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| Modification proposal: | <b>Uniform Network Code (UNC) 326VV: Allocation of unidentified gas following the appointment of the Allocation of Unidentified Gas Expert (UNC326VV)</b> |                      |     |
| Decision:              | The Authority <sup>1</sup> has decided to reject this proposal  |                      |     |
| Target audience:       | The Joint Office, Parties to the UNC and other interested parties   |                      |     |
| Date of publication:   | 23 February 2012  | Implementation Date: | N/A |

## Background to the modification proposal

The Allocation of Unidentified Gas Expert (AUGE) is an independent expert appointed by the Gas Transporters (GTs). The AUGE was introduced by modification UNC229<sup>2</sup>. Its aim is to provide a methodology to identify the sources of Unaccounted for Gas (UAG)<sup>3</sup> and populate a table in the Uniform Network Code (UNC) that would apportion a fixed volume of UAG to the Larger Supply Point (LSP) sector<sup>4</sup>.

Prior to the implementation of UNC229 in April 2011, all UAG was allocated to the Smaller Supply Point (SSP) sector through the Reconciliation by Difference (RbD) process. This process looked at differences between (actual) metered and deemed (estimated) measurements of gas. Under the RbD process, energy and commodity transportation charges are levied on LSPs based on the volume of gas metered. SSPs are charged the difference between the volume of gas measured coming into the network, and the volume of gas charged to the LSP sector. This difference would include all the UAG volumes, and prior to UNC229 none of these volumes were therefore attributed to the LSP sector.

Every year the AUGE will publish its methodology and an estimate of the amount of UAG, for each source and market sector, in a document referred to as Allocation of Unidentified Gas Statement (AUGS). By the end of September each year, the AUGE estimates the level of UAG that will be allocated to the LSP sector for the following AUG Year, from April to March. The estimated annual UAG allocated to the LSP market is then pro-rated to provide a monthly volume.

For each month, the allocated UAG is subsequently converted into a financial amount by applying the previous month's daily System Average Price (SAP<sup>5</sup>). Each shipper is allocated a proportion of this amount based on its share of volume of gas over any reconciliation month<sup>6</sup>. Therefore the AUGE apportions a fixed proportion of costs prospectively to the LSP market, which are an estimate of the likely costs associated with the LSP shipper, and do not necessarily represent the actual value of UAG that occurs over that period.

<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.

<sup>2</sup> UNC229: "Mechanism for correct apportionment of unidentified gas" had an implementation date of 1 April 2011. Available at <http://www.gasgovernance.co.uk/0229>. The effect of UNC229 will be from April 2012 onwards. UNC317 was raised to allocate gas in the interim (from April 2011).

<sup>3</sup> UAG refers to gas which is supplied to the gas network, but whose use cannot be directly attributed to a shipper after correcting for the volume of gas lost in the network (eg due to leakage), known as shrinkage. Examples of UAG include gas theft or unidentified meter errors.

<sup>4</sup> In the GB gas market consumers may be classed as being part of the Smaller Supply Point (SSP) market where their AQ (an estimate of the annual consumption) is below 73.2MWh, or of the LSP if the AQ is above this limit.

<sup>5</sup> SAP is the weighted average price of all trades for the relevant gas day on the On-the-day Commodity Market (OCM), an anonymous trading service to which offers or requests for gas at a nominated price can be posted.

<sup>6</sup> A LSP Shipper would be debited its share of UAG, and a SSP Shipper would be credited its share of UAG.

## **The modification proposal**

Scottish Power (the Proposer) raised UNC326VV on 21 July 2011. The modification proposes to reconcile any future newly discovered source of UAG back to the period to which it relates, irrespective of when the issue was identified by the AUGÉ.

The proposer argues that this modification would contribute to a more accurate allocation of costs between shippers. It also considers that implementation of the proposal would represent a rebasing of risk, ensuring that the SSP and LSP markets faced the same risks from UAG.

### *Timing and definition of new sources of UAG*

The backstop date for reconciling such new sources of UAG would be either the AUGÉ Application Date of 1 April 2012, or the maximum invoice date as set out in UNC Section S, paragraph 1.4.4<sup>7</sup>. Such new sources would only be reconciled back where it could be demonstrated that the issue was prevailing at that time.

The proposal would not cover sources of UAG which have been included in any previously agreed AUGÉ methodologies. The proposer sets out that only future newly discovered sources of UAG, like GT notified metering errors, would be reconciled back.

### *Impacts*

The costs of updating the industry central systems, as a consequence of this proposal, would range between £30k and £80k. The proposal also sets out that ongoing operational costs associated with managing reconciliation charges could be up to £20,000 per year (if reconciliation is undertaken in all periods).

The potential benefits of implementing the proposal have not been quantified. The proposer argues that reconciling back any new issues to the period which they relate would contribute to more appropriately allocating costs between shippers.

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

At the Modification Panel meeting held on 19 January 2012, two votes were cast in favour of implementation of the proposal and eight votes were cast against it. The UNC Panel therefore did not recommend the implementation of the modification proposal.

## **The Authority's decision**

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 19 January 2012. The Authority has also 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>.

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<sup>7</sup> The maximum invoice date would apply where this date is more recent than the AUGÉ Application Date. Under the current UNC rules (UNC Section S sets out the arrangements for invoicing and payment, including retrospective invoicing) all retrospective invoices are limited to a period between 4 years to 4 years and 365 days. Two modifications are proposing to change this period. UNC395 "Limitation on Retrospective Invoicing and Invoice Correction" (available at [www.gasgovernance.co.uk/0395](http://www.gasgovernance.co.uk/0395)) proposes to move the reconciliation window to a minimum of 2 years and a maximum of 2 years and 364 days. UNC398 "Limitation on Retrospective Invoicing and Invoice Correction (3 to 4 year solution)" (available at [www.gasgovernance.co.uk/0398](http://www.gasgovernance.co.uk/0398)) proposes to move the reconciliation window to a minimum of 3 years and a maximum of 3 years and 364 days.

<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.co.uk](http://www.gasgovernance.co.uk)

The Authority has concluded that implementation of the modification proposal will not better facilitate the achievement of the Relevant Objectives of the UNC<sup>10</sup>.

### **Reasons for Authority decision**

We have assessed the proposed modification against the UNC Relevant Objectives. We consider this proposal will not further objective (d) and is neutral with regard to the other Relevant Objectives.

#### ***Standard Special Condition A11.1 (d): the securing of effective competition between relevant Shippers, between relevant Suppliers, and between Distribution Network Operators and relevant Shippers***

The proposer and some respondents to the modification consultation consider that apportionment of UAG costs associated with issues over the period in which these costs have been incurred, rather than just prospectively, could result in UAG costs being more accurately attributed to the appropriate Shippers. The proposer notes that accurate allocation of costs supports the development of competitive markets, and hence the proposal would help to facilitate the securing of effective competition between Shippers.

One respondent noted that the proposal is unclear on how precisely a newly discovered source of UAG would be reapportioned back to the relevant year<sup>11</sup>. Another respondent noted that, during development of the proposal, it had been clarified that metering errors would not have an impact on the AUG allocation of costs. The proposer had pointed to this as the main future source of UAG which could be addressed by this proposal. The latter respondent therefore considers that there is uncertainty as to which types of errors would be covered by the proposal.

We note that the latest AUG Statement<sup>12</sup> includes meter errors (including Local Distribution Zone offtake meter errors) to be an existing source of UAG. It is therefore unclear how meter errors would be considered to be a future newly discovered source of UAG. We consider also that the proposal is unclear on what type of new sources of UAG it could potentially address.

The proposal does not set out how any new source of UAG would be reconciled over the period in which the costs had been incurred. The nature of the calculation made by the AUG<sup>13</sup> includes a category of "Theft + Other". This category is derived from the total amount of estimated UAG and the volumes that can be attributed to other sources. Any subsequent adjustment to account for a new source of UAG would therefore need to take into account the impact of the allocation of UAG to the Theft + Other category. Any reallocation of UAG from one source to another will have impacts on the allocation of charges to the LSP market (as each source is likely to have its own estimate of how much UAG should be attributed to the LSP market). Such a process has not been established in the proposal nor the impacts assessed. We therefore do not consider that UNC326VV, in its current form, would contribute to better facilitate the securing of effective competition.

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<sup>10</sup> As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: <http://epr.ofgem.gov.uk/index.php?pk=folder590301>

<sup>11</sup> The respondent sets out two examples where more detail would be necessary to reallocate retrospectively any charges. One example refers to a change to the appointed AUG, and the other to shippers that may have exited the market.

<sup>12</sup> Available at <http://www.gasgovernance.co.uk/auge/state>

<sup>13</sup> The AUG directly estimates UAG individual component parts where possible, and calculates the aggregate effect of the remaining causes (i.e. those that it is not possible to estimate directly in a robust manner) by subtraction based on an estimated value for SSP load. For further details on the methodology, please see the AUG Statement, Section 4.

Some respondents also noted that allowing retrospective cost allocations creates risk and uncertainty, potentially reducing the benefits introduced through the establishment of fixed annual values, applied prospectively, via the AUGÉ process. These respondents argued that the increased risk and uncertainty would be counter to facilitating the securing of effective competition between Shippers.

We consider that the impact of introducing allocations which are made on a retrospective basis have not been fully weighed in the proposal. In particular, the proposal is not clear as to what may be the potential impacts on those organisations that have made their financial plans and risk mitigation measures based on their understanding of the amount of UAG attributed by the AUGÉ. We consider that such type of retrospective changes may introduce a risk, and therefore a cost, against which the industry may not be able to hedge.

At this stage it is not clear that the potential benefits from this proposal, as set out by the proposer, would outweigh the potential costs of introducing a retrospective allocation of charges, or that these benefits would represent an improvement in relation to the current AUGÉ process. While we agree with the principle that accurate allocation of costs would contribute to improving competition, we do not consider that UNC326VV, in its current form, would contribute to increase accuracy in allocation. We note however the industry wider work to improve accuracy of allocation, namely through Project Nexus, and we would encourage the timely development of this work.

For the reasons set out above we therefore consider that this proposal will not better facilitate the achievement of Relevant Objective (d).

### **Further issues**

We are mindful of the fact that the AUGÉ process has yet to complete a full cycle. We consider it would be prudent for the industry to consider any future modification on the basis of evidence, ie after the AUGÉ process has operated in practice for a full cycle.

**Colin Sausman**  
**Partner, Smarter Markets**

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