

Modification proposal:	Uniform Network Code (UNC): Creation of Incentives for the Detection of Theft of Gas (Supplier Energy Theft Scheme) (UNC277) and An Alternative to the Supplier Energy Theft Scheme Based on Throughput (UNC346)		
Decision:	The Authority ¹ has decided to reject these proposals		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	26 March 2012	Implementation Date:	N/A

Background to the modification proposal

Theft of gas² increases the costs³ paid by consumers and can have serious safety consequences. It also leads to a misallocation of costs among suppliers, which can distort competition and the efficient functioning of the market.

Improving the arrangements to detect and prevent theft should improve the safety of the gas networks and reduce the costs to consumers associated with the value of stolen gas and the costs incurred by suppliers to detect and prevent theft.

In April 2004, Ofgem consulted on whether the gas and electricity theft arrangements were fit for purpose. As a result, a joint Energy Retail Association (ERA)/Energy Networks Association (ENA) workgroup was established to explore the issues involved and published two reports in 2006 and 2007⁴. These reports identified the lack of proper incentives in existing market arrangements to detect and prevent theft⁵ and suggested that improvements to incentives should be made. It also considered that licence conditions did not place clear obligations on suppliers to proactively detect theft⁶.

A UNC Review Group, UNC245⁷, was established in April 2009. In November 2009, it made recommendations on changes to improve theft detection. This included two mechanisms, a Supplier Energy Theft Scheme (SETS) and a National Revenue Protection

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

² We have used the term "theft" as a simple way to describe a number of offences under schedule 2B (paragraphs 10 and 11) of the Gas Act 1986 where a customer prevents a meter from correctly registering the amount of gas supplied, has damaged equipment or reconnects the supply without the relevant permission.

³ The cost of illegally taken gas where theft remains undetected is usually smeared across suppliers, so that all consumers pay for the stolen gas through increased charges as suppliers seek to recover associated costs. Where theft is detected, the supplier seeks to recover costs directly from the consumer but may only be able to recover a proportion of these.

⁴ Report of the Theft of Energy Work Group, April 2006 and Report of the Theft of Energy Incentive Group – Final Proposals, June 2007.

<http://www.energyretail.org.uk/documents/ReportoftheTheftIncentiveSchemeDevelopmentGroup-FinalProposalsJune2007.pdf>

⁵ Suppliers are eligible for compensation payments from a self-funded scheme where they have identified theft but have failed to recover charges from the customer, having undertaken reasonable endeavours to do so. These compensation arrangements seek to cover elements of the investigation, meter replacement costs and transportation costs. In practice, these arrangements are not widely used. In October 2009, British Gas proposed UNC modification UNC231V to improve the operation of this compensation arrangement. We have rejected this modification in light of our alternative package of proposals for theft reform and signalled our intention to remove the supplier facing element of this scheme.

⁶ Suppliers are however required by licence to conduct two-yearly meter inspections, including checking for evidence of theft.

⁷ UNC245 - Review of arrangements regarding the detection and investigation of Theft of Gas.

Scheme (NRPS), for improving detection of gas theft. The modifications described in this letter propose to introduce the SETS.

The modification proposals

British Gas (the proposer) raised UNC277 in December 2009 and UNC346 in November 2010. The proposals seeks to introduce the SETS mechanism by placing a financial incentive on a supplier (through its shipper) to detect and report gas theft, including damage to equipment.

Under UNC277 a shipper would be required to fund the incentive scheme in accordance with its market share of Supply Points⁸ and would be eligible for incentive payments in line with its relative performance in detecting theft at Supply Points at the end of each scheme year. By contrast, under UNC346, which is the same as the UNC277-proposed SETS in all other respects, shippers would fund the incentive scheme in accordance with their share of throughput⁹ and would receive incentive payments based on the volume of theft detected rather than on a measure of Supply Points.

Both proposals would be supported by an audit process to provide assurance that shippers were identifying theft in accordance with a code of practice. Where a code of practice is not in place, the modification proposals set out explicit standards against which suppliers would be audited.

The aim of SETS is to incentivise suppliers to invest in theft detection and to reward those most successful in doing so. A 'windfall avoidance' measure would apply for the first two years of the scheme's operation. The aim of this is to reduce concerns that suppliers, who had already invested in theft detection, could disproportionately take advantage of the incentive payments provided by SETS. The proposer included this measure as it perceived that its own theft detection arrangements and performance could result in a potential initial windfall.

The value of the incentive payment under UNC277 was calculated to be approximately £10m per year. For UNC346 it was approximately £12m. The proposer derived these figures by extrapolating its own spend on theft detection activity so as to deliver a similar level of performance across the industry.

UNC Panel¹⁰ recommendation

The Panel considered the draft FMR for both modification proposals at its meeting on 20 January 2011. The Panel voted by a majority to recommend the implementation of UNC277 but rejected UNC346. The views of Panel members appear in the FMR.

Tackling Gas Theft – Ofgem consultation and impact assessment

Ofgem published a consultation and draft impact assessment on tackling gas theft in August 2011¹¹. This consultation considered both UNC277 and UNC346 against other

⁸ A Supply Point is defined in Section G 1.1.1(a) of the UNC and describes a meter point (or aggregation of meter points that meet set criteria) registered to a shipper.

⁹ By throughput the proposer means the mean aggregate Annual Quantity (AQ), so it is a volume-based rather than supply point count-based measure of market share.

¹⁰ The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

¹¹ The draft impact assessment and consultation and responses to it appear on Ofgem's website:

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=70&refer=Markets/RetMkts/Compl/Theft>

industry proposals for theft reform. In that consultation we requested views on our initial assessment of UNC277 and UNC346¹².

The consultation period ended in October 2011. We have now set out our views on an alternative package of measures that should be implemented¹³. These measures include a new licence condition for gas suppliers, an incentive mechanism, a Theft Risk Assessment Service, a code of practice on theft investigations as well as other supporting measures.

The Authority's decision

The Authority has considered the issues raised by the modification proposals and the FMR dated 21 January 2011. The Authority has considered and taken into account the responses to the Joint Office's consultation on the modification proposals which are attached to the FMR and the responses to the August 2011 impact assessment and consultation carried out by Ofgem.

The Authority has concluded that implementation of one or other of the modification proposals will not better facilitate achievement of the relevant objectives of the UNC¹⁴.

Reasons for the Authority's decision

We have assessed the proposed modifications against the UNC Relevant Objectives. Other than the Relevant Objectives stated below, we consider that the modification proposals have no impact or are neutral when assessed against the remaining objectives.

Relevant Objective (a) 'the efficient and economic operation of the pipe-line system'

We agree with the views of the Panel members that considered that the modification proposals would better facilitate this objective. We agree that the proposals are likely to increase theft detection. It is therefore likely that they would increase the efficient operation of the pipe-line system by preventing unsafe interference in the system, for example caused by gas leaks or explosions.

Relevant Objective (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 agree with the views expressed that these proposals would impact on the efficient discharge of gas transporters' licence obligations. We note that gas transporters are required under SLC 7 of the Gas Transporters Licence to investigate theft in the course of conveyance. However, it is not clear how UNC 277 or UNC346 will improve the efficient discharge of this requirement to investigate, although it may identify more instances that gas transporters are required to address.

¹² In the consultation we noted the potential benefits of incentives. We also set out concerns that the value of the incentive pots did not appear to be based on a robust methodology (and we note that the proposer set out an alternative approach in its response to our consultation). We also reflected concerns that, without a robust methodology for establishing and maintain the size of the incentive pot then this may lead to unwarranted distribution effects between suppliers and negatively impact on competition.

¹³ Tackling Gas Theft: Way Forward, March 2012 at <http://www.ofgem.gov.uk/Markets/RetMkts/Compl/Theft/Pages/Theft.aspx>

¹⁴ As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: <http://epr.ofgem.gov.uk/index.php?pk=folder590301>

Relevant Objective (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

We agree with the views expressed in the FMRs and in responses to our August 2011 consultation that increased theft detection could result in overall improvements to the accuracy of cost allocation between suppliers and increase effective competition between them.

However, we remain concerned that the justification and size of the incentives under UNC277 and UNC346 have not been well established. In particular, we are concerned that they may not be proportionate to the expected benefits for consumers.

We note the concerns raised that the incentive scheme may have a potentially negative impact on competition as some parties may be better able to respond to the scheme than others. In particular, this is because theft may not be distributed evenly between supplier portfolios and that some suppliers may be better able to exploit economies of scale in analysing data. In this context we note that the methodology for deriving the size of the incentive, which will determine the impact on parties in the market, has not been linked to the overall benefits to consumers. We consider that an incentive arrangement should be constructed so as to establish clear benefits for consumers and that any reallocation of funds between suppliers, and subsequent impact on competition, would need to be justified in that context.

We welcome the development of the windfall avoidance measures in the proposals which seek to address potential competition effects in the short-term. However, because the proposals do not contain an enduring mechanism to consider whether they remain fit for purpose, we do not consider that this fully addresses concerns resulting from the size of the incentive pot and the potential distribution effects and the impacts on consumers.

We therefore consider that it is not clear whether either of UNC277 and UNC346 better meets this relevant objective.

Relevant objective (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'

In our March 2012 Way Forward document we set out principles for an incentive scheme to encourage theft detection that we considered should be developed through a modification to an industry code. We also set out our expectation that this amended incentive scheme should be in place by the end of 2012.

In light of the concerns noted above on the potential competition effects of UNC277 and UNC346 and proposals for an alternative incentive scheme that seeks to address these weaknesses, we do not consider that it would be efficient in terms of the administration of the UNC to accept either UNC277 or UNC346 for the expected short period of time that it would be in place.

Summary and related issues

We recognise that, by itself, either one of UNC277 or UNC346 may have offered some benefits in terms of an overall increase in theft detection. However, we note the concerns over the potential competition impacts arising from the size of the incentive pots and the weak link to the anticipated benefits for consumers. In the context of our broader reform package we do not consider that UNC277 or UNC346 should be implemented.

However, we recognise the benefits of incentives in encouraging suppliers to be proactive in detecting theft. In our March 2012 Way Forward document, we have therefore proposed an alternative incentive scheme, backed by supporting measures to help suppliers respond to these commercial incentives, that we consider addresses the weaknesses identified in UNC277 and UNC346¹⁵.

Colin Sausman
Partner, Smarter Markets

Signed on behalf of the Authority and authorised for that purpose

¹⁵ Further detail on our proposals for reform and reasons for rejecting UNC277 and UNC346 are set out in the March 2012 Tackling Gas Theft: Way Forward document.