

Tim Davis  
Modification Panel Secretary  
Joint Office of Gas Transporters  
Ground Floor Red  
51 Homer Road  
Solihull  
B91 3LT

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Email: [lorraine.kerr@scottishpower.com](mailto:lorraine.kerr@scottishpower.com)

*(by e-mail)*

Dear Tim

**UNC Draft Modification Reports 0277 and 346 – Creation (and alternative) of Incentives for the Detection of Theft of Gas (Suppliers Energy Theft Scheme)**

Thank you for the opportunity to respond to the above Draft Modification Reports.

This response is non-confidential and ScottishPower are happy for this to be posted on your website.

ScottishPower do not support either Proposal.

ScottishPower do agree with the proposer that theft of gas is dangerous and poses a real risk to consumers and the network; that theft of gas currently costs all domestic customers money and that where gas is stolen it is not used efficiently. However, we do not believe that the measures being proposed by the Modifications will deliver the results claimed and we have a number of fundamental concerns with the principles of the proposals, namely:

The proposals are based on flawed and unsubstantiated assumptions;

- it is assumed that there is an equal spread of theft across market sectors and geography;
- the introduction of either proposal will result in an increase in theft detection; and
- that there is a direct connection/link between costs and results.

We expand on each of these issues below.

**Market Share and Theft Detection**

A grounding principle of Modifications 0277 and 0346 is that there is a direct relationship between a supplier's market share and the level/volume of theft that occurs on their supply points. This principle is flawed. Industry data (from xoserve) presented to the MOD 0277 workgroup and also the ERA/ENA report 2006<sup>1</sup> confirmed that there is a geographical basis to theft of gas. Therefore, the assumption that theft is correlated to throughput is

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<sup>1</sup> Joint ENA/ERA report, 'Report of the Theft of Energy Working Groups' (April 2006).

inaccurate, consequently setting targets for theft detection based on market share is not appropriate.

In addition the Proposals state that the Supplier Energy Theft Scheme (SETs) was a solution recommended by the ENA/ERA report. This statement is not completely accurate. The ENA/ERA report stated that '*incentives **may** provide a more appropriate economic incentive*' and further noted that smaller parties could be disadvantaged by an incentive regime and highlighted that, due to geographical differences in theft behaviour suppliers that have a more rural customer base would be disadvantaged.

The Modifications also reference that SETs was a recommendation from UNC Review Group 0245. While SETs was one of the recommendations this was only supported by the proposer of these Modifications, with the remainder of the industry supporting the consensus model of a National Revenue Protection Service (NRPS).

We also note that the SETs option was discounted in similar discussions in electricity. In electricity the two options that have been taken forward, and are currently being developed, are a National Revenue Protection Scheme and the Reasonable Endeavours Scheme. The main reasons for discounting the SETs option was due to the majority of industry participants recognising that the actual share of losses between Suppliers may be affected by other factors in addition to market share, e.g. customer type, geographical split, and therefore the setting of targets to detect theft based on market share was not equitable or reasonable. Such a scheme could result in a Supplier being penalised for failing to meet targets that are not achievable.

### **Measurement of Theft Targets**

The Proposals require that monthly reports will be provided to each Shipper by the Gas Distribution Network (GDN) to show the number of valid offences recorded by all Shippers in the Scheme Year to date. While such a report is necessary to allow Shippers to track their performance against the industry it does highlight that the Proposals are not the best way to incentivise theft detection.

An individual Shipper's target will change depending on the performance of other parties. Although the Proposer suggests that this will increase competition, and therefore the amount of theft detected, we do not believe that this will be achieved:

- If a Shipper significantly increases efforts in Revenue Protection Services (RPU) to the extent that they visit every supply point on a fortnightly basis and do not find any further cases of theft, they could be penalised for not meeting our target (either number or volume based) despite the extraordinary steps we have taken.
- Another party may not have invested in any further RPU activities and one of their agents (meter readers) stumble across multiple linked thefts (for example, a chain of fast food outlets) resulting in them exceeding their target.

It seems inequitable that any Shipper should be penalised via the SETs scheme, when they have invested both time and money in investigating theft, while another party would be rewarded who has made little or no effort to detect theft. This highlights that it is does not necessarily '*cost money to do nothing*' and reward those '*who do most to reduce theft*'<sup>2</sup>, as stated by BGT within the Proposals.

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<sup>2</sup> P2 MOD 277, P3 MOD 346  
Cathcart Business Park, Spean Street, Glasgow G44 4BE  
Tel: 0141 568 3284 Fax: 0141 568 3050  
[www.scottishpower.com](http://www.scottishpower.com)

Specifically in relation to MOD 0346, ScottishPower do not believe that setting targets based on volume of gas detected is a prudent approach, as it could have the perverse effect of letting a detected theft continue for longer to increase the volume detected to help a Shipper achieve targets. Equally this will play into the amount of gas being smeared through RbD. Therefore, although ScottishPower do not support either proposal the original 0277 is better than 0346, as it does not have this perverse incentive.

Also, the introduction of either competitive solution contemplated by these Proposals will result in 'detection' becoming more rewarding than 'prevention'. This is not a desirable result and will not lead to the industry working together to prevent theft, unlike the (NRPS) alternative that will place an emphasis on prevention and detection, by providing an industry wide view of theft and ensuring each case is dealt with in a consistent manner.

### **Value of the Scheme**

The Proposals state in a number of sections that the proposal 'will' result in an increase in the amount of theft detected by Suppliers. This is purely an assumption and cannot and has not been substantiated. The introduction of an incentive scheme does not guarantee that it will lead to an increase in the amount of theft detected. The industry does not yet know exactly how much theft occurs, therefore, it is impossible for any Party to "guarantee" that the introduction of a SETs scheme 'will' deliver an increase in the level of theft detection. The Proposal suggests that BGT operate an efficient and robust RPU scheme, noting that of the 2017 theft of gas cases recorded in 2009, BGT detected 1675 (83%) of these. Applying the principle that everyone could endeavour to work to the same level as BGT this would indicate that there is only circa 3815 cases of theft that can be identified across the industry. On this basis it is important that any scheme is proportionate to this.

The proposals also suggest that the overall scheme value should be £10.062m for Modification 0277 and £12.062m for Modification 346. These figures have been calculated from the £4.417m BGT spend to fund a 'satisfactory performance level' pro-rated up on the basis on the BGT market share. Again, this is making the assumption that BGT operate efficiently and effectively and that every other party can run an RPU service on the same cost base, when this will not be the case. Taking the figures provided in the respective Modifications for the 1675 cases of theft BGT identified the cost of each was £2637 (this does not include any investigations that resulted in no theft being found). Further, no details have been provided as to the scope of the BGT RPU service and therefore we are unclear if these costs include litigation, debt follow-up etc or purely just the investigation of theft. Also, we are aware that BGT currently conduct RPU services on a commercial basis for other industry participants and it is not clear if these costs have been ring fenced or included within the figures used. In order to determine that any proposed incentive scheme is proportionate and suitable for industry, we believe it is essential that the basis of the costs and performance on which the scheme is based are transparent to all Parties.

It is also unclear how the future value of the scheme will be calculated, for example, it is the intention that the value will be fixed at the figures provided in the Proposals or will these figures have to be re-calculated on a regular basis (in addition to inflation)? We do not believe that the proposal is sufficiently developed, as these aspects have not been determined.

## **Evidence of Theft**

ScottishPower agree with the proposer that in order to prevent gaming of the system Shippers will have to collect and retain sufficient evidence for each theft detection, to prove, on the balance of probabilities, that a meter tampering offence has been committed as defined under Schedule 2B of the Gas Act (1986). However, we are aware that currently Shippers/Suppliers have a differing approach to assessing a 'valid' theft with some parties counting theft in instances that others would not. We welcome the recent Ofgem guidance in this area, but believe that in order for the SETs scheme to work fairly a 'valid' theft has to be defined and consistent across market participants. This will not only ensure a level playing field but also ensure that all customers are treated equally and consistently irrelevant of which company supplies their gas.

## **Implementation and Windfall Avoidance**

ScottishPower welcome the refinement of the Windfall Avoidance rules, per the feedback that we and other industry participants provided through the workgroup. However, we remain unconvinced that the new proposals will encourage or incentivise any excluded party to detect more theft.

Also, it is noted that any Shipper eligible for Windfall Avoidance measures will be expected to fund any User Pays charges but is not clear what this will include. We would expect this to be the share of the set-up costs of the scheme as well as the ongoing administration and audit of the scheme. However, since this is not clear from the Modifications we do not believe that the Proposals have been sufficiently developed.

## **Principles of Calculation**

The proposals state that the credits and debits for the Scheme Year will be calculated on the number of offences shown in the monthly report for the final month of each Scheme Year and the market share at the end of the Scheme Year. We believe this has to be clarified to ensure these figures are the cumulative totals for the year and not only the measurements as at the end of that final month. Otherwise, the calculations will not account for any movement that may occur throughout the year.

## **Audit**

ScottishPower welcome the inclusion of an audit in the scheme, which we believe is a fundamental requirement of any incentive scheme of this nature. While the general audit principles seem fair, i.e. all parties are audited in the same and consistent manner, there is a lack of detail regarding audit, for example, the requirements of an 'ongoing audit'. There are no dispute arrangements specified for the audit. We believe all Parties should have the right to challenge the audit where they believe they have sufficient justification for this.

## **Benefits**

ScottishPower do not agree with a number of the benefits stated within the Modification Report:

- *Provides Suppliers with an incentive to detect theft* – Suppliers (in the SSP market) do already have an incentive to detect theft since theft does result in loss of revenue and also impacts on RbD. Also either proposal can in fact result in

perverse incentives, whereby 'detection' becomes more rewarding than 'prevention'.

- *Ensures proper cost allocation, by ensuring those who do nothing subsidise those who do something* – as we have clearly shown above this is an assumption and in fact parties who invest may be detrimentally affected by the SETs scheme, based on number or throughput.
- *Administration costs are not onerous* – initial costs quoted in the xoserve ROM indicate £220-£380k to develop the requirements to support SETs and a further £130k pa running costs (£50k for auditing). We would suggest such costs are not insignificant.
- *Ensure competition in the provision of theft detection* – BGT reference findings of 'The Benefits from Competition: some illustrative UK cases' by DTI to support this statement. While this document does indicate that competition can be a key driver in delivering greater productivity we would suggest that the report does not point to or conclude that ensuring competition in the provision of theft detection will lead to the 7 claims made in the Workgroup Report. The DTI report was written in 2004 and is based on 6 market case studies<sup>3</sup> that are not related to the gas industry. The Report also notes due to the timescale of the research it 'precluded the possibility of in-depth rigorous academic study, based on formal theoretical modelling and econometric testing'. We do not therefore believe this Report is a sound basis for the claims being made within the Workgroup Report.
- *SETs is self-financing; total credits will equal total benefits (less scheme administration costs)* – we disagree that the scheme is self-financing. The introduction of the Scheme will require parties to find an annual investment of the Scheme value without any guarantee that they will be able to recover the costs or in fact they may have to contribute further. This in turn makes it extremely difficult to budget for the costs, with the potential for parties to have to continually invest in paying for a Scheme as well as increased RPU costs, without the ability to determine how successful they will be.

We do not believe that the consequences of non-implementation will be the continuation of no effective incentive on gas Shippers or Suppliers to detect theft. In fact, we believe that the introduction of SETs may have more detrimental impacts. For instance, there is a risk that the introduction of SETs will increase costs to the end consumer, as the cost of a Supplier's RPU service mount, with absolutely no guarantee that additional theft of gas will be found. This is especially the case since the proposed Schemes measure either the number of cases found or throughput based on market share. As we have previously stated it is widely acknowledged and proven that there is no direct link between market share and levels of theft.

More worryingly for small market players they may simply not be able to meet the targets they are set because there is not a sufficient concentration of theft on their portfolio. The result being these parties will be required to pay into a Scheme they cannot recoup their costs from. This could ultimately distort competition in the market, deter market entry or place an unacceptable burden on Shippers.

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<sup>3</sup> Retail Opticians, International Telephone Calls, Net Book Agreement, Passenger Flights in Europe, New Cars and Replica Football Shirts  
Cathcart Business Park, Spean Street, Glasgow G44 4BE  
Tel: 0141 568 3284 Fax: 0141 568 3050  
[www.scottishpower.com](http://www.scottishpower.com)

## **Facilitation of Relevant Objectives**

ScottishPower does not agree with the proposer that the Modifications would better facilitate the following relevant objectives:

### **Standard Special Condition A11.1 (c): so far as is consistent with sub-paragraphs (a) and (b), the efficient discharge of the licensee's obligations under this licence:**

We do not think this objective is relevant to the Proposals since we do not believe that the Licensees will be affected by the implementation of either Proposal. The proposer argues that by increasing the number/volume of theft identified upstream more theft will be found downstream on the Network. As previously noted it cannot be guaranteed that there 'will' be an increase in the amount of theft detected as a result of the Proposals. At best this is what is endeavoured by the Schemes being proposed. Therefore, it is a stretch to suggest the introduction of either Modification will be an efficient mechanism to discharge the Licensee's objectives.

### **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.**

As outlined above, we also believe that the introduction of these Proposals may actually distort competition, as opposed to increasing competition, for some parties, since the proposals introduce a requirement for increased and uncertain costs with no guarantee of return.

The Proposals may also result in a disincentive for Shippers and Suppliers to work together to resolve theft for the benefit of the whole industry and customers alike. If Shippers are competing against each other to detect the highest number or volume of theft there is no incentive to alert another Shipper to potential theft at one (or many) of their sites. This is in direct opposition to the NRPS model that will introduce a holistic industry approach to theft detection and prevention with all companies working together, via the NRPS service provider, with the aim of preventing and reducing theft across the Great Britain, irrespective of whom the Supplier is. The NRPS model will also ensure settlements costs are reallocated accordingly which the Proposed Modifications fail to do. The result being all industry players in the SSP market will continue to pick up a smear of theft costs (via RbD), despite the fact that an individual Supplier may have recouped monies for the stolen energy. This does not secure effective competition between Shippers/Suppliers.

Due to the competitive nature of RPU services intended to be introduced by either proposal we believe this may lead to more aggressive behaviour in order to meet the targets set. This could result in a very varied approach by individual companies (despite any Code of Practice) to tackling theft with customers receiving a different experience dependant on who they are supplied by. This is not to the benefit of customers. The alternative consensus approach of a NRPS would remove such issues ensuring a consistent approach across the board. The NRPS would also allow theft to be tracked at a centralised level, with the hope of identifying more theft if it is occurring.

It is also worth noting that the statement that the NRPS scheme will require incentives on suppliers to be effective contained within the Proposals is not accurate. The NRPS would work equally on behalf of the industry with no preference for any party and we believe SETs is not compatible with the NPRS proposals.

**Standard Special Condition A11.1 (e): so far as is consistent with sub-paragraphs (a) to (d), the provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards (within the meaning of paragraph 4 of standard condition 32A (Security of Supply – Domestic Customers) of the standard conditions of Gas Suppliers’ licences) are satisfied as respects the availability of gas to their domestic customers;**

Again, there is a flaw with the fundamental assumption of the Proposals that there is a link between costs and benefits to performance. Also, it is no more than an assumption to state that a consequence of either proposal ‘will’ be an increase in the amount of theft detected.

We do not believe there has been any evidence presented within the review group, or otherwise, to suggest that incentives will result in more theft being detected, therefore, the claims that the proposals will result in better gas forecasting and the prevention of damage to the network are not founded.

Further these Modifications will not provide any incentive in relation to supply security standards.

**Standard Special Condition A11.1(f): so far as is consistent with sub-paragraphs (a) to (e), the promotion of efficiency in the implementation and administration of the network code and/or the uniform network code;**

It cannot be assumed that the Proposals will result in an increase in the number of theft cases detected; therefore it cannot be assumed this will have a positive impact on the activities of the AUGÉ.

Lastly due to the points outlined above, we do not believe that SETs is an efficient means of implementing the Network Code obligations.

I hope you find these comments useful and should you wish to discuss further please do not hesitate to contact me.

Yours sincerely,

Lorraine Kerr  
Commercial Regulation Manager  
ScottishPower