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

8th January 2008

Dear Julian,

RE: MODIFICATION PROPOSAL 0171 – Amendment of "User SP Aggregate Reconciliation Proportion" to incorporate historical AQ Proportions

British Gas are strongly opposed to the implementation of this modification proposal, and have raised an alternative proposal 0171A.

We have set out in detail under the following headings, why we believe that modification proposal 0171 is fundamentally flawed and compromises the achievement of the relevant objectives of the Uniform Network Code.

1. Executive Summary
2. Background
3. The Modification Proposal
4. Advantages of the Proposal
5. Disadvantage of the Proposal
6. Consequence of implementation

1. Executive Summary

Modification Proposal 0171 seeks to change the way that historical charges are apportioned. Crucially this proposal seeks to change the charging arrangements for invoices that pre-date the modification implementation date. British Gas are supportive of prospective change of the present cost allocation regime, but do not support retrospective changes to the Uniform Network Code.

Modification 0171 is retrospective in nature as it seeks to amend the trading arrangements after they have occurred. Under the present market structure Shippers enter into a contract to take gas on a Gas Day, with the knowledge that they may be subject to future reconciliation according to the reconciliation rules that prevail on that Gas Day. By seeking to amend the process for reconciliation after the event Npower's modification 0171 would therefore retrospectively change the market arrangements.

Retrospective changes to industry codes damage market confidence in, and the efficient operation of, trading arrangements. The application of retrospective change creates market uncertainty and introduces incalculable levels of risk. This stimulates the application by participants of inflated risk premiums as they seek to protect their commercial interests. Therefore whilst the total costs that are being allocated differently by 171 would not change, the introduction of additional risks and the inevitable premiums that would flow on would increase costs to the overall customer.

Such market instability introduced by the application of retrospective change provides a significant barrier to entry to new market entrants. The advantages to new shippers entering the market, and existing ones seeking to increase market share are identical for both 0171 and 0171A. However 0171, unlike 0171A through its retrospective nature and the precedents that it would set impairs confidence in the market arrangements and certainty thereof.

It might be argued that modification proposal 0171 seeks to change the way historical costs are allocated and that any changes to arrangements for allocation of such historical costs must by their very nature be retrospective. This is absolutely not the case, indeed in our alternative modification 0171A we suggest new arrangements for the application of historical charges, but we propose that they are applied from a future date. It is possible to improve the enduring regime, to the advantage of any new market entrants, without compromising the integrity of the market and deterring new entrants through the application of a retrospective change.

Modification 0171 seeks to impose charges upon shippers that apply to customers who are no longer supplied by them, and for whom there is no mechanism for applying a backdated charge. Because the Npower proposal is retrospective Shippers have not had the opportunity to apply to such customers a risk premium or discount. By changing the regime from some future date as per our proposal 0171A 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 that ultimately any back dated charges may apply.

The Npower proposal seeks to secure commercial advantage from a directional shift in a shippers portfolio AFTER that directional shift has occurred. This is clearly an unwelcome precedent and if approved would stimulate a raft of modification proposals from other shippers similarly seeking the same commercial advantage.

If a precedent for retrospection was set via modification proposal 0171 then it may be, in our opinion, more difficult for the Authority to reject a number of other “retrospective proposals” including for example the retrospective application of modification 0640. With modification 0640 there is a far stronger argument for retrospective correction of charges that had been incorrectly calculated as a direct result of erroneous shipper inputs.

Modification 0171 through its retrospective nature does not better facilitate the relevant objectives. The proposal compromises competition, will result in less efficient operation of the Pipeline System, increase the complexity and administration of the Uniform Network Code and will also have a raft of additional unintended consequences, such as an increase in costs to customers as Shippers seek to protect themselves from an increase in risk by way of an increase in risk premiums, or as a new deterrent to market entry as confidence in the market arrangements are undermined.

Modification 0171A improves the targeting of costs but without introducing diminishing confidence in the market arrangements. It therefore better facilitates competition, and so better facilitates the relevant objectives.

2. Background

Modification 0171 seeks to retrospectively amend the cost allocation methodology for reconciliations greater than 50GWhs.

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 20th 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”

When contracting with customers Shippers can take a view of the enduring regime, and apply appropriate risk premia or discounts based upon their view of the regime at that time. Retrospective amendments to the market arrangements remove Shipper’s ability to calculate risk premia with any degree of confidence and so undermine the basis on which the market has been developed.

3. The Modification Proposal

This modification proposal seeks only to address very large reconciliations, caused as a result of the identification of errors with the LDZ measurement process. These errors are often only identified after a considerable period of time after they have occurred and by their very nature the reconciliation periods involved are protracted, during which time significant shifts may have occurred within a shipper’s portfolio.

This proposal imposes charges upon shippers which relate to customers who are no longer supplied by them, and for whom there is no mechanism for recovering backdated costs.

Npower refer in their modification proposal to a “polluter pays” principle without acknowledging that the parties to whom they seek to retrospectively apply additional cost have had no influence over the manifestation of such historical charges.

British Gas accept however, that there is need for reform to the current allocation methodology and so have proposed and alternate modification 171A. By changing the methodology prospectively, i.e. from a future date, Shipper’s are able to take an informed view of both their portfolio position and risk exposure to this type of error, this allows them to develop suitable risk premia and so ensure that costs are effectively targeted, in contrast to Npower’s modification proposal

4. Advantages of the Proposal

British Gas accept that the current methodology for allocating large reconciliations is inequitable and may act as a barrier to entry, as under the current regime new entrants may be exposed to costs which relate to periods prior to their entering the market.

We therefore also accept that there is need for reform to the current arrangements and that there is merit in the proposal that large reconciliations of this nature should be targeted to the shippers who were active at the time that the error occurred. However we do not believe that a retrospective amendment to the arrangements would create either a more equitable market or suitably remove a barrier to market entry, as previously stated by Ofgem, retrospective changes damage both market confidence and the efficient operation of trading arrangements. By introducing a retrospective change, the implementation of this modification would replace one barrier to entry with another.

British Gas’ alternative modification proposal 171A addresses all of the issue that Npower’s modification does, without introducing a retrospective change to the arrangements.

For the period prior to our suggested implementation reconciliations would still be calculated using the current methodology, but it should be recognised that where under the current regime a Shipper is exposed to costs for a period prior to their market entry or based on a period when they had a smaller market share, they will have recognised and accepted this risk at the point that they acceded to the UNC. Furthermore, they will have had the opportunity to develop within their product development a risk premium to offset against the exposure to these costs and will have recovered these premia from their customers.

5. Disadvantages of the Proposal

In addition to the key disadvantage of this proposal, namely the introduction of retrospective change to the market arrangements, we belive that modification 0171 provides a lesser degree of accuracy than our alternative proposal 0171A through it’s use of monthly average values.

Throughout the development of this proposal at Distribution Workstream, there was a considerable amount of discussion around how the ‘historic market share allocation’ would be calculated. In their initial draft of this modification and throughout subsequent discussions, Npower actively sought a daily market share allocation and made a number of arguments as to why this was preferable to an average monthly value.

Through development the Distributors explained that it would not be possible to show a daily figure as their systems only hold the aggregated monthly values and that once they had calculated the monthly aggregated totals the daily figures were no longer required and so had not been retained.

In our alternate proposal, 0171A, British Gas have opted to retain the ‘daily allocation’ originally suggested by Npower as we agree that this is preferable to using monthly averages. As our modification proposal is prospective in nature rather than retrospective there is no dependency in our modification on historic data and so a daily allocation would be achievable.

With regards to Standard Special Condition A11.1 of the Gas Transporters’ Licence and the impact upon the relevant objectives;

Standard Special Condition A11.1 (a) The efficient and economic operation of the pipeline system.

We do not support Npower’s assertion that their modification ensures that costs are targeted to those who incur them. As we have already demonstrated, retrospective implementation of this modification would expose Shippers to costs for customers which they no longer supply and have no means of recovering from. To date Ofgem have given strong and clear signals to the market that retrospective changes will not be implemented; Shippers operating in the market have based their risk premia around this principle. We would again refer to Ofgem’s decision letter dated 20th December 2006 which clearly sets out Ofgem’s view that retrospective amendment to the trading arrangement damage the efficient and economic operation of trading arrangements.

Standard Special Condition A11.1 (d) the securing of effective competition (i) between relevant shippers and (ii) between relevant suppliers, by removing a potential barrier to entry to any new Shippers entering the UK, and those entering new areas outside of their traditional core business

This modification would set a precedent for further retrospective changes to the market arrangement and so would result in increased uncertainty in industry arrangements, a lack of confidence in procurement and investment decisions.

As we have demonstrated the implementation of this retrospective change to the arrangements would result in the replacement of a perceived barrier to entry with the creation of a new one.

6. Consequence of implementing this proposal

If implemented this modification would set a precedent for other retrospective changes to the industry arrangements and so would potentially destroy confidence in the market’s stability.

British Gas would expect to see a plethora of modifications generated by parties seeking to retrospectively change arrangements to move costs between market sectors and parties. Furthermore we would expect to see significant challenge to Ofgem’s previous decisions on modifications that have a retrospective nature.

This modification, if implemented, would result in the application of excessive risk premiums by all parties in an effort to protect themselves from unstable market arrangements, where costs can be imposed upon them for past transactions following changes to the basis of the arrangements that existed at the time that the transaction occurred.

In summary, Modification 0171 and 0171A would offer identical advantages in terms of cost allocation to a shipper that enters the market or grows market share after the date of implementation. However the retroactive nature of 0171 would mean that new market entrants were deterred via the introduction of a barrier to entry, namely lack of certainty in the market arrangements, brought about by the introduction of retrospective changes. In addition overall costs to customers would increase because whilst aggregate costs allocated directly to the whole shipping community may stay the same, total risk would increase and end users could pay for that risk by way of risk premiums passed on to them.

Yours sincerely,

Mitch Donnelly

Regulatory Manager