



Tim Davis
UNC Panel Chair

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value for all customers*

Our Ref: UNC395/398 and UNC335/335A
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Date: 15 March 2012

Dear Tim,

Determination regarding the 'send back' of Uniform Network Code ('UNC') modification proposals 398 and 395 and our 'minded to' position on UNC 335 and 335A

Having considered the Final Modification Reports (FMRs) for UNC395¹ and UNC398² we have decided to send the reports back to the UNC Panel for further assessment. We have also decided to consult on our current position of being minded to reject UNC335 and its alternative UNC335A³. This letter sets out the reasons for these decisions.

UNC395 and 398

We⁴ have considered the FMRs for modification proposals UNC395 and UNC398 submitted on behalf of the UNC Modification Panel⁵ together with all representations received⁶ and have determined that we cannot properly form an opinion on the above proposals⁷ based on the information contained in those FMRs. Our concerns were raised, but not sufficiently addressed, at the January 2012 UNC Modification Panel⁸. Therefore, in order to facilitate an appropriate decision on these modification proposals, we direct⁹ the UNC Modification Panel to expand upon the analysis and supporting information contained within the modification reports prior to their resubmission to the Authority. As a minimum, we would expect the additional information in the revised FMR to:

- quantify the benefits of the modification proposals in terms of the reduction in shippers' risk and credit exposure;
- determine the causes of energy remaining un-reconciled after 3-5 years;
- set out the typical lead times to resolve settlement disputes or adjustments, together with the estimated scale and age profile of such adjustments;

¹ UNC395: 'Limitation on Retrospective Invoicing and Invoice Correction'.

² UNC398: 'Limitation on Retrospective Invoicing and Invoice Correction (3 to 4 year solution)'.

³ UNC335/335A: 'Offtake Metering Error - Payment Timescales'.

⁴ The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

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.

⁶ UNC modification proposals, modification reports and representations can be viewed on the Joint Office website at <http://www.gasgovernance.co.uk/>.

⁷ References to modification proposals also include alternative proposals where applicable.

⁸ For Panel minutes see the Joint Office website:

<http://gasgovernance.co.uk/sites/default/files/Minutes%20and%20Voting%20Record%20Jan%2011%20v2.pdf>

⁹ Pursuant to Special Standard Condition A11(15(b)(ii)) of the Gas Transporters Licence and Clause 9.3.8 of the UNC Modification Rules.

- consider the financial implications of a shortened reconciliation window in terms of re-distribution between Small Supply Point (SSP) and Large Supply Point (LSP) sectors (or vice versa); and,
- further consider the impact of these proposals upon UNC Parties non-code liabilities, their ability to mitigate any associated risk and the applicability of remedies outside of the normal settlement process.

Background

Following the implementation of UNC152V¹⁰ 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'), with the 1st April cut off date being incremented each formula year. The billing position for any date beyond this cut off date is considered to be crystallised; any error that is subsequently discovered will not be reconciled.

Modification proposals UNC398 and UNC395 propose to reduce the cut off date to a period of 3 years to 3 years and 365 days ('3-4 year solution') and 2 years to 2 years and 365 days ('2-3 year solution') respectively. These proposals are not intended to be mutually exclusive; UNC398 has been proposed as an interim solution, allowing for the settlement window to be reduced by one year at a time if both are implemented.

On 19 January 2012, the UNC Panel, with 6 votes in favour and 4 against, recommended implementation of UNC398. However, in its subsequent meeting of 16 February 2012, the UNC Panel voted by a majority of 8 votes to 2 not to recommend implementation of UNC395.

The Authority's initial thinking

We have undertaken an initial assessment of the modification proposals against the relevant objectives of the UNC, as set out in Standard Special Condition A11(1) of the Gas Transporters Licence¹¹. Whilst we consider that there is merit in these modification proposals, we are concerned that issues associated with their implementation have not been adequately assessed and mitigated. There is therefore a risk that any benefit that could be expected to accrue from these proposals would be outweighed, at least in the short term, by the negative consequences. In particular, we are concerned that the causal factors of energy remaining un-reconciled beyond the proposed cut off dates have not been adequately explored and that the proposed implementation dates may not provide adequate time for them to be addressed.

For the purpose of this letter we focus on the areas which we would like the UNC Modification Panel to further assess before resubmitting the FMR.

Redistribution of costs

Whilst we recognise that the residual amount of energy to be reconciled is relatively small, being around 3%¹² (with a recent upward trend) of the original allocation after 3 years, this equates to a material amount of costs that may not have been accurately allocated. There is no indication within the FMRs whether further reconciliation subsequent to the proposed cut off would ordinarily be expected to simply confirm the original allocations, or involve a significant redistribution of costs. However, to the extent these proposals were raised in order to mitigate shippers exposure to unexpected invoices, there appears to be at least a perception that the cost of the residual energy would ordinarily be redistributed. We would welcome further evidence as to whether this is actually the case.

¹⁰ See www.ofgem.gov.uk/LICENSING/GASCODES/UNC/MODS/Documents1/UNC152D.pdf

¹¹ See <http://epr.ofgem.gov.uk/index.php?pk=folder590301>

¹² Source: xoserve figures contained within the FMR

We would also welcome further evidence of the extent to which suppliers' tariffs currently anticipate this risk of reconciliation and the likely effect that its removal may have on tariff structures.

Consumer Focus note that 40% of energy related complaints that Consumer Direct receives from micro-businesses relate to back-billing. They believe that shortening the back-billing window would increase incentives on shippers to get accurate meter data into settlement quickly. They contend that this would in turn increase incentives on suppliers to also resolve consumer-facing issues related to outstanding meter reads. We would welcome further assessment of the extent to which meter reading performance is influenced by the prevailing settlement window, rather than vice versa.

We note that the UNC Modification Panel made contrasting recommendations with respect to UNC395 and UNC398, yet there were few, if any, comments relating to the differences between the two proposals, namely the relative length of the proposed settlement windows and their respective implementation dates. Some further explanation of the Panel's rationale would therefore be welcome, together with an assessment of the optimum implementation date.

Limitation Act 1980

Several respondents made reference to the 'Statute of Limitations', which we take to be a reference to the Limitation Act 1980. We are concerned that these erroneous references may indicate a more general misunderstanding, or at least difference in opinion, on the application of the Limitation Act 1980 to this area. We would therefore encourage Parties, in particular those shippers who were opposed to the reduction in the settlement window, to further explore alternative remedies under the UNC, in equity and in law, including further consideration of how the Limitation Act 1980 would be applied and its effect on any right of recovery. For instance, we note that the Limitation Act 1980 does not create a right to recover a debt or damages, as seemed to be implied in some responses. It appears that any reconciliation process would sit outside of the shippers' right to raise a defence against a supplier's claim to recover losses. The modification in question is a control on retrospective invoicing and invoice correction but it has not been made clear how this control would affect any right to recover any amount paid out to a supplier's customer as a result of an over-read.

UNC335 and 335A

We are minded to reject both UNC335 and its alternative UNC335A. The details of this are set out in Appendix 1, though in summary, whilst we are sympathetic to the intent of UNC335/335A:

- we do not consider a sufficient case has been made for this to have retrospective effect;
- we are concerned about the potential size of penalties faced by GDNs, in the case of UNC335 being potentially unlimited and in the case of UNC335A insufficient to provide the desired incentive; and,
- given that the impact of offtake meter errors is proportionate, we do not feel that a sufficient case has been made with the FMR to warrant the differing treatment of shippers as set out in UNC335A.

Interaction between the proposals

We note that two of the respondents¹³ to the Joint Office consultations highlighted the relationship between the arguments put forward to support a reduction in the settlement window and the intent of UNC335/335A. Whilst we generally consider that each proposal should be considered on its own merits, we do agree with those respondents that in this instance there is a relevant relationship between the various proposals and that they should appropriately be considered in the round.

Each proposal seeks, at least in part, to mitigate the same risk to shippers of a large and potentially unexpected invoice resulting from a retrospective reconciliation. While UNC335/335A is specific to the risk of offtake metering errors being reconciled, UNC395 and UNC398 seek to mitigate reconciliation risk more generally, though there is little supporting evidence of the alternative causes and associated scale. Absent this, we are unable to determine whether UNC335/335A and UNC395/398 are individually beneficial proposals, or in effect, alternatives to each other. This interaction therefore needs to be explored further.

Next steps

We encourage the UNC Panel to send both modification proposals UNC395 and UNC398 back to a workgroup for further assessment, as set out above. We expect the outcome of those discussions to feed into both the revised FMR, and responses to our 'minded to' consultation on UNC335/335A. We will be happy to attend a future meeting of the appropriate group in order to participate in discussions and elaborate upon our thinking.

We consider that it will be appropriate for the UNC Panel to determine when and where these modification proposals will be further discussed. However, we would welcome views on our minded to position on 335/335A and a revised FMR on UNC395 and UNC398 by **22 June 2012**.

Yours sincerely

Jon Dixon
Head of Industry Codes and Licensing

¹³ National Grid NTS in its response to UNC395 and Scottish Power in its response to UNC398.

Appendix 1 – ‘Minded to’ position on UNC335/335A

Background

UNC335 (proposed by RWE) proposes that the recovery of payment for off-take metering error should be spread over a period that is commensurate with duration of error itself, e.g. an error that occurred over 9 months would be recovered via 9 monthly invoices to shippers/suppliers. In the absence of any reduction in the settlement window, this period of recovery could last as long as 5 years.

Gas Distribution Network (‘GDN’)s would pay any shortfall immediately to shrinkage manager (National Grid National Transmission System (‘NG NTS’)), and would then bill shippers/suppliers for the shortfall in increments for the duration of the meter error. Therefore, GDNs would incur a financing penalty according to the size and duration of the meter error.

UNC335 would apply to the following meter errors:

- significant errors (defined as > 50GWh)
- where it involves debit to shippers/suppliers (errors in favour of shippers/suppliers paid immediately)
- future and pre-existing Significant Offtake Metering Errors (i.e. applies to those yet to be resolved)

The alternative proposal UNC335A proposed by SGN modifies the original proposal in two ways, it:

- removes the retrospective elements of the original proposal, and
- limits the proposed arrangements to smaller shippers/suppliers, defined as those with a national portfolio size of less than/equal to 100K small supply points (SPP), and where the shipper’s credit limit with the respective DN is less than/equal to £500K.

Panel recommendation and representations

The UNC Modification Panel did not recommend the implementation of either UNC335 or UNC335A. Five (of ten) members voted in favour of UNC335; three (of ten) voted in favour of implementing UNC335A.

We have had regard to a late representation to the Joint Office’s consultation, which is available on its website, but not reflected within the FMR. Including this late submission, we note that there were eleven responses to the Joint Office consultation. Responses to the original proposal were broadly balanced, with five respondents in support and six opposed to its implementation.

All shippers/supplier respondents (with the exception of SSE) supported UNC335 (one provided qualified support). Smaller shippers/suppliers also supported UNC335A. All Gas Transporter (‘GT’) respondents (with the exception of SGN) opposed both UNC335 and UNC335A.

Authority’s provisional thinking and ‘minded to’ position

Relevant objective (a) – the coordinated, efficient and economic operation of the pipeline system [to which the licence relates];

We note that RWE’s intention in raising UNC335 was, at least in part, to provide greater cash flow incentive for GDNs to minimise offtake meter errors through further investment. The proposed penalty on GDNs is a function of both the size of the error, and the length of time during which it remains undiscovered. These are the parameters that affect cash-flow

risk, and therefore provide the correct incentives on GDNs. To the extent that UNC335 provides a higher penalty than UNC335A, it could be considered to better meet that aim. However, we are concerned that neither the original or alternative proposal sets these incentives at an appropriate level.

Both UNC335 and UNC335A would apply only to meter errors in excess of 50GWh. Our analysis (see Table 1 below) of the Joint Office offtake meter measurement error database (which records all meter errors from 2008) suggests that of the 104 offtake meter errors, 5 would be subject to a penalty under UNC335/335A (i.e. if the modifications had been in place at the time). However, these five errors constitute in excess of 90% of the total meter errors in GWh (some figures remain to be confirmed).

Table 1 sets out the penalties that we consider would have been applied under UNC335 and UNC335A. This shows that the total financing penalties under UNC335 would have been around £3.4m, while under UNC335A there are no instances of a penalty exceeding £100K.

Table 1: Offtake meter errors and estimated penalties to GDNs

	Off-take	GDN	GWh	Total value of gas (£m)	Estimated penalty (£M)	
					335	335A
1	Horndon B MTA	National Grid - DN	125	2.1	0.2	0.0
2	Blackrod MTA	National Grid - DN	60.78	1.0	0.1	0.0
3	Aberdeen MTA	Scotia Gas - DN	3223	55.0	2.8	0.0
4	Braishfield B MTB	Scotia Gas - DN	1161	19.8	0.3	0.0
5	Gilwern MTA	WWU - DN	50.7	0.9	0.1	0.0
	Total		4620.5	78.8	3.4	0.0

Source: Ofgem analysis of Joint Office Measurement Error Register (open and closed cases since 2008). See: <http://www.gasgovernance.co.uk/MER> Note: UNC335A penalty based on assumption that small shipper market of the Small Supply Point sector is around 1%¹⁴.

Whilst these figures are currently only an approximation and may fluctuate as small shippers' share of the SSP market increases, either nationally or proportionately within a given Local Distribution Zone, it does suggest that the penalty associated with UNC335A is too low to provide an effective incentive. Conversely, under UNC335 the penalties could be material. A penalty approaching £3m for an error such as that associated with the Aberdeen meter offtake error represents in excess of 1% of SGN's allowed revenues¹⁵.

Therefore, whilst we consider that a cash-flow incentive such as that set out in UNC335 would provide an effective incentive for GDNs to make appropriate investment to avoid future offtake metering errors, we consider that the GDNs liability must be proportionate and should be capped. Otherwise, this could have the inappropriate effect of diverting investment from elsewhere and potentially run counter to our duty to ensure that license holders are able to finance their licensable activities.

We consider that a reduction in the settlement window as proposed under UNC395 and UNC395 would limit one of the parameters that effect the cash-flow risk and therefore go some way to cap liabilities, though this would do nothing to limit the impact arising from the size of the error. Absent any certainty over the level of any future liability, we are

¹⁴ We consider that there will be a close corollary between SSP shipper and GB domestic supply market share – see 'The Retail Market Review – Findings and Initial Proposals (supplementary appendices) p.49 onwards; http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/RMR_Appendices.pdf

¹⁵ SGN allowed revenues for Scotland Gas Networks = £200m p.a. (2005-06 prices) or c. 230m in 2010/11 prices. Inflation = 226/193 Source: Gas Transporter Licence, Part E, E2, Annex A. http://epr.ofgem.gov.uk/document_fetch.php?documentid=15106

unable to conclude that UNC335 or UNC335A would better facilitate the efficient and economic operation of the pipeline.

Relevant objective (d) – securing of effective competition: (i) between relevant shippers; (ii) between relevant suppliers; and/or (iii) between DN operators and relevant shippers

We are sympathetic to the problems that charge volatility has on shippers, particularly newer entrants and smaller parties who may not have the same access to finance as larger well established parties, or who may be more reliant upon and therefore relatively exposed to a specific sector of the market. The proposers of both UNC335 and UNC335A contend that their implementation would assign the costs associated with meter offtake error to the responsible parties (GDNs), which should reduce the volatility in expected charges for shippers/suppliers.

We agree that the effect of a cash-flow penalty as proposed under UNC335 could have a two-fold effect on volatility. Firstly, the imposition of a financial liability for the accuracy of offtake meters should incentivise GDNs to ensure that instances of error are minimised. Secondly, requiring the GDNs to recover the costs of reconciled energy over a period commensurate with the original error will smooth the impact upon shippers and their budgets. To the extent that these effects will reduce the risk to shippers, we consider that efficient operators will be able to reflect this as a reduced premium in consumers' tariffs, thereby promoting effective competition between shippers and suppliers.

However, we are concerned that other aspects of both UNC335 and UNC335A could have negative impacts upon elements of competition.

To the extent UNC335 applies to several identified but as yet unresolved significant meter errors, its implementation would have retrospective effect. We generally hold the view that retrospective modifications should be avoided. This has been a consistent feature in our decisions¹⁶ on proposals which have a retrospective element, and in our published guidance on urgency criteria¹⁷. It is a general principle that rules ought not to change the character of past transactions, completed on the basis of the then existing rules. To do so may be considered unreasonable, or at best undermine market confidence. However, despite this general principle, we consider that there may be exceptional circumstances under which a modification with retrospective effect may be justified. As set out in the published guidance on urgency, these circumstances may include:

- a situation where the fault or error giving rise to additional costs or losses was directly attributable to central arrangements;
- combinations of circumstances that could not have been reasonably foreseen; or,
- where the possibility of a retrospective action had been clearly flagged to the participants in advance, allowing the detail and process of the change to be finalised with retrospective effect.

We also consider that in any event, any cost/loss incurred due to the prevailing rules would need to be material in order to warrant a retrospective modification. We do not consider that these circumstances can be applied in the case of offtake metering errors. Whilst we recognise that the scale of these errors can be significant, the impact upon shippers is entirely proportionate to the amount of energy that the shipper has initially been allocated, and more importantly, billed their customer for. Therefore, any invoice which follows the discovery of an offtake metering error is not an additional cost, but simply a correction, with the shipper being exposed to no greater or less cost than they should have been initially invoiced had the meter been entirely accurate.

¹⁶ For instance, UNC341: 'Manifest Errors in Entry Capacity Overruns' - <http://www.ofgem.gov.uk/Licensing/GasCodes/UNC/Mods/Documents1/UNC341D.pdf>

¹⁷ See: www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=213&refer=Licensing/IndCodes/Governance

We further consider that retrospective application of UNC335 would not achieve the proposers stated intent of incentivising GDNs to improve offtake meter accuracy. Such an incentive can only be effective on a prospective basis, providing the relevant parties the opportunity to respond to the investment signals the incentive provides.

Given the above, we consider that UNC335 fails to further relevant objective (d), which alongside its failure to further relevant objective (a) means we are minded to reject it.

Whilst we welcome the fact that regard is being given to the needs of smaller market participants, we do not consider size to be a relevant factor which may warrant different treatment in this instance. Both small and large suppliers are affected proportionately by offtake meter errors, as the apportionment of the associated costs is based on market share¹⁸. For example, the Aberdeen offtake meter error will result in a charge to shippers/suppliers of around £65m¹⁹, of which British Gas expects a charge of around £24m²⁰. We further note that since the implementation of UNC171²¹, reconciliation of historic errors is based on the AQ distribution (a proxy for market share) during the occurrence of the error rather than at the time of its discovery. We therefore disagree with those respondents who suggested that the existing exposure to reconciliation acts as a barrier to entry of new participants.

Although UNC335A may offer some short term relief to a sub-set of SSP shippers in the event of a significant offtake meter error, given the above we are not convinced that it would have a beneficial effect on competition between shippers and suppliers. We are therefore minded to reject UNC335A.

Conclusion

While we are minded to reject both UNC335 and UNC335A we would welcome any further views on the issues set out above and to the extent that are substantiated and relevant, will take them into consideration before making our final decision. However, we recognise that the existing proposals cannot at this stage be further developed in order to address our concerns.

¹⁸ See British Gas (2 Dec 2011) Modification 335, para 7.

¹⁹ Joint Office of Gas Transporters (15/12/2011) op. cit., p.12.

²⁰ See British Gas (2 Dec 2011) Modification 335, para 7.

²¹ UNC171: 'Amendment of 'User SP Aggregate Reconciliation Proportion' to incorporate historical AQ proportions' - <http://www.ofgem.gov.uk/Licensing/GasCodes/UNC/Mods/Documents1/171%20D.pdf>