Joint Office of Gas Transporters

Representation

Draft Modification Report

0388 - Fixed parameters for determining Shipper contribution to Unidentified Gas

Consultation close out date: 30 September 2011

Respond to: enquiries@gasgovernance.co.uk

Organisation: **Total Gas & Power Ltd**

Representative: Richard Dutton

Date of Representation: 13 September 2011

Do you support or oppose implementation?

Support

Please summarise (in one paragraph) the key reason(s) for your support/opposition.

As the proposer, we raised this modification in order to achieve a number of objectives. By calculating the price in advance of delivery allows:

1) A cost~~,~~ that can be priced transparently into gas contracts.

2) A cost that is fixed and therefore removes the need for risk premiums to be built into future gas contracts. This will also help the SSP suppliers when returning this benefit to the SSP sector.

3) Removes the need for any reconciliation, or retrospective billing to the customer and therefore reduces both complexity and cost and further risk of reconciliation amounts not being met where customers have switched

4) Will also provide the LSP sector with certainty of the value of Unidentified Gas prior to the period

5) Would act in a similar way to the existing Transportation Charges and Notices

We do not believe that there is any impact on wholesale balancing activities.

We recognise that the overall cost of Unallocated Gas is an arbitrary one, and not an exact science, as the volume we are applying the prices to is an estimate. We also recognise that the value returned to the SSP sector will, under this proposal, be different to the existing proposal, but this could be up or down. This in turn should not be seen as an issue as within the AUGE guidelines, the mechanism is there to allow for any under or over recovery to be smeared into the following year(s).

It is not our intent to reduce the value of Unallocated Gas to be returned to the SSP sector, it is merely to fix it in advance.

Ofgem have indicated that it would be particularly helpful if the following questions could be addressed in responses:

Ofgem understand that the main issue to be solved is the reduction of costs associated with the SAP mechanism. This involves replacing SAP with a fixed price. They are concerned that this may discriminate between LSPs and SSPs, as LSP uncertainty is reduced at the expense of greater uncertainty for SSPs.

Ofgem ask the following questions to better understand the context and scale of the issue, and how the solution will affect parties.

Understanding the processes

1. Would it be helpful to show, through a diagram, how the current and proposed pricing flows are passed through the industry.

There are two scenarios: Where the price is fixed, all costs are built into the price. The greater the uncertainty the bigger the risk, the bigger the risk, the greater the premium. From an invoicing perspective, however, these are simple fixed price products. The complexity comes from those customers where the costs are passed through.

We cannot bill to an actual cost for the month of delivery because we are dependent on knowing two variables, SAP and the LSP market AQ for the month. Whilst the SAP price would be known within the first few days of the month, the LSP market AQ will not be published until the middle of the month. Even if both were known at the beginning of the month, the calculation still needs to be made for each supply point or "pricing group" of supply points and then charged accordingly. This is further complicated, as instead of being a straightforward commodity charge, the Unallocated Gas Charge is calculated as a pence per unit of AQ, which may then need to be converted to a commodity charge if there is no standing charge element to the customer's invoice, in which case consumption also potentially needs to be taken into consideration.

This then leads to one of two routes, estimate the Unallocated Gas Charge and then reconcile, or bill the Unallocated Gas Charges a month or more in arrears. Neither of these are satisfactory to the customer or the supplier.

Understanding the scale of the problem

2. The proposal sets out that the existing pass-through mechanism mainly affects approximately 75% of LSP NDM customers. What proportion of all gas goes to these parties?

Non-Confidential: We affirm that the NDM gas volume supplied on Transportation Pass Through contracts exceeds the percentages indicated in our modification proposal. The DM gas volume supplied on supplied on Transportation Pass Through contracts is in excess of 99%. We believe that TGP is the largest supplier by volume in the LSP NDM sector.

Confidential: Values provided to Ofgem.

Understanding the strength of the proposed solution

3. Do you agree LSPs are less able to manage the risk of fluctuating prices and to what extent?

We believe that this modification helps both LSP and SSPs, in that the costs and benefits are known and fixed in advance. It is this predictability that we have been asking for with regards to Transportation Charges, and something that we believe the customer, as well as the industry, suppliers and shippers, desires. It improves forecasting and removes risk, and therefore risk premiums. This we believe, is one of the aims of other recent modifications as well as the forthcoming Price Controls.

4. What is the level of saving made by LSPs under this modification proposal - for example of avoiding administration costs?

The current methodology, whilst on the face of it seems relatively straightforward is actually very complicated, primarily because of the fact that the costs are unknown at the point of billing, and because the charge is on a pence per unit of AQ held and not a commodity based price. Where transportation is passed through, which as indicated is the majority of our portfolio, and believe is the case for the rest of the industry, we are left with 2 options: to bill 2 months in arrears to an actual cost, amending Unallocated Gas costs monthly or to estimate and then reconcile. Neither of these are satisfactory to us as a supplier, nor to the customer, particularly when the customer changes supplier, or indeed goes into administration or insolvency. To implement either solution, there are significant up front IT development costs, we believe circa £100,000, and then further ongoing administration costs, which we believe would be a further cost of £100,000 annually. On top of this is the cost of having debt outstanding.

5. Would the risk borne by SSPs under this modification proposal increase?

No. We do not believe that this financial readjustment and the volume of gas purchased by the Shipper to cover its SSP portfolio are linked – shippers will not reduce their wholesale gas purchases in line with the likely reimbursement they will receive under the AUGE process (and indeed by deliberately not purchasing gas to cover part of their portfolio would be going against their licence obligations). Shipper exposure to imbalance costs will therefore not be varied by any aspect of the AUGE process and so risk will not increase or decrease.

Instead SSPs will have certainty on the unit rate that they will be reimbursed for Unidentified Gas, instead of a varying rate based on SAP. This certainty will reduce risk for SSPs. They too can then factor this known benefit into their pricing. To us this is a win win situation.

6. How does the modification proposal affect the allocation of unidentified gas between parties?

The current process as introduced by modification 0229 does not reallocate Unidentified Gas between parties – instead there is a bottom line financial adjustment. Therefore this modification will not alter how Unidentified Gas is reallocated, but instead removes risk from both sides (both SSP and LSP) that the value of Unidentified Gas will vary unpredictably on a monthly basis. This provides certainty to both sides of the equation.

7. What are the arguments for a shipper not taking on this risk?

For fixed price products, the supplier will be taking on some of the risk, but with risk comes a premium and therefore additional cost to the customer. TGP, through this modification are trying to reduce this risk (as well as cost), and therefore believe it to be beneficial to the customer. Again, this is to the advantage of both the LSP and SSP sector.

8. For a range of different gas price scenarios, how are parties affected? For example, is a long--run increase in gas prices taken into consideration?

This modification uses a published forward price to determine the cost to the LSP sector. This price will follow wholesale price trends and will be update annually in light of those trends. This will mean that both LSP and SSP shippers be debited and credited an Unidentified Gas cost that takes into account the cost of wholesale gas in the market and so will be equally affected, irrespective of how prices vary. This is in contrast to the current process which uses a retrospective price.

9. If one sector (SSPs or LSPs) is always going to have to bear the risk set out by this modification proposal, which sector is better able to manage that level of risk efficiently and effectively? At present, how does each sector deal with risk?

It is not the intention of this modification to transfer any risk, and we do not believe that this does. This modification is providing certainty to both sides. It is clearly setting the cost to be passed back to the SSP sector in advance. However, to answer your question, the SSP sector is better able to manage risk, simply because of their size and the ability they have in their agreements with the customer to amend prices and therefore mitigate any fluctuations, here or in any other input costs.

Implementation of the proposed solution

10. What are the implementation costs associated with this modification proposal in the following two cases: a) decision is reached before 1 November 2011; b) decision is reached after 1 November 2011?

As the proposer we support a decision prior to 01 November 2011 as both xoserve and shippers are currently developing system solutions to accommodate the AUGE process. A decision by the 01 November will therefore allow xoserve and shippers to take into account any process changes easily and so costs to the industry (and so therefore the customer) will be minimal.

Any decision after this date will run the risk of both xoserve and shippers implementing system solutions on the basis of the UNC as currently drafted, and then subsequently altering that process to take into account the new fixed parameters. We do not believe, however, the cost to xoserve to implement this is significant

11. If this modification results in losses or gains for LSPs, in comparison to the baseline solution (P229), should they be recovered through the subsequent AUGE process?

We do recognise the concerns that this process will mean the ultimate financial adjustment that would have been paid to the SSP would differ compared to the current process, though we believe that the SSP sector will be remunerated a higher amount under this proposed process. However, all things being equal, the remuneration to the SSP sector should be higher. This is because we are introducing the further risk of time into the equation. However as previously stated, we believe that the AUG within it's guidelines has the ability to incorporate any over or under recovery into the following year(s).

12. Would a further modification be needed to make the adjustment envisaged by the previous point (question 11)?

This modification does not include such a process, but we do not believe that any such adjustment process would need to be included in the UNC. We would envisage however that any such under or over recovery should be taken into account by the AUGE process in the following year(s).

Are there any new or additional issues that you believe should be recorded in the Modification Report?

Further to our points above, if there is any concern that the AUGE process cannot take into account in the AUGE guidelines document we will raise the "roll-over" process as described in question 11/12 above as a change to complement this modification.

Relevant Objectives:
How would implementation of this modification impact the relevant objectives?

As stated in the modification, the modification furthers relevant objective (d) as fixing the parameters used to determine the apportionment of Unidentified Gas will allow a unit rate to be created that LSP shippers can apply to their own portfolio. This will provide certainty to LSP customers with regard to the Unidentified Gas costs they will be charged in pass through contracts and will reduce potentially substantial shipper costs by avoiding reconciliation of customer bills.

Impacts and Costs:
What analysis, development and ongoing costs would you face if this modification were implemented?

Removing the need to reconcile this cost pass-through item will result in significant administrative cost savings, in our case we estimate the saving to be around £100,000 plus the cost of implementation. It also removes the risk of that reconciled customer debt being unrecovered.

With regard to implementation costs, shippers are at present looking to develop system solutions and processes in order to accommodate the processes that Modification 0229 will introduce. Implementing Modification 0388 by the 01 November 2011 will mean that no additional costs will be incurred by shippers. If the modification is implemented after this date, then it is likely that shippers (and ultimately customers) will incur significant additional costs in adjusting these systems.

Implementation:
What lead-time would you wish to see prior to this modification being implemented, and why?

Please see our response above to question 11.

Legal Text:
Are you satisfied that the legal text will deliver the intent of the modification?

As the proposer we have reviewed the legal text and are happy that it delivers the proposed modification as intended.

Is there anything further you wish to be taken into account?

Please provide any additional comments, supporting analysis, or other information that that you believe should be taken into account or you wish to emphasise.

No