant objectives of the Uniform Network Code.

1. Executive Summary
2. Background
3. The Modification Proposal
4. Benefits of our Proposal
5. Consequence of non-implementation
6. Implementation

1. Executive Summary

Modification Proposal 0640 'End of Year Reconciliation of specific categories of Smaller Supply Points', was implemented in June 2004.

1. There is currently a loophole in the End of Year AQ Reconciliation Process, which was introduced by modification proposal 640.
2. In real terms this means that energy is inaccurately allocated. In the 2005/6 Gas Year the inaccurately allocated energy associated with this loophole increased to 435,800 mWh¹, this equates to c£10m of misallocated charges. We have significant concerns that some Shippers may be taking systematic advantage of this loophole.
3. The financial cost of this loophole is borne solely by Reconciliation by Difference (RbD) Shippers i.e. the domestic sector. This inappropriate allocation of costs is unfair, creates a cross-subsidy across market sectors and does not promote the facilitation of effective competition between either relevant Shippers or relevant Suppliers,
4. The loophole within the End of Year AQ Reconciliation process, in the first instance, rewards a Shipper for erroneously amending a supply point below the 73,200 kWh threshold. In doing this the Shipper avoids energy costs, providing that ultimately it appeals the supply point above the threshold during the subsequent Gas Year, before the provisional AQ value is calculated.
5. Ultimately point 4 provides Shippers with a perverse incentive. It should however be recognised that some sort of reward for correcting erroneous energy allocation can be beneficial, providing that any reward does not in itself act as a perverse incentive, as is the case with the current arrangements.
6. Our proposal closes the unfair and inappropriate loophole that is existent within the current process, whilst retaining an appropriate level of incentive on Shippers to proactively correct erroneous energy allocations.
7. We believe that our proposal better facilitates the achievement of the relevant objectives of the Uniform Network Code. It reduces the extent to which cross subsidies exist between Shippers, thereby securing effective competition between them.

¹ Data provided by xoserve

2. Background

A fundamental principle underpinning the competitive gas market is that of fair and equitable apportionment of costs and charges, in particular ensuring that these are attributed to the correct place, whether this is upon an individual party or, at an aggregate level, a market sector.

In June 2004 Modification Proposal 640 was implemented and introduced arrangements to reconcile energy and transportation commodity charges where the revision of the Annual Quantity (AQ) had caused a Supply Point to be re-classified as a Larger Supply Point (LSP).

The introduction of these arrangements resulted in a significant improvement to the accuracy and equitability of the gas settlement processes. The arrangements however, contained three specific exclusions. During the development of Mod 640 these exclusions were deemed appropriate in order to simplify the arrangements and were considered, at the time, to be of little significance and of low materiality.

The release of subsequent industry data, issued by xoserve via the Billing Operations Forum, made it apparent that the original level of significance and materiality had not been understood and in July 2006 BGT raised modification proposals 094, 095 & 096. These modifications were raised seeking to remove each of the three exclusions, which were at the time detailed within Section E7.4.3 (a), (b) and (c) of the Uniform Network Code Transportation Principal Document.

The Authority subsequently approved modification proposals 094 & 095 on 30 October 2006, however modification proposal 096 was rejected.

It should be noted that since the rejection of modification proposal 096, it has become evident that the negative impact of the loophole in the End of Year AQ Reconciliation process has increased and the scale of the problem and its impact to RbD Shippers is worsening.

3. The Modification Proposal

This modification proposal seeks to address the concerns raised within the Authority's 096 decision letter dated 30 October 2006 and remove the sole existing exclusion from the Mod640 arrangements.

Within the 096 decision letter the Authority made reference that:

'... the exclusion contained within E7.4.3 (c) and the ability to avoid the revision charge provides an incentive on shippers to proactively monitor and pursue threshold crosser appeals.'

It further stated that:

'... in addition to correctly allocating costs to the individual LSP rather than the RbD sector at an earlier stage, we also consider that this should provide administrative

efficiencies, encouraging appeals to be made throughout the year, rather than concentrated in the post-provisional AQ window’.

Modification proposal 0136 seeks to maintain the incentives upon Shippers to proactively monitor and pursue threshold crosser appeals, but also remove the incumbent perverse incentives on Shippers to ensure that appeals are concluded prior to, and as close as possible to, the post-provisional AQ window.

It is proposed that where a successful threshold crosser appeal takes place, regardless of when the appeal is undertaken, either before or after the date when provisional Annual Quantity calculations are undertaken by the Gas Transporters, that the Supply Point will not be excluded from the End of Year Reconciliation calculations.

It is further proposed that the Supply Point would not be exposed to the full resulting Annual Quantity Revision Difference Transportation Charge, but instead would only be charged a proportion of this charge, this proportion being 90%.

4. Benefits of the Proposal

4.1 Removal of current inequitable arrangements

The remaining exclusion to the End of Year Reconciliation arrangements, provides Shippers with a perverse incentive to ensure that threshold crosser appeals are concluded prior to, and as close as possible to, the post provisional AQ window.

Under the current arrangements all Supply Points, which have had successful threshold crosser appeals prior to the post-provisional AQ window, are excluded from the subsequent End of Year Reconciliation calculations and will not be subject to the resulting Annual Quantity Revision Difference Transportation Charges.

Below is a step by step example which describes the particular scenario to which we refer:

Gas Year 1

Step 1	Provisional AQ set by xoserve at:	250,000 kWh
Step 2	AQ amended by Shipper to:	1 kWh
Step 3	AQ set at 1 st October for new Gas Year as:	1 kWh

Gas Year 2

Step 4	Shipper appeals back to correct AQ just prior to calculation of the provisional AQ:	250,000 kWh
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- In this example the Shipper benefits by not being exposed to the Annual Quantity Revision Difference Transportation Charge and;

- RbD Shippers face increased charges as a result.

The impact of the perverse incentive upon Shippers is further magnified as approximately 80% of annual gas consumption takes place during the winter months, within a window which begins at the commencement of the new Supply Point AQ (1st October) and the date when Provisional Annual Quantity calculations are undertaken by the Gas Transporters (end of March).

The effect of all successful threshold crosser appeals undertaken prior to the end of March, has a significant and detrimental impact to the RbD sector.

Although Supply Points which have been successfully appealed as a threshold crosser will, from that point forward, transfer its classification to an LSP and subsequently be subject to individual supply point reconciliation, the costs associated with its original incorrect classification as an SSP will have already been incorrectly allocated to the RbD sector.

The impact to RbD is compounded due to the profile of annual gas consumption over the winter months and the propensity for spikes of AQ appeals to be undertaken just prior to the post-provisional AQ window. For example, any appeals which are progressed just prior to this window, allocates up to six months (October to March) of costs and approximately 80% of annual gas consumption for the Supply Point to the incorrect market sector, to the detriment of RbD.

Further the registered Shipper of the Supply Point escapes from any exposure to Annual Quantity Revision Difference Transportation Charges.

4.2 Significance and Materiality

Over the past two years, industry data has identified that the level of significance and materiality to the industry and specifically the RbD sector, relating to the specific End of Year AQ Reconciliation process exclusion which this modification proposal is seeking to remove, has proved to be higher than was originally assumed during the development of Mod 640.

Appendix A attached, provides supplementary information relating to the modification proposal 0640 adjustments for the 2004/5 Gas Year and highlights the specific impact of AQ's 'appealed during the appeals window' and therefore exempt from the Annual Quantity Revision Difference Transportation Charges.

It further provides information relating to the modification proposal 0640 adjustment for the 2005/6 Gas Year, specifically in relation to the impact of AQ's 'appealed during the appeals window' and therefore exempt from the Annual Quantity Revision Difference Transportation Charges.

Based upon corresponding Mod 640 reconciliation invoices for the 2004/5 and 2005/6 Gas Years, the non-reconciliation of 'appealed during appeals window' upward threshold crossers represents c£13m of misallocated charges between the SSP and LSP markets and has a sole detrimental impact to RbD.

It is evident that the original assumptions made relating to the level of significance and materiality associated with this exclusion were inaccurate and that the current arrangements create an inappropriate cross-subsidy across market sectors. BGT believe that due to the significant level of financial materiality, which is now known to be associated with this exclusion, it is no longer appropriate for this level of market cross-subsidy and inappropriate allocation to continue.

4.3 Maintain incentives on Shippers to undertake threshold crosser appeals

This modification proposal seeks to maintain an incentive on Shippers to proactively monitor and pursue threshold crosser appeals, as detailed within the Authority's decision letter for modification proposal 096.

It is therefore proposed that where a successful threshold crosser appeal takes place, regardless of when the appeal is undertaken, that the Supply Point will not be excluded from the End of Year Reconciliation calculations.

This approach will ensure that energy is allocated appropriately across market sectors and that the RbD sector does not continue to be exposed to undue volumes of unreconciled energy, as detailed previously.

However, as an incentive on Shippers to continue to undertake threshold crosser appeals in a timely manner, this modification proposal proposes that where a successful Supply Point threshold crosser appeal is undertaken prior to the calculation of the Provisional Annual Quantity, it would not be exposed to the full resulting Annual Quantity Revision Difference Charge.

Instead, all successful threshold crosser appeals, undertaken prior to the calculation of the Provisional Annual Quantity, would be charged a proportion of the charge. The proportion proposed by this proposal is 90% of the resulting Annual Quantity Revision Difference Charge, which BGT believe provides an appropriate balance between ensuring that Shippers continue to have an incentive to monitor and pursue threshold crosser appeals, whilst ensuring that energy is allocated to the correct market sector and the RbD sector does not continue to be unduly penalised.

The 90% value is deemed by BGT to be a fair and reasonable solution to this particular problem and material in its approach. Prior to raising this modification proposal, consideration was given to the appropriateness of the value and we concluded that RbD Shippers should not financially incentivise the facilitation of any inappropriate Shipper behaviour, to a degree that suggests that any such inappropriate behaviour is deemed to be acceptable. Therefore, we believe that the use of any lower value, other than the proposed 90%, would portray this message i.e. a 70% value would suggest that it is acceptable for a Shipper to keep a 30% share of the spoils associated with any inappropriate behaviour. It would also maintain an unacceptable level of market cross-subsidy.

Whilst a lower value may further incentivise the progression of more timely appeals, this approach would in our opinion, be sanctioning the existence of a

perverse incentive, whereas our proposed 90% value provides a material incentive and acts as an enabler to ensure the facilitation of a more equitable approach and outcome.

In summary, it could be argued that the greater the level of potential to gain from inappropriate behaviour, the greater the potential and incentive for parties to act inappropriately in the first place.

It should be noted that the 90% value approach was discussed during the development of the proposal at the Distribution Workstream, with no alternative options or percentage values being proposed by industry participants.

The '10%' of the proposed incentive will ultimately be funded by RdD Shippers and is proposed as a material solution to ensure that the unacceptably high financial impacts associated with the misallocation of charges and the existing levels of market cross-subsidy do not continue.

As RbD Shippers alone will ultimately fund this incentive and receive the subsequent benefits, it would seem appropriate that responses from RbD Shippers should be given key consideration as part of the consultation process.

This proposal will result in the reduction of unreconciled energy and cost to RbD. As this will ultimately be beneficial to RbD Shippers, on this basis we believe that it would be difficult to understand the motives of any RbD Shipper who does not support this proposal.

The implementation of the proposed arrangements will appropriately incentivise Shippers to continue to monitor and pursue threshold crosser appeals, as the alternative will be a Shipper ultimately facing exposure to 100% of the Annual Quantity Revision Difference Charge once the AQ value is revised, should an appeal purposely not be processed.

4.4 Improving the accuracy, equitability and efficiency of gas settlement processes

In raising this modification BGT is seeking to build upon the improvements introduced by Mod 640 in June 2004 and by Mods 094 & 095 in October 2006.

This modification proposal will improve the accuracy, equitability and efficiency of gas settlement processes, by ensuring more accurate allocation of costs to Shippers and market sectors and will therefore better facilitate the achievement of the relevant objectives, by the securing of effective competition between relevant Shippers and relevant Supplier, in accordance with Special Standard Condition A11 of the Gas Transporter Licence.

5. Consequence of not implementing this proposal

Should this modification proposal not be implemented the current arrangements will continue to be inequitable. The existing perverse incentives, which are incumbent

within the existing arrangements, will continue to exist and significant amounts of energy will continue to be allocated to the incorrect market sector i.e. this will be allocated in aggregate across SSP's, rather than being correctly applied to the LSP sector.

6. Implementation

As detailed within the modification proposal itself, in the event that this modification is approved, BGT recommend that implementation of the proposal is undertaken with immediate effect and is applied to the End of Year Reconciliation calculations for the Gas Year 2006/7.

Due to the nature of this proposal, as a follow-up to the rejected modification proposal 096, we recommend that the Authority cross references the responses to this consultation to those provided to 096, as BGT believe that it would be fallacious for a Shipper to argue against the implementation of 096 and subsequently argue that 0136 does not provide a strong enough incentive to monitor and pursue threshold crosser appeals.

Should you have any queries with regard to this response please do not hesitate to contact me.

Yours sincerely

Chris Wright
Commercial Manager

Appendix A

Reconciliation following AQ Amendment

Modification Proposal 640 Adjustments – 2004/5 Gas Year

	(mWh)
Initial Threshold Crosser Volume established	4,093,625
Less Exclusions Applied	
Shipper Transfers	989,372
Appealed during appeals window	205,916
Increases less than 15k and 20%	75,878
SSP to LSP after appeals window (no reconciliation)	341,787
Other Reasons (e.g. Duplicates)	149,098
Final Reconciliation Volume	2,331,574
Unreconciled Volume due to exclusions	1,271,166

Source for data above: xoserve

BGT have calculated that based upon Mod640 Reconciliation invoices for the 2004/5 Gas Year, non-reconciliation of 'Appealed during appeals window' upward threshold crossers represents **c£3m** of misallocated charges between the SSP and LSP markets.

Modification Proposal 640 Adjustments – 2005/6 Gas Year

	(mWh)
Appealed during appeals window	435,800

Source for data above: xoserve

BGT have calculated that based upon Mod640 Reconciliation invoices for the 2005/6 Gas Year, non-reconciliation of 'Appealed during appeals window' upward threshold crossers represents **c£10m** of misallocated charges between the SSP and LSP markets.