



Gas Transporters, Shippers,
Suppliers, consumers and other
interested parties

*Promoting choice and value for
all gas and electricity customers*

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Date: 28 November 2012

Dear Colleagues,

'Minded to' consultation on Uniform Network Code ('UNC') modification proposals 395 and 398

Having considered the Final Modification Reports ('FMRs') for modification proposals UNC 395¹ and UNC 398² and the further responses received after our decision to send back the reports to the UNC Panel for further assessment³, we have decided to consult on our 'minded to' position to accept UNC395 and reject UNC398.

We welcome responses to the 'minded to' position on or before 25 January 2013.

Background to the modification proposals

The UNC sets out the rules by which gas is allocated to gas shippers, subsequently reconciled against individual sites consumption and settled through energy invoices.

Following the implementation of UNC152V⁴ in April 2008, the UNC contains a 'Code Cut Off Date' which limits the retrospective reconciliation of invoices to a period of between 4 years to 4 years and 364 days ('4-5 year solution'); the 1 April cut off date being incremented each formula year. The billing position for any date beyond this cut off date is considered to be final; i.e. any error that is subsequently discovered will not be reconciled.

Modification proposals UNC395 and UNC398 propose to reduce the cut off date to a period of 2 years to 2 years and 364 days ('2-3 year solution') and 3 years to 3 years and 364 days ('3-4 year solution') respectively. These proposals were not intended to be mutually exclusive; UNC398 was proposed as an interim solution, allowing for the settlement window to be reduced by one year at a time if both are implemented.

At the 19 January 2012 meeting of the UNC Panel⁵, we initially raised concerns that the content of the UNC398 FMR did not contain sufficient information to enable us to take a

¹ All documentation in relation to UNC 395 'Limitation on Retrospective Invoicing and Invoice Correction' can be found on the Joint Office website at www.gasgovernance.co.uk/0395

² All documentation in relation to UNC 398 'Limitation on Retrospective Invoicing and Invoice Correction (3 to 4 year solution)' can be found on the Joint Office website at www.gasgovernance.co.uk/0398

³ Our letter on the decision to 'send back' UNC 395 and UNC 398 and the responses received can be found on the Joint Office website at <http://www.gasgovernance.co.uk/03950398>

⁴ See www.ofgem.gov.uk/LICENSING/GASCODES/UNC/MODS/Documents1/UNC152D.pdf

⁵ The UNC Modification Panel is constituted pursuant to Special Standard Condition A11 (6d) of the Gas Transporters Licence and Clause 3.1 of the UNC Modification Rules.

robust decision⁶. However, the UNC Panel opted not to send the report back to the workgroup and subsequently voted by 6 votes to 4 in favour of implementing UNC398.

At the following meeting of 16 February 2012, the UNC Panel voted by a majority of 8 votes to 2 not to recommend implementation of UNC395.

Following consideration of the FMRs for both UNC395 and UNC398 we directed⁷ the UNC Panel to expand upon the analysis and supporting information contained in the FMRs, prior to their resubmission to the Authority, in accordance with the UNC modification rules. As detailed in our March 'send-back' letter, we directed that the revised FMRs should contain, as a minimum, the following additional information:

- quantification of the benefits of the modification proposals in terms of the reduction in shippers' risk and credit exposure;
- causes of energy remaining un-reconciled after 3-5 years;
- typical lead times to resolve settlement disputes or adjustments, together with the estimated scale and age profile of such adjustments;
- financial implications of a shortened reconciliation window in terms of re-distribution between Small Supply Point (SSP) and Large Supply Point (LSP) sectors (and vice versa); and,
- further consideration of the impact of these proposals on UNC non-code liabilities, their ability to mitigate any associated risks and the applicability of remedies outside of the normal settlement process.

It is disappointing that the revised FMRs received on 28 August 2012 do not satisfactorily address these points, despite concerns having been raised by our representative at the February UNC Panel meeting⁸.

Minded to position

Attached to this letter we set out our provisional thinking, including our conclusion that on balance we are presently minded to accept UNC395 and to reject UNC398. However, we would welcome your views on the specific questions that are set out in the attached, as in some cases we have had to make certain assumptions and/or are seeking further evidence. At this stage, we agree with the UNC Panel that these modifications should be assessed against relevant objectives d) and f).

Relevant Objective d) securing effective competition between shippers

It is a generally held view that timely and accurate settlements facilitate competition insofar as they allow for the accurate allocation of costs and efficient use of capital. In seeking to reduce the current settlement window both proposals would be expected to better facilitate this objective. However, to the extent that UNC395 reduces the settlement window by the greatest extent, we consider that it offers greater potential than UNC398 for benefits to competition.

However, the improvement either of them would make to the timeliness in reaching a final settlement position must be balanced against the possible impacts upon accuracy. Whilst we acknowledge that additional volumes of gas currently continue to be reconciled for periods that would be excluded from settlements under either proposal, with the greater impact being from UNC395, we have seen nothing to suggest that this reconciliation

⁶ For minutes of this UNC Panel see the Joint Office website: <http://www.gasgovernance.co.uk/sites/default/files/Minutes%20and%20Voting%20Record%20Jan%2011%20v2.pdf>

⁷ Pursuant to Special Standard Condition A11(15(b)(ii)) of the Gas Transporters Licence and Clause 9.3.8 of the UNC Modification Rules.

⁸ For minutes of this UNC Panel see the Joint Office website: <http://www.gasgovernance.co.uk/sites/default/files/Minutes%20and%20Voting%20Record%2016%20Aug%2012%20V1.pdf>

activity is not within shippers' control and therefore could not be brought forward should the settlement arrangements require it. In particular we understand that the raising of these modification proposals has already prompted greater attention from shippers to the accuracy of their data.

We also recognise that UNC398 was intended to act as an interim solution, potentially being in place for one year only before being replaced by UNC395. Given the period that has lapsed since these proposals were first raised, which of itself seems to have negated the immediate concerns around possible implementation dates, together with consideration of administrative efficiency, we are minded to accept the proposed enduring solution contained within UNC395.

Relevant Objective f) promotion of efficiency in the implementation and administration of the UNC

Whilst we do consider that improving the settlement regime will in the longer term lead to efficiency gains, for instance through reduced use of estimates and the administration of subsequent iterative reconciliations, it is not clear that these benefits would be directly attributable to either of these modifications. The effect of this modification may simply be that the same administration and other activity is carried out, but over a shorter timescale. We therefore currently consider that these proposals are neutral against relevant objective f) but will review this position in light of response to this consultation.

Next steps

Responses to this consultation should be submitted on or before **25 January 2013** to industrycodes@ofgem.gov.uk

All non-confidential responses will be published on our website. Therefore, if responses do not wish all or part of their response to be made public, they should clearly mark their response as confidential. It would be helpful if any confidential information could be contained within a separate appendix in order that the main response and any non-confidential information may be published.

Yours Sincerely

Jon Dixon
Head of Industry Codes and Licensing

Annex 1 – ‘minded to’ position on UNC395 and 398

Final settlement and corrections

Traditionally, the gas arrangements did not seek to reach a final settlement position as such, with reconciliations taking place as and when new information came to light, potentially dating as far back as the introduction of the network code arrangements (now set out in the UNC). Following the implementation of UNC152V⁹ in April 2008, the UNC now contains a ‘Code Cut Off Date’ which limits the retrospective reconciliation to a period of between 4 years to 4 years and 364 days, with the 1 April of the outlying year acting as the fixed cut off date and incremented each year to the following 1 April. This exposes shippers to potential ‘windfall’ losses (or gains) if a site is subject to a subsequent billing correction for periods which cannot be backed off into settlements. As noted in the FMR, this exposure to billing error corrections may extend up to 6 years under the prevailing Limitations Act 1980.

In contrast to this near 5 year settlement ‘window’ in gas, final reconciliation is reached in the electricity industry after only 14 months. However, the Balancing and Settlement Code (BSC) does allow for subsequent corrections, subject to certain criteria. This may be through either the trading dispute process or for smaller correction through the Gross Volume Correction (GVC) process. The GVC process was formally incorporated into the BSC with the implementation of modification P176¹⁰ in June 2005 and is currently subject to a further modification proposal¹¹, which seeks to limit its application.

We note that modification proposal UNC429¹², which is currently in the workgroup development stage, seeks to introduce a claims process that would allow shippers to correct settlement errors that fall beyond the prevailing UNC ‘Code Cut Off Date’, but within the currently 6 year period set out in the Limitations Act 1980. Whilst we cannot fetter the Authority’s discretion over any future decision on UNC429 and do not seek to comment here on the specifics of that proposal, the current absence of a process such as that proposed under UNC429 is relevant to our thinking on UNC 395 and UNC398. It is clear from those responses which were opposed to either UNC395 or UNC398 that it is their impact on reducing the opportunity to back off billing correction through the settlement process that causes greatest concern.

Given the above, we would welcome views on the potential relationship between these various modification proposals, particular from those respondents who have previously expressed concerns at UNC395 and/or UNC398.

Question 1: Would your assessment of risk from UNC395 and/or UNC398 differ if the UNC allowed for the correction of settlement errors beyond the prevailing Code Cut Off Date?

Extent of the benefit

The proposer of UNC395 noted that although the volume of unallocated gas is relatively small after 2 years, the current arrangements mean that a shipper will have little certainty of their energy costs until 5 years after the event. This means that they are particularly exposed to the risk of large and unexpected debits, for instance through the discovery of meter offtake errors. The proposer considers that these risks are acting as a barrier to entry. They also consider that as incumbents will seek to hedge those risks through a premium on tariffs, costs to consumers are increased.

⁹ See www.ofgem.gov.uk/LICENSING/GASCODES/UNC/MODS/Documents1/UNC152D.pdf

¹⁰ P176: “Clarification of the Requirements for Estimation/Deeming of meter Readings/Advances in Certain Circumstances to Facilitate Correction of Anomalies in Settlement Consumption”.

¹¹ P274: “Cessation of Compensatory Adjustments”

¹² UNC429: “Customer Settlement Error Claims Process”

Whilst there is little in the FMR to suggest the extent of the benefit shippers will receive from increased certainty of gas allocation, some have anecdotally suggested that this risk premium may equate to around £1 - £2 per domestic supply point, per annum. Whilst this may not seem a significant benefit, this should be considered in the context of the immaterial direct costs of implementation¹³. However, other shippers have suggested that they do not factor this risk into the tariffs at all.

Whilst we sought further information from shippers on their assessment of this risk and by implication the extent to which it fed through into consumers' tariffs, we appreciate the reservations shippers may have had in sharing this with the workgroup and it being reflected in the FMR. We would therefore again invite views on this, which may if appropriate be contained in a separate confidential annex to responses to this consultation.

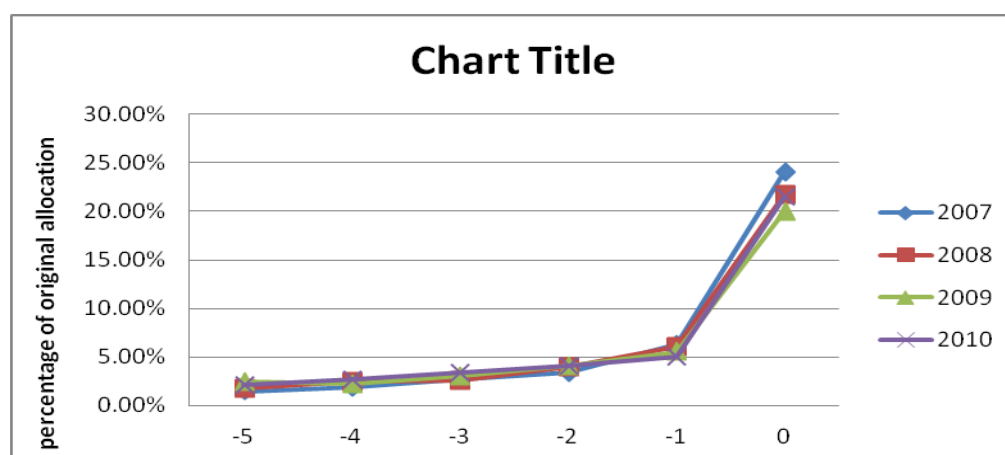
Question 2: What is your perception of risk resulting from the current gas settlement arrangements and to what extent is this reflected in setting consumer tariffs?

Impacts on allocation

The figures provided by xoserve, which are repeated below, do suggest that there is a relatively small amount of gas remaining to be allocated after the cut off dates proposed under either UNC395 or UNC398. This is to be expected given the UNC and Gas Suppliers licence requirements regarding the procurement of meter readings. However, this relatively small percentage does represent a significant monetary value.

It is also significant that the degree of improvement tends to flatten beyond year 3, suggesting that many of these may remain difficult if not impossible to reconcile regardless of the cut off date. For instance the FMR refer to sites which will never reconcile as they no longer exist (as a gas supply point). We remain keen to understand the extent to which shippers will be able to manage any reduction in the settlement window and what issues, if any, are beyond their control.

	-5	-4	-3	-2	-1	0
2007	1.48%	1.86%	2.67%	3.38%	6.30%	24.09%
2008	1.82%	2.45%	2.60%	3.97%	6.05%	21.74%
2009	2.42%	2.24%	3.04%	4.09%	5.54%	19.97%
2010	2.15%	2.72%	3.39%	4.13%	4.99%	21.47%



¹³ Xoserve has estimated the systems implementation costs to be no greater than £15,000.

Question 3: what are the current causes for energy remaining unallocated after 3-5 years?

Redistribution

Views amongst respondents were mixed on the extent to which reconciliations, even after several years, simply reflect the gas allocations that were initially estimated. There are also views that the current extended window ensure that the maximum amount of gas is eventually reconciled accurately. However, other respondents considered that as any unallocated gas will initially be picked up through the Reconciliation by Difference (RbD) process, the protracted settlements window has the effect of transferring cash flow issues and other risks from the LSP to the SSP sector, at least in the short term.

We will further explore with xoserve the extent to which the initial allocation of gas is subsequently reflected in settlements and whether there is any systemic bias. However, we would also welcome further views on this and the extent to which moving the Code Cut Off Date as set out under either proposal may help or exacerbate the issue.

Question 4: Do you consider that the current system produces a systemic bias insofar as it generally results in gas being allocated to or from a particular sector, rather than being evenly redistributed in line with initial estimates?

We note the views of ICoSS - contained in the report¹⁴ produced on its behalf by Waters Wye Associates (WWA) - that the majority of large reconciliations come about as a result of mechanical failure of the meter or associated equipment, meter drift etc. This report suggests that an inability to carry out reconciliations where such issues are unidentified could expose the relevant shipper to liabilities that they are unable to back off in settlements, which may jeopardise their commercial viability. Whilst we welcome this contribution we understand that it was published after the close out of response to the latest Joint Office consultation on UNC395 and UNC398, with respondents therefore having no opportunity to comment on the report as part of their response. Whilst the WWA report does not directly form part of this consultation, *we would therefore welcome any further comments on the data it contains and the conclusions it draws.*

Given that the report focuses on the discovery of and correction of errors, it seems to suggest that the additional risk to LSP shippers arising from these proposals is around restricting their ability to make adjustments to previously reconciled positions, rather than on the extent of unallocated gas that may be timed out from being reconciled.

Question 5: To what extent do you consider the risk of reconciliation adjustments - such as meter failure or erroneous correction factors - are manageable by shippers, and do you therefore consider it appropriate that those risks should continue to be backed off and to an extent socialised through the UNC settlements process?

Offtake meter errors

An example of risk of a large and unexpected debit cited by the proposer of UNC395 is where a significant offtake meter error is discovered, though it is also acknowledged in the FMR that this could result in a credit to some or all shippers rather than a debit. Indeed it was the meter error discovered at the Farningham offtake that ultimately led to UNC152 and the establishment of a Code Cut Off Date.

In our letter which sent the UNC395 and UNC398 back to the UNC Panel for further assessment we highlighted the potential interaction between those modification proposals and initiatives to address offtake meter errors. In particular, we drew parallels with the intent of modification proposal UNC335 and its alternative UNC335A and appended to the

¹⁴ See: <http://gasgovernance.co.uk/03950398>

send back letter our position on being minded to reject those proposals, together with our reasons.

UNC335/A were subsequently rejected,¹⁵ though it is possible that further proposals may be raised that are targeted to address this specific area of concern which would not have the wider implications for settlements associated with UNC395 or 398. We therefore remain keen to understand more about shippers' perceptions of the cause and extent of large and unexpected reconciliations risks beyond those associated with offtake meter errors.

Question 6: Other than offtake meter errors, what do you consider to be the systemic risks to settlement accuracy and how great are these risks?

¹⁵ See: [Uniform Network Code \(UNC\) 335: Offtake metering error - payment timescales \(UNC335\)](#) and [Significant Offtake Metering Error - Small shipper payment timescales \(UNC335A\)](#)