

Modification proposal:	<b>Uniform Network Code (UNC) 317, 317A: Interim Allocation of Unidentified Gas Costs; and UNC 327: Alternative to Interim Allocation of Unidentified Gas Costs</b>		
Decision:	The Authority <sup>1</sup> directs that proposal UNC 317 be made <sup>2</sup>		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	17 November 2010	Implementation Date:	To be confirmed by the Joint Office

## Background to the modification proposal

Reconciliation by Difference (RbD) was introduced in the Small Supply Point (SSP) sector in 1998 to facilitate the introduction of competition in the domestic gas market. RbD is the method of reconciling the difference between actual (metered) and deemed (estimated) measurements of gas. At the time RbD was introduced, it was not considered practical to individually reconcile all supply points in this sector (which currently number around 22.3 million) based on actual meter readings. The introduction of RbD was designed to offer an efficient mechanism for reconciling consumption in the SSP sector, as a cost-efficient alternative to individual meter point reconciliation (as used for the Large Supply Point (LSP) sector). The introduction of RbD avoided the development of a more complex system at considerable cost and a delay in the roll-out of domestic competition.

Gas that is not directly attributed to a shipper is known as Unidentified Gas. RbD manages the allocation of Unidentified Gas to shippers in the SSP market and it is treated as a smeared cost for all SSP shippers. No volumes of Unidentified Gas are currently attributed to the LSP sector. Unidentified Gas may be caused by a number of factors including theft, gas offtaken at late registered or unregistered sites or measurement errors.

## UNC Modification Proposal 229

UNC 229<sup>3</sup> (Mechanism for correct apportionment of unidentified gas) introduced a mechanism for apportioning Unidentified Gas between the SSP and LSP sectors. This modification proposal introduced a table to the UNC which would apportion a fixed volume of Unidentified Gas to the NDM LSP and DM LSP sectors and introduced a requirement for an independent expert (Allocation of Unidentified Gas Expert, or AUGEX) to apportion values within this table on an enduring basis.

This proposal was accepted by Ofgem on 26 May 2010. In our decision letter we commented that UNC 229 offers a route to allocate Unidentified Gas based on a widely researched and transparent analysis of the underlying causes of Unidentified Gas, and for that methodology to be replicated on an enduring basis.

<sup>1</sup> The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

<sup>2</sup> This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.

<sup>3</sup> The decision letter for UNC229 can be found on the Joint Office website at: <http://www.gasgovernance.co.uk/0229>. At the time we considered modification proposals UNC194, UNC194A, UNC228, UNC228A and UNC229.

We considered that UNC 229 would improve transparency and accuracy in the allocation of Unidentified Gas to the appropriate sector. We also considered that the aims and objectives of UNC 229 promote effective and efficient competition between the parties.

We published an Impact Assessment (IA) in November 2009<sup>4</sup> that discussed a number of related modifications. The November 2009 IA set out our minded-to view to accept UNC 229 and reject the other remaining proposals. Some respondents to the IA noted the potential long lead-time in the AUGE appointment process that could have potentially delayed the effective start of the reallocation process.

In our decision letter directing the proposed modification UNC 229 be made, we encouraged industry parties to complete the appointment process and appoint the AUGE as soon as possible so as to achieve the start date of April 2011 set out in the legal text for the modification.

#### *Modification proposal implementation process*

In the decision letter for UNC 229, we welcomed commitments provided to Ofgem from Transporters to provide monthly reports to Ofgem and the industry to increase transparency on progress in implementing UNC 229 including the appointment of the AUGE, and to provide parties with the information that they need to consider the merits of potential interim solutions.

We note that the current timelines set out in these reports will not achieve an AUGE appointment date which would allow the AUGE to produce a statement (the AUGS) to populate the AUGE table for the April 2011 proposed date.

UNC 317, UNC 317A and UNC 327 were raised to address any delay in the appointment of the AUGE, production of an AUGS and population of the AUGE table in time for an April 2011 start date.

### **The modification proposals**

#### *UNC Modification Proposals 317, 317A, 327*

This decision letter sets out the Authority's decisions for UNC Modification Proposals 317, 317A, and 327. Collectively, these proposals seek to introduce interim arrangements for of the allocation of Unidentified Gas, in advance of the AUGE arrangements being implemented.

- UNC 317 was raised by Shell Gas Direct on 8 July 2010. It seeks to set values in the AUGE Table if the AUGE is not appointed for 1 April 2011. For each AUGE year commencing 1 April 2011 until the AUGE has defined its charging methodology and an AUGS is produced, the LSP NDM sector will contribute £2.75m towards the total cost of Unidentified Gas and the LSP DM sector will make no contribution.
- UNC 317A is an alternative proposal to UNC 317, raised by British Gas Trading on 22 July 2010. UNC 317A seeks to introduce an application date for the AUGE of 1 April 2011, so that from 1 April 2011 until the AUGE produces an AUGS, LSP NDM sites will contribute £2.75m/year for Unidentified Gas. Once the AUGS has

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<sup>4</sup>Identification and Apportionment of Costs of Unidentified Gas (reference 143/09) may be found on the Ofgem website: <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=Unidentified%20Gas%20-%20RIA%20final%20version.pdf&refer=Licensing/GasCodes/UNC/Ias>

been established a reconciliation will take place to give effect to the AUGS as if it had been in place for April 2011.

- UNC 327 was raised by British Gas Trading on 4 August 2010. It seeks to introduce the same reconciliation mechanism as UNC 317A, the difference being the size of the annual contribution by LSP NDM sites. UNC 317A proposes that LSP NDM shippers make a contribution of £121m/year, to be reconciled against the future AUGS.

## **UNC Panel<sup>5</sup> recommendation**

### *UNC 317 and UNC 317A*

At the Modification Panel meeting held on 21 October 2010, of the nine Voting Members present, capable of casting eleven votes, seven votes were cast in favour of implementing UNC 317. Therefore the Panel recommended implementation of this Proposal.

At the same meeting, two votes were cast in favour of implementing UNC 317A. Therefore the Panel did not recommend implementation of UNC 317A.

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<sup>6</sup>. Of the nine Voting Members present, capable of casting eleven votes, six votes were cast in favour of implementing UNC 317 in preference to UNC 317A, and two votes were cast in favour of implementing UNC 317A in preference to UNC 317. Therefore, the Panel determined that, of the two Proposals, UNC 317 would better facilitate the achievement of the Relevant Objectives.

### *UNC 327*

At the Modification Panel meeting held on 21 October 2010, of the nine Voting Members present, capable of casting eleven votes, two votes were cast in favour of implementing UNC 327. Therefore the Panel did not recommend implementation of this Proposal.

The Panel also voted on whether Proposal UNC 327 would be expected to better facilitate achievement of the Relevant Objectives than UNC 317A. One vote was cast to prefer UNC 327 to UNC 317A. Therefore of the two less preferred modification proposals, UNC 317A was preferred to UNC 327.

## **Relevant Issues**

### *Risk Sharing*

With respect to risk sharing, in our November 2009 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. British Gas Trading<sup>7</sup> argued that "suppliers generally retain the right to 're-open' contracts so that they can take account of new regulatory charges".

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<sup>5</sup> The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

<sup>6</sup> The UNC Relevant Objectives can be found at: <http://www.gasgovernance.co.uk/UNC>.

<sup>7</sup> British Gas Trading IA response point 38.

However, 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 issuing an AUGS and those values taking effect, in order to allow shippers to factor them into their future volume and pricing assumptions. Overall, we concluded that the proposal to appoint an independent expert to develop a methodology to allocate Unidentified Gas is appropriate, and as such risk sharing is neutral in its impact on competitive markets.

### *Reconciliation of Charges*

There continues to be debate between the LSP and SSP sectors as to the total cost of Unidentified Gas attributable to the LSP sector. We consider that determining the appropriate allocation of Unidentified Gas to each sector is a role best fulfilled by the AUGE. We approved UNC 229 to allow an AUGE to determine the allocation of Unidentified Gas between sectors. However, having recognised that the AUGE may not be in a position to determine an AUGS until 2012, we consider that there is a case for introducing an interim arrangement dealing with the allocation of Unidentified Gas.

In this case we consider an advance payment followed by reconciliation to be potentially onerous given the uncertainty that this approach would introduce. We note that shippers that operate in both sectors of the market may not be subject to the same degree of uncertainty and may not need to price a value for an unknown volume of Unidentified Gas into their customer contracts. For these shippers, any increase in payments from the LSP sector may, to some extent, be compensated by a reduction in payments in relation to their SSP portfolio. We note that uncertainty may therefore have a disproportionate effect on those shippers that operate only or predominantly in the LSP sector.

Neither Ofgem nor industry parties are certain of the extent of Unidentified Gas attributable to the LSP sector. The two assessments of the values proposed in UNC 317, its alternative and UNC 327 are significantly different and exemplify the risks associated with seeking to anticipate the work of the AUGE in determining an appropriate allocation of charges.

### **The Authority's decision**

The Authority has considered the issues raised by the modification proposals and the FMRs dated 27 October 2010. The Authority has considered and taken into account the responses to the Joint Office's consultation on the modification proposal which are attached to the FMR<sup>8</sup>. The Authority has concluded that:

1. Implementation of modification proposal UNC 317 and rejection of modification proposals UNC 317A and UNC 327 will better facilitate the achievement of the relevant objectives of the UNC<sup>9</sup>; and
2. Directing that the modification be made is consistent with the Authority's principal objective and statutory duties<sup>10</sup>.

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<sup>8</sup> UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at [www.gasgovernance.com](http://www.gasgovernance.com).

<sup>9</sup> 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](http://epr.ofgem.gov.uk/document_fetch.php?documentid=6547).

<sup>10</sup> 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 for UNC 229, we consider that the arrangements for the allocation of Unidentified Gas should be reformed such that each market segment makes an appropriate contribution to these costs.

We have assessed each of the Proposed Modifications against the UNC Relevant Objectives. We consider that the Proposed Modifications impact on Relevant Objective (d)<sup>11</sup> only. We note that some parties specifically commented on Relevant Objective (f)<sup>12</sup> and we have therefore also set out our views on why we are neutral on whether this objective is better met. We are neutral with regards to the other Relevant Objectives. A summary of our views against Relevant Objectives (d) and (f) is set out below.

### UNC 317

The Panel recognised that not all Unidentified Gas should be attributed to the SSP sector. The proposed amount to be paid for by the LSP sector in this case is based on a figure from the TPA report<sup>13</sup> commissioned by a number of shippers operating exclusively in the LSP sector. We consider that the arrangements introduced by UNC 229 provide a route to allocate risk based on a researched and transparent analysis of the underlying causes of Unidentified Gas, and for a methodology to be replicated and refined in ongoing years. The implementation of UNC 229 aims to produce transparent charges for Unidentified Gas based on a consistent methodology, which could in theory be reconciled back to April 2011. However, in our view this approach carries a high degree of uncertainty and risk to the LSP sector. UNC 317 provides a fixed allocation of charges to the LSP market and removes the uncertainty brought about by the AUGS not being in place by April 2011, when compared to UNC 229. It also reduces uncertainty compared to the other modification proposals discussed in the decision letter. We therefore consider this modification proposal to be appropriate, as it helps to facilitate the achievement of Relevant Objective (d).

We note that under UNC 317, the balance of Unidentified Gas, other than the £2.75m that will be charged to the LSP market will continue to be charged to the SSP market until the AUGS is in place and has produced an AUGS. However, in this instance we consider that the proposed charge to LSP shippers under UNC 317 at this stage represents both an improvement on the current baseline and the best option available. There is consensus amongst industry participants that £2.75m is the minimum annual payment that should be made based on analysis of the available data. We therefore consider that unless better information becomes available it should serve as an interim basis for allocation costs of Unidentified Gas in advance of the AUGS being implemented.

There has been no substantive evidence to draw a conclusion as to the costs of implementing this proposal, or assess its efficiency in relation to the implementation and administration of the UNC. We therefore consider that the effect of this modification proposal on Relevant Objective (f) is neutral.

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<sup>11</sup> 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.

<sup>12</sup> 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.

<sup>13</sup> The TPA report can be found in the list of responses to the UNC229 Impact Assessment, at <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=24&refer=Licensing/GasCodes/UNC/Ias>.

## *UNC 317A*

Some Panel members considered that the additional facet of 'payment on account' with subsequent reconciliation would create uncertainty and that the implementation of this modification proposal would therefore be detrimental to effective competition. The implementation of this modification proposal would require LSP shippers 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. We consider that, in this instance, compared to UNC 317, this significant uncertainty for small shippers and LSP shippers may have a detrimental impact on competition, in particular in relation to shippers operating only or predominantly in the LSP sector. Therefore we do not consider UNC 317A to facilitate Relevant Objective (d).

There has been no substantive evidence to draw a conclusion as to the costs of implementing this proposal, or assess its efficiency in relation to the implementation and administration of the UNC. We therefore consider that the effect of this modification proposal on Relevant Objective (f) is neutral.

## *UNC 327*

The Panel members had less confidence that this modification proposal would deliver a more accurate allocation than under modification proposal UNC 317A. Similarly, we are concerned that UNC 327 places significant upfront charges on LSP parties without clear rationale as to why those charges are justified. The proposal also retains the continued uncertainty and risk associated with reconciliation (as noted above, this is a particular issue for those parties that operate predominantly in the LSP market). As such, we do not consider that this modification proposal offers an improvement on competitive environment when compared to the UNC 229 arrangements and therefore does not facilitate the achievement of effective competition and Relevant Objective (d).

There has been no substantive evidence to draw a conclusion as to the costs of implementing this proposal, or assess its efficiency in relation to the implementation and administration of the UNC. We therefore consider that the effect of this modification proposal on Relevant Objective (f) is neutral.

## *Conclusion and other considerations*

For the above reasons, we accept modification proposal UNC 317. However, we consider that this decision should not provide incentives on any party to delay the effect AUGS arrangements from April 2012.

Industry participants have indicated that the timeframe for the implementation of the AUGS arrangements will be April 2012. We note the effect of UNC 317 is that it will continue to require a contribution of £2.75m/year from LSP NDM shippers until the AUGS arrangements are in place and that this could potentially be after April 2012. Whilst we have expressed concerns about the impact of reconciliation above, should the 2012 date be threatened by circumstances within the control of market participants, we may reconsider this view and note that parties may raise further modification proposals that sought to encourage an April 2012 effective start date.

Our decision to accept modification proposal UNC 317 does not reflect any view, or attempt to provide any influence on the overall value of Unidentified Gas that the LSP sector should be responsible for under the AUGS arrangements. As noted above, this is

the role of the AUGÉ. Our decision reflects the current analysis presented to Ofgem and avoids the uncertainties associated with a reconciliatory approach.

**Decision notice**

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority, hereby directs that modification proposal UNC 317 be made.

**Ian Marlee**

**Partner, GB Markets**

Signed on behalf of the Authority and authorised for that purpose.