Modification proposal:	**Uniform Network Code (UNC) 194, 194A, 228, 228A and 229: These proposals deal with the identification and apportionment of costs of Unidentified Gas**		
Decision:	The Authority[1] directs that UNC229 proposal be made[2]		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	26 May 2010	Implementation Date:	To be confirmed by the Joint Office

Background to the modification proposal

Reconciliation by Difference (RbD) was introduced, following the launch of competition to the domestic gas market. RbD is the method of reconciling the difference between actual (metered) and deemed (estimated) measurements of gas. It was introduced in 1998 in order to facilitate competition in the Small Supply Point (SSP) sector, as at the time it was not considered practical to individually reconcile all supply points in this sector (which numbered around 20 million on average during 2008) based on actual meter readings. The introduction of RbD was designed to offer an efficient mechanism for reconciling consumption in the Large Supply Point (LSP) sector to that in the SSP sector, as a cost-efficient alternative to individual meter point reconciliation for each SSP consumer, which would require development of an extensive system at considerable cost. RbD was established to manage errors in the allocation of gas to shippers in the SSP market. Such errors may be caused by theft or gas offtaken at late registered or unregistered sites.

Gas that is not directly attributed to a shipper is known as Unidentified Gas. It is treated as a smeared cost for all shippers operating in the SSP market. By contrast, no volumes of Unidentified Gas are attributed to the LSP sector.

UNC Modification Proposals 115 and 115A

Two previous modifications proposals, UNC115 and UNC115A (Correct Apportionment of NDM Error) had sought to tackle the imbalance of the SSP sector bearing all costs of Unidentified Gas. Both proposals were rejected by Ofgem on 25 October 2007. In the decision letter for these modification proposals, we said that neither proposal addressed the underlying issues which contribute to the volumes of Unidentified Gas, which we considered were leading to a higher than acceptable RbD charge. For example, no measures to introduce incentives for the SSP or LSP sectors to reduce the quantity of gas allocated to the RbD process were proposed. However, Ofgem did consider that exposing LSP shippers to the costs of RbD may provide a diluted incentive for them to seek improvements.

Ofgem's decision letter considered that an assessment of RbD would require consideration of each contributing factor to the RbD costs to be assessed in turn and if possible quantified. Ofgem observed that the proposals "have made a convincing case for LSP sites to make a contribution to RbD costs", but also noted that the proposals did not provide sufficient evidence as to how big that contribution should be.

[1] The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.
[2] This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.

The modification proposals

UNC Modification Proposals 194, 194A, 228, 228A and 229

This decision letter sets out the Authority's decisions for UNC Modification Proposals 194, 194A, 228, 228A and 229. Collectively, these proposals seek to address the equity of the allocation of gas which cannot be identified as being the responsibility of any one shipper.

These modification proposals seek to introduce methods for allocating an element of unallocated gas to the appropriate parties.

- UNC Modification Proposal 194 (UNC194) seeks to introduce an RbD Allocation Table to the UNC which would apportion a percentage of Unidentified Gas to the SSP, Non-Daily Metered (NDM) LSP and Daily Metered (DM) LSP sectors. The proposal did not seek to populate this table with values. Such values were intended to be added and amended by further modifications to the UNC.

- UNC Modification Proposal 194A (UNC194A) is an alternative proposal to UNC194 that seeks to introduce a table to the UNC which would apportion a fixed volume of Unidentified Gas to the NDM LSP and DM LSP sectors. As with UNC194, the values to populate this table were intended to be added and amended by further modifications to the UNC.

- UNC Modification Proposal 228 (UNC228) seeks to populate the RbD Allocation Table introduced under UNC194 with percentage values to reflect the expected distribution of Unidentified Gas to each industry sector and to introduce a methodology to arrive at those values.

- UNC Modification Proposal 228A (UNC228A) is an alternative proposal to UNC228 that seeks to populate the Large Supply Point Unidentified Gas Allocation Table introduced under UNC194A with a fixed volume of gas, and to introduce a methodology to arrive at this fixed volume.

- UNC Modification Proposal 229 (UNC229) seeks to introduce a table broadly in line with that envisaged by UNC194A and to introduce the role of an independent expert to apportion values within this table on an enduring basis.

We published an impact assessment (IA) on the proposed modifications in November 2009[3] that discussed each of the proposed modifications in detail together with the background of the issues. It also set out our minded-to view to accept UNC229 and reject the remaining proposals.

[3] Identification and Apportionment of Costs of Unidentified Gas (reference 143/09) may be found on the Ofgem website: http://www.ofgem.gov.uk/Licensing/GasCodes/UNC/Ias/Documents1/Unidentified%20Gas%20-%20RIA%20final%20version.pdf.

UNC Panel[4] recommendation

UNC194 and UNC194A

At the Modification Panel meeting held on 20 November 2008, of the eight Voting Members present, capable of casting ten votes, three votes were cast in favour of implementing UNC194. Therefore the Panel did not recommend implementation of this Proposal. At the same meeting, seven votes were cast in favour of implementing UNC194A. Therefore the Panel recommended implementation of UNC194A.

The Panel then proceeded to vote on which of the two Proposals (the original or its alternative) would be expected to better facilitate achievement of the Relevant Objectives[5]. Of the eight Voting Members present, capable of casting ten votes, one vote was cast in favour of implementing UNC194 in preference to UNC194A, and eight votes were cast in favour of implementing UNC194A in preference to UNC194. Therefore, the Panel determined that, of the two Proposals, UNC194A would better facilitate the achievement of the Relevant Objectives.

UNC228 and UNC228A

At the Modification Panel meeting held on 19 March 2009, of the eight voting Members present, capable of casting nine votes, two votes were cast in favour of implementing UNC228. Therefore the Panel did not recommend implementation of this Proposal. At the same meeting, four votes were cast in favour of implementing UNC228A. Therefore the Panel did not recommend implementation of UNC228A.

The Panel then proceeded to vote on which of the two Proposals (the original or it's alternative) would be expected to better facilitate achievement of the Relevant Objectives. Of the eight Voting Members present, capable of casting nine votes, one vote was cast in favour of implementing UNC228 in preference to UNC228A, and five votes were cast in favour of implementing UNC228A in preference to UNC228. Therefore, the Panel determined that, of the two Proposals, UNC228A would better facilitate the achievement of the Relevant Objectives.

UNC229

At the Modification Panel meeting held on 18 June 2009, of the ten Voting Members present, capable of casting ten votes, five votes were cast in favour of implementing this Modification Proposal. Therefore the Panel did not recommend implementation of UNC229.

[4] The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.
[5] The UNC Relevant Objectives can be found at: http://www.gasgovernance.co.uk/UNC.

Impact assessment

We received 16 responses to the IA[6]. Broadly, respondents were in favour of the implementation of UNC229, although some respondents had concerns about the arrangements for the appointment of the Allocation of Unidentified Gas Expert[7] (AUGE) and the length of time the appointment process may take. Some of those respondents advocated the implementation of proposal UNC228 or UNC228A as an interim measure until such time as the AUGE could be appointed and implement a methodology for the apportionment of unidentified gas. In this section we summarise respondents' views to the IA on each of the proposed modifications below. We then set out the response to some of the broader issues.

UNC 228 and UNC228A

Five parties considered that either UNC228 or UNC228A should be implemented in the short term. Seven parties were strongly opposed to the implementation of either option. Four parties did not comment as to whether they supported these proposals as an interim solution.

One respondent that supported introducing UNC228A presented a cost benefit analysis assessing the fixed costs of implementing the modification and the anticipated cost reduction to domestic consumers. They concluded that there would be a net benefit to implementing UNC228A as an interim measure after seven months. By contrast, one confidential response to the IA suggested that the xoserve data had overestimated the benefits to domestic customers in the SSP market. Others questioned the assumptions and the methodology that supported the figures proposed in UNC228 and UNC228A. No respondents supported UNC228 or UNC 228A as an enduring solution.

UNC194 and UNC194A

No parties explicitly referred to adopting UNC194 or UNC194A.

UNC 229

Thirteen respondents considered UNC229 to be the preferred long term solution. Of the other three respondents, one was strongly opposed to the proposal in the short term whilst still considering it to be a long-term viable option. The other two respondents considered that a clear methodology, Terms of Reference document, and legal text should be agreed under an alternative modification proposal. There were a number of areas of concern identified with UNC229 as currently drafted. Parties expressed concern over a potential lack of balance in the voting parties on the UNCC. In their IA response, British Gas noted that "The constitution of the UNC Panel is currently weighted in favour of those suppliers predominantly active in the LSP sector, and therefore those suppliers with an incentive to dilute and delay reallocation proposals". Another issue raised was

[6] Responses to the IA can be found at: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=24&refer=Licensing/GasCodes/UNC/Ias.

[7] The AUGE would collect the requisite information to produce an Allocation of Unidentified Gas Statement (AUGS), which would allow for a fixed volume of gas to be allocated to the LSP sector, in a similar fashion to the LSP Unidentified Gas Allocation Table introduced by UNC194A. The table would be reviewed at appropriate intervals and would not require further modifications to amend the values. The values provided by the AUGE would be supported by evidence, and no User would be able to influence this work but would have a right of appeal to Ofgem in the event that the third party had not followed their mandate. Any changes to the AUGS proposed by the AUGE would be implemented in the following gas year.

the potential long lead time in the appointment process. Many respondents noted that the proposal's implementation time was likely to be between one and two years. There were also lesser concerns regarding the methodology to be employed in choosing the AUGE, the scope of activities carried out by the AUGE itself, and the number of opportunities for parties to question the AUGE's decisions. This methodology is set out in the guidance document associated with the Final Modification Report (FMR).

Seasonality and risk sharing

In the IA we said that further investigation would be required before any relationship between seasonality and the component factors of RbD is demonstrated. In the IA we also considered that any methodology introduced by a third party expert could be developed to reflect seasonal load patterns in the volume of gas charged to this sector, providing adequate notice was given so that supply contracts could be adapted to reflect the change.

With respect to risk sharing, in the IA we noted that structural differences between the LSP and SSP sectors (most notably the nature of contracting in the LSP sector) may make it difficult at present for LSP shippers to pass on additional costs without fundamentally altering contracts with their customers. This argument received mixed responses, where on the one hand it was noted by British Gas[8] that "suppliers generally retain the right to 're-open' contracts so that they can take account of new regulatory charges". On the other hand, it was felt by some respondents that there would be an impact on competition in the short term, and one respondent considered there should be a reasonable lead time between the AUGE making its determination and those values taking effect, in order to allow shippers to factor them into their volume and pricing assumptions. Overall, we have found that risk sharing is neutral in its impact on competitive markets.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and each of the FMRs. The Authority has considered and taken into account the responses to the Joint Office's consultation on the modification proposals which are attached to the FMRs[9] and responses to the IA carried out by Ofgem. The Authority has concluded that:

1. Implementation of modification proposal UNC229 and rejection of modification proposals UNC194, UNC194A, UNC228 and UNC228A will better facilitate the achievement of the relevant objectives of the UNC[10]; and
2. Directing that the modification be made is consistent with the Authority's principal objective and statutory duties[11].

[8] British Gas IA response point 38.
[9] UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com.
[10] As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://epr.ofgem.gov.uk/document_fetch.php?documentid=6547.
[11] The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Gas Act 1986.

Reasons for the Authority's decision, and assessment against UNC Relevant Objectives

As stated in Ofgem's decision letter rejecting UNC115 and UNC115A, we consider that the arrangements for dealing with the allocation of unidentified gas should be reformed such that each market segment makes the appropriate contribution to the costs of Unidentified Gas. This section sets out Ofgem's views following the IA, addressing concerns raised by respondents to the IA with respect to each modification individually.

We have assessed all of the Proposed Modifications against the UNC Relevant Objectives. We consider that the Proposed Modifications impact on Relevant Objective (d)[12] only, and that the proposals are neutral with regards to the other Relevant Objectives. A summary of our views against Relevant Objective (d) is set out below.

UNC229

We consider that the aims and objectives of modification proposal UNC229 promote effective and efficient competition between the parties, and allow for an ongoing equitable distribution of unallocated gas charges between sectors.

Some respondents to the IA argued that the costs of procurement of an AUGE would likely be high. We consider that the tendering process will allow the industry to determine the balance between the cost of appointing an AUGE and the level of accuracy required by any process which is introduced.

In the IA Ofgem noted that the role of information providers in any process to populate the Unidentified Gas tables as introduced under UNC194 or UNC194A are not clearly defined. At present the majority of data is provided by xoserve on an ad hoc basis. This information is not available without cost, and of the modification proposals under consideration in this IA, only UNC229 considers how the analysis to inform the distribution of Unidentified Gas (through the appointment of an AUGE) should be resourced.

We note the concerns about the time that it may take to establish the AUGE and implement reforms. Ofgem considers that UNC229 offers an expedient route to establish an appropriate solution. We note that work is being undertaken by industry groups to consider refinements to UNC229. For example, modifications can be made to the guidelines referenced in UNC229 immediately following the implementation of the modification through the UNCC.

We note the concerns around the current composition of the UNCC and influence this may have upon its decisions in relation to the AUGE and the allocation methodology. However, we would expect members of that committee to act impartially, in a manner best suited to fulfilling the relevant objectives of the UNC. In the event that any Party feels the UNCC has acted inappropriately they have the opportunity to bring the matter to Ofgem's attention, either in the form of a corrective modification proposal or otherwise. UNC parties are also at liberty to raise proposals to change the composition of the UNC panel and/or the UNCC and we note that UNC Modification Proposal 294

[12] Standard Special Condition A11.1 (d): so far as is consistent with sub-paragraphs (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.

(Changes to UNC Modification Panel Constitution) has recently been raised with that intent.

UNC229 offers a route to allocate risk based on a widely researched and transparent analysis of the underlying causes of Unidentified Gas, and for a methodology to be replicated and refined in ongoing years. Unlike UNC228 and UNC228A, it does not rely upon the creation of future modification proposals to ensure that the process continues to be representative of the distribution of Unidentified Gas over time.

The introduction of the AUGE is intended to enable an appropriate methodology to be developed, using the best evidence available to determine which market sector is likely to have contributed to Unidentified Gas and how these costs should be apportioned. This approach aims to establish an enduring methodology. Whilst the concerns we raised in UNC115 are still present, as we are concerned about the lack of incentives to drive down RbD charges, the provision of an AUGE in UNC229 is a positive step to mitigate these issues. We consider that UNC229 will improve transparency and accuracy in the allocation of RbD gas to the contributing sector.

UNC 194/194A

Both UNC194 and UNC194A represent an improvement on the current arrangements, in that Unidentified Gas is allocated across LSP and SSP sectors. However, we are concerned that these proposals do not specifically provide for changes in allocation, as changes are deferred until a modification proposal has been approved.

We note that UNC194A was the only modification proposal to gain approval by the Panel. UNC194A proposes to apportion an annual fixed volumetric quantity of gas to the LSP NDM and LSP DM sectors. However, given the difficulties found in attributing values to each sector, we consider that the implementation of UNC229 with the AUGE responsible for devising the methodology for allocating unidentified gas offers a more complete solution.

UNC 228/228A

With regard to the methodology of the proposals, we accept the attraction of introducing a modification that solves the problem quickly, however, we have difficulty with the provenance of the figures provided in these proposals. The report from TPA[13], in response to the IA, questions the rationale and data of UNC228A. We recognise the desire to correct the inequality of the current allocation method. However, as in the IA, we do not consider that these proposals provide an explicit and traceable methodology for distributing Unidentified Gas. We did not receive any further data that supported the figures in the proposals for UNC228 or UNC228A. For these reasons we do not consider that either proposal facilitates effective competition.

In the IA we stated that we believed that any agreement to reallocate charges for Unidentified Gas should be based on a replicable methodology, using publically available data sampled over a consistent timeframe and with a view to updating the distribution at fixed, constant intervals. Given that none of the IA respondents in favour of UNC228 and

[13] This report can be found in the list of responses to the IA, at http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=24&refer=Licensing/GasCodes/UNC/Ias.

UNC228A considered them to be enduring solutions, we do not consider that either proposal satisfactorily meets these tests.

These modification proposals have no clear arrangements (other than future UNC modifications) for updating the allocation of Unidentified Gas as new information becomes available. We consider that the lack of arrangements would risk misallocating energy and could therefore be actively detrimental to effective competition. In the IA we noted that the lack of an ongoing, agreed process to revise the distribution of Unidentified Gas over time creates the risk that a distribution could remain fixed in the UNC due to a lack of successful proposals to update the distribution, were no party willing to undertake the analysis required to produce an updated distribution. We suggested that such a static distribution would present an increased risk of inaccurate allocation of Unidentified Gas as time passed, would further dilute any existing incentives upon shippers to address the underlying causes of Unidentified Gas, and would risk weakening the efficient operation of the UNC.

Implementation of UNC228 or UNC228A would also be expected to attract future modifications. Given the uncertainties associated with the measurement of Unidentified Gas itself, we consider it would be imprudent to implement such a proposal even in the short term.

Conclusion

For the above reasons, we accept modification proposal UNC229. We believe that UNC228 and UNC228A would not reflect an improvement on the current baseline, or in the case of UNC194, would impose considerable risks upon the UNC, as the efficient operation would be jeopardised given only recourse to update the allocation of unidentified gas would be through the UNC modification process. Given the difficulties found in attributing values to each sector, we consider that the implementation of UNC194A would be onerous as UNC229 offers a more complete solution. Therefore we reject UNC194, UNC194A, UNC228 and UNC228A.

Other considerations

Modification proposal implementation process

Given the concerns, recognised by all parties, with the existing allocation of Unidentified Gas, we think it is important that new arrangements be put in place as soon as reasonably practicable. Following Ofgem's decision to implement UNC229, we encourage industry parties to complete the appointment process and put the AUGE in place as soon as possible.

To the extent that changes to the existing guidelines are deemed appropriate, we encourage industry parties to reach consensus so that the AUGE appointment process is completed smoothly. Once the AUGE is in place, we expect industry parties to agree the allocation methodology promptly. However, we note that the AUGE process will take effect from 1 April 2011 regardless of the time taken to reach consensus.

While an interim measure could have benefits in reducing the inaccurate allocation of Unidentified Gas between the LSP and SSP sectors, we do not consider that the values proposed in UNC228 or UNC228A are sufficiently well evidenced to merit implementation. However, if industry parties can provide sufficient evidence to justify an interim solution, we would consider such proposals.

To increase transparency on progress in implementing UNC229, and to provide parties with the information that they need to consider the merits of potential interim solutions, we welcome commitments provided to Ofgem from Transporters to provide monthly reports to Ofgem and the industry. We consider that these reports should be provided on the Joint Office website, include key performance indicators and details of milestones where Shipper agreement is required.

Incentives to detect, prevent and investigate theft of gas

In our UNC115 and UNC115A decision letter we noted that theft of gas was likely to be present in the LSP sector, but that under the current arrangements there is no incentive on shippers to deal with theft of gas issues. The SSP sector is incentivised as a whole to reduce the level of theft of gas by minimising the volumes of Unidentified Gas and therefore its RbD charges. The LSP sector does not have these incentives. We stated that it is no longer appropriate for the costs of theft to be borne solely by the SSP sector, and for the perverse incentives on LSP shippers to remain. However, whilst it may be inappropriate for LSPs not to contribute to the costs of theft, it would also be inappropriate for them to contribute too much.

It is important that robust arrangements are in place to tackle theft of gas. We consider that UNC229 helps to pave the way for appropriate incentives on both LSP and SSP sectors. While UNC parties remain best placed to take appropriate action to reduce occurrences of theft, we would encourage the AUGE to help reduce theft by providing transparency in the Unidentified Gas arrangements, for example with respect to volumes of theft and potentially to supplier performance.

We note that Corona Energy referenced the proposed National Revenue Protection Service in their response, which could help to detect, investigate and prevent theft and therefore reduce the volume of unallocated gas. Work is currently being undertaken in this area through UNC274 and is also being discussed in other industry groups. We note that a separate modification, which aims to incentivise suppliers through a relative performance payment, is also being considered under UNC277. Ofgem is also currently considering a further modification to the theft arrangements under UNC231 (Reduction of disincentives to investigate theft) and we note that the industry is developing codes of practice to deal with theft under the SPAA arrangements. Ofgem is currently working with the industry to develop these proposals and we expect that substantial progress on identifying an improved framework for tackling the theft of gas to have been made by summer 2010. Ofgem welcomes the proactive work by the industry to review the theft arrangements.

Future Developments

We note that future developments, in particular Project Nexus and the roll-out of AMR and smart metering will provide better data to assess the causes and volumes of unidentified gas. Project Nexus offers the possibility of removing the need for RbD through the adoption of meter point reconciliation for SSPs. In these scenarios, the correct allocation of Unidentified Gas will remain an issue and there are likely to be merits in retaining the functions of an AUGE.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority, hereby directs that modification proposal UNC 229 be made.

Ian Marlee
Partner, GB Markets
Signed on behalf of the Authority and authorised for that purpose.