

Modification proposal:	<b>Uniform Network Code (UNC) 456: Revision to the treatment of Allocation of Unidentified Gas for the 2013/14 AUG Year</b>		
Decision:	The Authority <sup>1</sup> has decided to reject this proposal <sup>2</sup>		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	28 June 2013	Implementation date:	N/A

## Background to the modification proposal

Historically, the cost of any gas that could not be allocated to an individual shipper was passed through the Reconciliation by Difference ('RbD')<sup>3</sup> process to Smaller Supply Points ('SSPs'). Domestic sites typically fall within this category. No costs were allocated to the Larger Supply Point ('LSP') sector.

This situation was considered to be inequitable as some of the root causes of unidentified gas consumption, such as theft and unregistered sites, could be as applicable to the LSP sector as SSP. Therefore, an independent expert was appointed in order to produce an evidence based methodology for the annual allocation of unidentified gas costs between the SSP and LSP sectors. This expert is known as the Allocation of Unidentified Gas Expert ('AUGE').

During the development of the 2013/14 allocation the AUGE informed the UNC Committee ('UNCC') that it was developing a new methodology which would take greater account of available data on consumption and theft than its previous RbD-based methodology. However, problems in obtaining accurate data for the revised methodology meant that it would be unlikely to be implemented in line with the UNC prescribed timetable to meet an effective date of 1 April 2013. The AUGE procedures and associated timelines, which are set out primarily in the AUGE Guidance Document<sup>4</sup>, allow for the previous year's unidentified gas volumes to be rolled over if revised figures are not produced.

On 28 December 2012<sup>5</sup> the AUGE published a letter indicating that the 2012/2013 volumes, as set out in AUGE Statement 1<sup>6</sup>, would indeed be rolled over into 2013/14. AUGE Statement 1 assessed aggregate unidentified gas volumes to be 6033GWh, with 988GWh being attributable to the LSP sector.

UNC modification proposals 442 and 442A were subsequently raised by British Gas and Scottish Power respectively. Each of these proposals sought to expedite the completion of the AUGE process, allowing for the revised methodology and associated statement of unidentified gas volumes to be implemented at the earliest opportunity. We rejected

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

<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> Reconciliation by Difference ('RbD') is the method of reconciling the difference between the initially allocated (estimated) measurements of gas and actual (metered) consumption. RbD was introduced in 1998 in order to facilitate competition in the Smaller Supply Point ('SSP') sector, as at the time it was not considered practical or economically efficient to individually reconcile all such supply points (which number in excess of 20 million) based on actual meter readings. Once the metered consumption at Daily Metered and Larger Supply Points ('LSPs') sector is taken from the amount of gas known to have been put into a given Local Distribution Zone ('LDZ'), the remainder is allocated across the SSP sector based upon the Annual Quantity ('AQ') of each supply point. The AQ is an estimate of annual consumption based upon historic meter readings received by the Gas Transporter ('GT').

<sup>4</sup> [www.gasgovernance.co.uk/sites/default/files/AUGE%20Guidelines%20v3.1%20approved.pdf](http://www.gasgovernance.co.uk/sites/default/files/AUGE%20Guidelines%20v3.1%20approved.pdf)

<sup>5</sup> See: [www.gasgovernance.co.uk/sites/default/files/AUGS%20Table%202012%2028122012.pdf](http://www.gasgovernance.co.uk/sites/default/files/AUGS%20Table%202012%2028122012.pdf)

<sup>6</sup> See: [www.gasgovernance.co.uk/sites/default/files/AUGS%202011%20Version%204.pdf](http://www.gasgovernance.co.uk/sites/default/files/AUGS%202011%20Version%204.pdf)

those proposals in part as they prescribed timescales for the completion of work that proved to be impracticable. Whilst we welcomed the prospect of a more accurate unidentified gas allocation methodology, we also raised concern at the uncertainty, particularly for the LSP sector, of allowing the process to be revisited mid-year.

### **The modification proposal**

UNC456 seeks to continue the development of the AUGE methodology and AUGS Table with a view to it coming into effect 1 October 2013. In order to meet this effective date, the proposer suggested that UNC456 would need to be implemented by 1 July 2013, allowing for the AUGE process to be completed during July and providing around two months notice of the revised unidentified gas volumes to shippers.

As with the earlier 442 proposal, the AUGE would be required to submit its methodology to the UNCC for approval. The methodology would be considered approved unless the UNCC unanimously supported a change to it, which would then be adopted immediately by the AUGE. There would be no option for the UNCC to reject the methodology in its entirety, or to conduct a further consultation.

This proposal was raised with a request that it follow an urgent timetable. We agreed to that request as we were of the view that the normal modification procedures could not be completed within the timescales required for the proposal<sup>7</sup>.

### **UNC Panel<sup>8</sup> recommendation**

At its meeting of 20 June 2013, the UNC Panel voted by a majority of nine votes to two not to recommend the implementation of UNC456.

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

The Authority has considered its statutory duties and functions in reaching its decision. The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 20 June 2013. 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>9</sup>. The Authority has been unable to conclude that the implementation of this proposal would better facilitate the achievement of the relevant objectives of the UNC<sup>10</sup>. On this basis, the Authority has taken the decision to reject the modification proposal.

### **Reasons for Authority decision**

We note that the proposer, respondents and the UNC panel focused on the potential impacts of UNC456 upon effective competition and agree that it is most appropriately assessed against relevant objective d), though there were also some comments in relation to f). We consider UNC456 would have a neutral impact upon the other relevant objectives.

*Relevant Objective d) – the securing of effective competition between relevant shippers*

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<sup>7</sup> See: [www.gasgovernance.co.uk/sites/default/files/UNC456\\_UD%20\(2\).pdf](http://www.gasgovernance.co.uk/sites/default/files/UNC456_UD%20(2).pdf)

<sup>8</sup> The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

<sup>9</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>10</sup> As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: <http://epr.ofgem.gov.uk/EPRFiles/Gas%20Transporter%20Standard%20Licence%20Conditions%20-%202010-11-2011%20-%20Current%20Version.pdf>

Each of the respondents, all of whom are gas shippers, made direct or indirect reference to this proposal having an impact upon effective competition, though views were evenly divided on whether this would be a positive or a negative impact. It is also notable that those views were polarised, with LSP shippers being opposed to UNC456 and the predominantly SSP shippers in favour. Cogent arguments were put forward both for and against implementation of the proposal.

We consider that whilst UNC456 may allow for the more timely and accurate allocation of some unidentified gas costs in the short term, this would come at the expense of additional volatility and market uncertainty. We have been unable to conclude that on balance 're-opening' the 2013/14 AUGE allocation would deliver net benefits to consumers as a whole.

### *Accuracy*

We welcome the work of the AUGE in developing what is widely recognised to be a more accurate and equitable methodology for the allocation of unidentified gas costs associated with previously unidentified gas. There is a consensus that the revised approach will be more accurate than the prevailing RbD-based methodology.

We note the AUGE letter of 25 June 2013<sup>11</sup> and appended responses to its consultation on the 1<sup>st</sup> draft of the 2013 AUG Statement for 2014/15. We understand that this would form the basis for the 2013/14 allocation, were UNC456 to be accepted. However, it seems clear from the AUGE letter that the methodology and any subsequent cost allocation table remain a work in progress. Whilst the letter notes a number of improvements to the accuracy of the methodology, there are several references to further work to be done. Much of this relates to the quality of the underlying data sets provided by Xoserve, which seem to have undergone several revisions.

We are unable to quantify the scale of any adjustment that would be made to the 2013/14 allocation, should UNC456 be implemented. However, certain conclusions can be drawn from the AUGE's correspondence and there is also anecdotal evidence to suggest that the scale of the adjustment will not be as significant as indicative figures circulated during late 2012 might suggest.

We acknowledge the points made by some of the respondents in favour of UNC456, which suggested that the methodology may never be perfect and that the aim should instead be an iterative process, making improvements to accuracy as and when possible. There is a view amongst some parties that, notwithstanding the issues identified in consultation responses and acknowledged by the AUGE as requiring attention, an expedited statement based on the revised methodology, even as it stands, will be more accurate than the prevailing volumes. At this stage we cannot conclude with any degree of certainty that the benefit of that improved accuracy would exceed the consequences of increased uncertainty and produce a net benefit to consumers.

### *Market certainty*

As noted in our decision on UNC442 and 442A, the value placed upon the independent expert is, at least in part, contingent upon it meeting the industry's expectations over the transparency and timeliness of its process, as well as the accuracy and rigour of its findings. We therefore sympathise with the concerns raised by some shippers that a relatively small delay in the AUGE's delivery of the revised methodology may result in the benefits of that revised approach being delayed for a whole year. However, that decision to roll over the 2012/13 allocation volumes was taken independently by the

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<sup>11</sup> See: [www.gasgovernance.co.uk/auge/comms3](http://www.gasgovernance.co.uk/auge/comms3)

AUGE and has itself raised a level of expectation that they will endure for the 12 month period set out in the AUGÉ procedures.

We also note the concerns of those respondents who suggested that modifications which seek to circumvent the established AUGÉ process may undermine its independence, as well as the status and degree of acceptance of conclusions. This prospect of iterative and countervailing modification proposals was one of the reasons we decided to accept UNC229<sup>12</sup> over the competing proposals considered at that time. That said, we also accept that no part of the UNC should of itself be excluded from the change process in circumstances where an appropriate modification proposal that is consistent with the decision making framework is brought forward.

Whilst we consider that any eventual unidentified gas allocation will be a small proportion of the shippers overall energy costs, we acknowledge that this could nonetheless have a significant impact if it has not been incorporated into financial planning. Those respondents who were opposed to UNC456 suggested that they had planned on the basis of the prevailing table and that it would be extremely difficult to pass through any additional costs given the prevalence of fixed contracts in the LSP sector. It was also suggested that thin margins meant that these additional costs could not be easily absorbed. It was noted that allowing a mid-year re-opener of the AUGÉ statement ran counter to our policy on network charging<sup>13</sup>. It was suggested that UNC456 was already causing uncertainty and difficulty in pricing contracts for the coming gas year.

In contrast, some of the respondents in favour of UNC456 suggested that they still held a great number of LSP sites, albeit typically of smaller consumption volumes and that the proportion of fixed contracts was relatively small. They went on to suggest that those fixed contracts must already factor in potential movements in unidentified gas allocation, amongst other things, and be appropriately hedged.

Some respondents commented on the concerns we raised in our UNC442 decision regarding the potential for a mid-year revision to unidentified gas allocation could (or would) result in a windfall gain for SSP shippers. They suggested that the proposed notice period would give adequate time for shippers to react and incorporate this into their pricing decisions. It was acknowledged that there was no guarantee that any short term reduction in costs would be passed through to SSP consumers as it would be only one of many relevant considerations. However, it was noted that without UNC456 there would not even be the opportunity to do so.

It was also suggested that some shippers may have anticipated a reduced allocation of unidentified gas costs based on the draft methodology and some provisional figures that the AUGÉ had released in late 2012. They argued that to the extent this anticipated reduction had already fed into their tariff setting, UNC456 would not result in a windfall, but would in fact correct an existing distortion.

We have been unable to conclude that the early implementation of a revised AUG Statement would offset the detrimental impact to market certainty. Whilst the actual scale of benefit from implementing UNC456 would only be known once the AUG Statement is produced, the costs of increased market uncertainty would be more immediately felt and may, at least initially, prove disproportionate to the eventual adjustment. Given the continuing uncertainty over the AUG methodology and applicable allocation volumes, we do not consider that UNC456 would better facilitate effective competition in between all relevant shippers.

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<sup>12</sup> [UNC229: 'Mechanism for Correct Apportionment of Unidentified Gas'](#)

<sup>13</sup> See: [Decision in relation to measures to mitigate network charging volatility arising from the price control settlement – 17 October 2012](#)

*Relevant Objective f) – the promotion of efficiency in the implementation and administration of the uniform network code*

One respondent suggested that UNC456 would undermine the legitimate expectations of UNC parties that the code would be administered in an efficient and consistent manner. Another commented that allowing UNC456 to be implemented would be inefficient for the UNC administration as it deviated from a recently established protocol. Further respondents commented that both the raising of this modification and decisions relating to its progression have had a negative impact upon their perceptions of the UNC process. In particular, some respondents have questioned whether it was appropriate to allow UNC456 to proceed and for it to be granted urgent status given that it was substantively the same as UNC442, which we had earlier rejected.

As noted above, our rejection of UNC442 was at least in part due to dates prescribed within that proposal proving to be impractical. Whilst we also raised more general concerns, these had not reached a definitive conclusion. We therefore considered that it was appropriate both to allow for a more attainable set of dates to be put forward, and to again allow interested parties to submit their views, rather than to foreclose further discussion. Given that any future modification proposal would also have to be considered on its own merits, we consider that the implementation or otherwise of UNC456 has a neutral impact upon the furtherance of this relevant objective.

### **Further issues**

As noted in our decision on UNC442, we consider that the development of the methodology for the 2013/14 AUG year has unearthed a number of shortcomings with the existing process. In particular, it was extremely disappointing that a relatively short and well signalled delay in the production of the 2013/14 volumes has resulted in the allocation for the entire year having to be based on the previous year's figures.

We welcome the review that has since been initiated by Xoserve, in accordance with the AUGE guidelines and look forward to seeing its report. We particularly look forward to seeing any recommendations that would prevent a reoccurrence of the problems faced during the development of the 2013/14 AUG statement.

Many of the challenges to the AUGE's earlier drafts have proven to be valid and we welcome the degree of rigour that has been applied to the development of the methodology and scrutiny of the underlying data. This is undoubtedly contributing to a more accurate product. From responses to both UNC456 and the earlier modification proposals, it is clear that there is a consensus of support for the AUGE's revised consumption based methodology being a more accurate basis for the allocation of costs than its previous RbD based approach. It is therefore disappointing that delays in the production and subsequent verification of data sets have delayed the introduction of the methodology. We consider that it should be possible to separate out these different elements such that a decision to accept the methodology can be made, without necessarily precluding further work on the data itself.

We note that as the AUGE Guidelines sit outside of the UNC itself and as a 'UNC Related Document' can be modified with the majority agreement of the UNCC alone, rather than requiring a UNC modification. Any UNC shipper or gas transporter is able to raise such a modification.

**Maxine Frerk**  
**Partner, Retail Markets and Research**

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