

**Draft Modification Report**  
**Amendment of "User SP Aggregate Reconciliation Proportion" to incorporate historical**  
**AQ Proportions**  
**Modification Reference Number 0171 / 0171A**  
**Version 2.0**

This Draft Modification Report is made pursuant to Rule 9.1 of the Modification Rules and follows the format required under Rule 9.4.

**1            The Modification Proposal**

Proposal 0171

The current method of calculating a Shipper's share of an Aggregate NDM Reconciliation charge within an LDZ is based on their proportion of Aggregate LDZ AQ in the month before the invoice is issued. This therefore means that a Shipper will be billed for the proportion of energy that is to be recovered based on the percentage of energy that they are currently liable for within that LDZ, and not on the proportion of energy that they were liable for at the time that the adjustment seeks to correct. This is not an equitable solution, as can clearly be seen in the recent reconciliation issue in the South East LDZ, where shippers picked up a share of a £25.8m reconciliation based on their current AQ holdings within the LDZ, even though some of them had not been active in this LDZ during the whole of the six year period that this invoice spanned.

The current regime acts as a barrier to entry for new Shippers entering the UK market as they may incur costs for a period before they commenced commercial activities. It also inhibits competition as Suppliers could be penalised by offering more attractive terms to gain new customers. Any Shipper taking on new customers will inherit the risk that a large reconciliation invoice may be issued for costs going back to 1<sup>st</sup> Feb 1998 (or the current effective backstop date following the implementation of UNC Modification 152V should any reconciliation take place after April 1, 2008). In extremis it could create pricing issues in a Supplier of Last Resort situation.

Under the current regime the energy charges and transportation charges are calculated on a daily basis for the period that it is being reconciled, and it is proposed that the Shipper's share of charges for this period are also calculated based on their historical AQ holdings at the time the error took place on a monthly basis. This will ensure that any costs/credits are targeted at those Shippers who have actually accrued them rather than the ones that are active in the market at the time the reconciliation invoice is issued.

It is recognised that due to changes in the Shipping community there may be instances when not all the costs can be recovered, for instance due to a Shipper becoming insolvent. It is additionally proposed that under these circumstances those monies that cannot be recovered should be smeared across the industry based on Shippers' proportion of AQ holdings within that LDZ on the dates that the costs were incurred. In the case of a User being merged with or acquired by another User, the existing post-merger User or the User that carried out the acquisition will be liable in relation to the former User.

It should be noted that this proposal is intended to apply to both credit and

debits.

Failure to implement this proposal will mean that Shippers will continue to pick up their share of any reconciliation based on their AQ holdings at the time that the invoice is issued, creating a barrier to entry for any new Shippers and those that wish to gain market share. Furthermore failure to implement this proposal will continue to ensure that there is no correlation between the energy delivered during the reconciliation period and the proportion of the reconciliation invoice that shippers are exposed to, and therefore transportation charges will not be cost reflective.

For the purposes of clarity it should be noted that this process should only be applied in cases where the reconciliation amount is a minimum of 50 GWhs. This is aimed specifically at adjustments to NTS/LDZ offtakes, which, we have been informed, Xoserve can manage via an off line solution.

### Proposal 0171A

Modification proposal 0171 raised by RWE Npower seeks to change retrospectively the arrangements for the allocation of LDZ Aggregate charges.

Shippers contract for the services associated with the Uniform Network Code for a given gas day/s on the basis of the arrangements that are in place at that time. It is widely understood and accepted that reconciliations may take place after a given gas days. However this is on the basis that such reconciliations will be applied in accordance with those arrangements that were set out and in effect at the time of those particular gas day/s.

The retrospective nature of the RWE Npower proposal is a fundamental flaw. Retrospection introduces commercial uncertainty, undermining confidence around industry rules and trading arrangements. This creates unacceptable levels of risk that destabilise competition, and stimulate inflated risk premiums.

Ofgem have to date consistently opposed retrospective changes to industry arrangements, and most recently stated the following in their decision letter regarding UNC modifications 117 and 0122 issued 20<sup>th</sup> December 2006.

"We consider that retrospective changes to industry codes will damage market confidence in, and the efficient operation of, the trading arrangements. Rather than protecting participants from "unforeseen unfairness" we take the view that signatories would generally prefer the assurance and certainty of rules that are unlikely to be changed retrospectively. We consider that there are generally accepted and well understood legal reasons why retrospective modifications are to be avoided. It is a general principle of law that rules ought not to change the character of past transactions completed on the basis of the then existing rules"

This Alternative proposal (0171A) raised by British Gas seeks to avoid the issues of retrospection by specifying a revision of the present arrangements for back dated charges but only from a fixed future date.

We propose that from 1/4/2008, or an alternate future implementation date to be specified by the Ofgem and enacted by the Transporters, hereafter referred

to as the "Proposed Effective Date", that reconciliations covering a period after this date be allocated based on daily AQ share, as described in more detail further on.

By changing the regime from some future date shippers can take an informed view of the enduring regime, and apply the appropriate risk premiums or discounts based upon their view of the regime, and the likely directional shifts in their portfolio. This also means that such risk premiums or discounts can be applied to those customers to whom any back dated charges may relate. Unlike 0171 this proposal, 0171A, does not seek to impose charges upon shippers that can apply to customers who are no longer supplied by them, and for whom there is no mechanism for recovering backdated costs.

This proposal provides new Shippers, entering the UK market after the "Proposed Effective Date", confidence that they will not incur charges that relate to a period prior to their market entry. In addition this Alternative proposal provides new and existing Shippers confidence that they can make commercial decisions based on a regime that will not be changed retrospectively.

British Gas proposes that, from the "Proposed Effective Date", LDZ Aggregate reconciliations are levied based upon historical daily AQ share. Any element of the charge that relates prior to this date will be applied based upon suppliers' market share as at implementation of this modification.

Where a reconciliation period crosses the cut-over date between the existing and new arrangements, xoserve will calculate the volume for the period prior to cut over and this will be charged based on AQ share at cut-over, the period post the "Proposed Effective Date" will be reconciled using a daily AQ share.

It is recognised that due to changes in the shipping community which occur after the "Proposed Effective Date", there may be instances when not all the costs can be recovered, for instance due to a Shipper becoming insolvent. It is additionally proposed that under these circumstances such monies that cannot be recovered and relate to a period prior to the "Proposed Effective Date" should be smeared across the industry based upon Shippers' proportion of the AQ holdings within that LDZ at cut-over. Costs which cannot be recovered and relate to a period after the "Proposed Effective Date" will be smeared based on AQ holdings on the dates that the costs were incurred. In the case of a User being merged with or acquired by another User, the existing post-merger User or the User that carried out the acquisition will be liable in relation to the former User.

Because this proposal seeks to change the regime prospectively Shippers can take an informed view of the potential for such charges being applied, and can adjust prices accordingly. If Shippers believe their potential exposure to invoice adjustments has increased further to the liquidation of another Shipper or Shippers, they can adjust prices accordingly, and immediately.

We should stress that modification proposal 0171 magnifies the issues associated with Shipper failures because it seeks to apply charges that relate further back and to apply them retrospectively. Shippers have had less opportunity to apply any risk premium or credit because the customers to which these charges relate may no longer be supplied by them, and the period

of time to which they apply is greater, and has already elapsed.

It should be noted that this proposal is intended to apply equally to both credits and debits.

For the purposes of clarity it should be noted that the revised reconciliation arrangements proposed herewith are only to be applied where the reconciliation amount is a minimum of 50 GWhs. This proposal is specifically aimed at adjustments to NTS / LDZ offtakes. We believe that this can be managed by xoserve via an off line solution, and that a demarcation line of 50 GWhs is a reasonable balance between introducing added complexity and cost in to industry processes and improving the equitability of cost allocation. Users are able to propose further alternatives thresholds should they see fit.

Failure to implement this proposal will mean that the present barrier to entry for any new shipper or those seeking to gain market share that are associated with the allocation of historical costs shall persist.

## **2 Extent to which implementation of the proposed modification would better facilitate the relevant objectives**

***Standard Special Condition A11.1 (a): the efficient and economic operation of the pipe-line system to which this licence relates;***

Implementation would not be expected to better facilitate this relevant objective.

BGT 0171A Proposal stated: Implementation would ensure costs are better targeted at those that incur them.

***Standard Special Condition A11.1 (b): so far as is consistent with subparagraph (a), the coordinated, efficient and economic operation of***

- (i) the combined pipe-line system, and/ or***
- (ii) the pipe-line system of one or more other relevant gas transporters;***

Implementation would not be expected to better facilitate this relevant objective.

***Standard Special Condition A11.1 (c): so far as is consistent with subparagraphs (a) and (b), the efficient discharge of the licensee's obligations under this licence;***

Implementation would help ensure that costs are targeted at those who incur them, facilitating the licence objective of cost reflective charges.

***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;*

Implementation would help ensure that costs are targeted at those who incur them, consistent with facilitating the securing of effective competition. Implementation would also remove a potential barrier to entry to any new Shippers entering the GB gas market, and those entering new areas outside of their traditional core business.

BGT 0171A Proposal stated:

Implementation would secure effective competition between relevant shippers, suppliers and DN operators by:

- 1) Ensuring better targeting of costs and by removing from the date of implementation a potential barrier to entry from any new shipper entering the UK, and those entering new areas outside their core business.
- 2) Protecting the fundamental principle of commercial certainty. Existing and new market entrants would have confidence that the market conditions are sufficiently stable to enable the pricing decisions that they make to be based upon an informed view of risk.

*Standard Special Condition A11.1 (e): so far as is consistent with subparagraphs (a) to (d), the provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards... are satisfied as respects the availability of gas to their domestic customers;*

Implementation would not be expected to better facilitate 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;*

Implementation would not be expected to better facilitate this relevant objective.

BGT 0171A Proposal stated:

The introduction of a retrospective Modification such as RWE Npower Proposal 0171 could act as a trigger for multiple retrospective Modifications. Specifically Shippers would be encouraged to raise Modifications that seek commercial advantage from any directional shift in the shape of their portfolio, after that directional shift had occurred.

Such retrospective Modifications would undermine the stability of the Uniform Network Code, creating a surge in Modification activity and increased administration costs. This modification avoids such precedent.

**3 The implications of implementing the Modification Proposal on security of supply, operation of the Total System and industry fragmentation**

No such implications have been identified for Proposal 0171.

Proposal 0171A avoids creating a precedent for retrospection; such retrospection could undermine any element of the Uniform Network Code or party to it. This extends to operation of the total system and to security of supply in that Users may have less confidence that the arrangements that apply to these are stable and will not be retrospectively altered.

**4 The implications for Transporters and each Transporter of implementing the Modification Proposal, including:**

**a) Implications for operation of the System:**

No implications for operation of the system have been identified.

**b) Development and capital cost and operating cost implications:**

xoserve has indicated that an offline process should be able to handle such events although costs have not yet been quantified.

An offline process could be used to deal with the revised arrangements set out in Proposal 0171A.

**c) Extent to which it is appropriate to recover the costs, and proposal for the most appropriate way to recover the costs:**

No cost recovery mechanism has been proposed.

**d) Analysis of the consequences (if any) this proposal would have on price regulation:**

No consequence for price regulation has been identified.

**5 The consequence of implementing the Modification Proposal on the level of contractual risk of each Transporter under the Code as modified by the Modification Proposal**

No such consequence is anticipated.

The proposer of 0171A believes that the Proposal will not have any effect on the Transporters' level of contractual risk. Whereas Modification Proposal 0171 would undermine the whole basis of the Uniform Network Code by introducing the concept of retrospection and so creating uncertainty and increased levels of risk.

**6 The high level indication of the areas of the UK Link System likely to be affected, together with the development implications and other implications for the UK Link Systems and related computer systems of each Transporter and Users**

xoserve has indicated that an offline process should be able to handle such events although costs have not yet been quantified.

**7 The implications of implementing the Modification Proposal for Users, including administrative and operational costs and level of contractual**

**risk**

***Administrative and operational implications (including impact upon manual processes and procedures)***

No material implications have been identified with respect to 0171.

The proposer believes Modification 0171A avoids the surge in administrative activity that could arise from the flood of retrospective Modifications that would be triggered by the RWE Npower Proposal.

***Development and capital cost and operating cost implications***

No such costs have been identified.

***Consequence for the level of contractual risk of Users***

Reduces contractual risk for those with a portfolio that is larger than when the error occurred, and vice versa.

The proposer believes Proposal 0171A avoids the significant increase in contractual risk that would result from the Modification Proposal 0171. Because this Alternative Proposal does not seek to introduce retrospection, it does not undermine the whole basis of commercial certainty surrounding the Uniform Network Code.

**8      **The implications of implementing the Modification Proposal for Terminal Operators, Consumers, Connected System Operators, Suppliers, producers and, any Non Code Party****

No such implications have been identified.

The proposer believes Proposal 0171A avoids the significant and unacceptable impacts that could flow through to third parties, not least inflated risk premiums applied by Shippers in order to protect themselves from unforeseeable retroactive changes to the Uniform Network Code.

**9      **Consequences on the legislative and regulatory obligations and contractual relationships of each Transporter and each User and Non Code Party of implementing the Modification Proposal****

No such consequences have been identified.

The proposer believes Proposal 0171A avoids setting a precedent whereby obligations can be changed retrospectively and "historical performance" becomes non-compliant. Thus creating regulatory uncertainty.

**10     **Analysis of any advantages or disadvantages of implementation of the Modification Proposal****

**Advantages**

- Costs more accurately apportioned to those who incur them, in line with the "polluter pays" principle.

- Reduces barriers to entry for new Shippers/Suppliers entering the GB market.
- Protects those Suppliers who are seeking to gain market share through offering more attractive prices from incurring costs not associated with previous activity.

BGT 0171A Proposal provided the following Advantages:

- This Alternative Proposal improves the ability of Shippers to price accurately by apportioning costs more accurately to them.
- This Alternative Proposal is not retrospective and so does not present a barrier to entry that arises from lack of confidence in the industry rules and trading arrangements.
- From the date of its implementation this Alternative Proposal will remove the barrier to entry associated with the allocation of historical costs.
- From the date of its implementation this Alternative Proposal will protect suppliers who are seeking to gain market share in the same way as the Npower Modification.
- This Alternative Proposal avoids the precedent of initiating retrospective Modifications that seek commercial advantage from a directional shift in a Shipper's portfolio AFTER that directional shift has occurred.

**Disadvantages**

- xoserve have indicated that there could be some costs involved.

BGT 0171A Proposal provided the following Disadvantage:

- In some cases a credit or debit results in a reciprocal increase or reduction in charges to ensure that revenues match those allowed. Under Proposal 0171A and to a greater extent Modification Proposal 0171 there is potential for Shippers to receive charges one way i.e. based on historic market share, and credits a different way i.e. based on present market share.

**11 Summary of representations received (to the extent that the import of those representations are not reflected elsewhere in the Modification Report)**

*Written Representations are now sought in respect of this Draft Report.*

**12 The extent to which the implementation is required to enable each Transporter to facilitate compliance with safety or other legislation**

Implementation is not required to enable each Transporter to facilitate compliance with safety or other legislation.

**13 The extent to which the implementation is required having regard to any proposed change in the methodology established under paragraph 5 of**



**Condition A4 or the statement furnished by each Transporter under paragraph 1 of Condition 4 of the Transporter's Licence**

Implementation is not required having regard to any proposed change in the methodology established under paragraph 5 of Condition A4 or the statement furnished by each Transporter under paragraph 1 of Condition 4 of the Transporter's Licence.

**14 Programme for works required as a consequence of implementing the Modification Proposal**

No programme of works has been identified as a consequence of implementing the Modification Proposal.

**15 Proposed implementation timetable (including timetable for any necessary information systems changes and detailing any potentially retrospective impacts)**

Proposal 0171 suggests implementation within two months of receipt of direction from Ofgem.

Proposal 0171A suggests a target implementation date of 01 April 2008, or on a future date to be determined by Ofgem in directing implementation and by the Transporters in enacting that implementation direction.

**16 Implications of implementing this Modification Proposal upon existing Code Standards of Service**

No implications of implementing this Modification Proposal upon existing Code Standards of Service have been identified.

**17 Recommendation regarding implementation of this Modification Proposal and the number of votes of the Modification Panel**

**18 Transporter's Proposal**

This Modification Report contains the Transporter's proposal to modify the Code and the Transporter now seeks direction from the Gas and Electricity Markets Authority in accordance with this report.

**19 Text**

**Representations are now sought in respect of this Draft Report and prior to the Transporters finalising the Report.**

For and on behalf of the Relevant Gas Transporters:

**Tim Davis**  
**Chief Executive, Joint Office of Gas Transporters**