Representation - Workgroup Report

UNC 0642 (Urgent) 0642A (Urgent) - Changes to settlement regime to address Unidentified Gas issues

UNC 0643 (Urgent) - Changes to settlement regime to address Unidentified Gas issues including retrospective correction

Responses invited by: 5pm on 08 February 2018

To: enquiries@gasgovernance.co.uk

Representative:	Rhys Kealley
Organisation:	Centrica
Date of Representation:	8 February 2018
Support or oppose implementation?	0642 - Oppose 0642A - Oppose 0643 - Oppose
Alternate preference:	*If either 0642, 0642A or 0643 were to be implemented, which would be your preference?* 0642A
Relevant Objective:	**d)** Negative

Reason for support/opposition: Please summarise (in one paragraph) the key reason(s)

- We fully supported the decision made by the Authority when approving the principle of universal meter point reconciliation in the gas market. These arrangements were implemented following a significant period of industry development, governance and expense to consumers, and we strongly believe it is inappropriate for these arrangements to be undermined or changed so soon after their implementation. A small number of industry parties, which may not have adequately prepared for the changes introduced on 1 June 2017, should not be permitted to seek changes to address failures in their own planning. We are particularly concerned that two of the proposals (0642 and 0643) contain retrospection, which undermines the principle of regulatory certainty.
- The industry should not seek a return to practices which negatively impact competition or penalise one market sector (or subset of consumers) over another in terms of unidentified gas cost allocation. Addressing the sources of unidentified gas must become an industry priority, with appropriate industry focus placed on this activity rather than expending energy on the consideration of how best to allocate it. Only genuine progression of the former will drive real benefits to all consumers.

Summary of position on Modification UNC 0642

- We are opposed to this modification. It provides no clear benefits case for competition or consumers. The proposal focuses on reallocating and obscuring unidentified gas, it does not address volume or volatility. It provides a safe-haven for DM sites from unidentified gas levels above 1.1%, and reduces incentives to fix measurement and settlement issues in this market segment. The proposal introduces a period of retrospection between the proposed implementation date and the date that industry systems are materially implemented, which is contrary to accepted market principles, and is likely to have significant unintended consequences to consumers.

Summary of position on Modification UNC 0642A

- We are opposed to this modification. It provides no clear benefits case for competition or consumers. The proposal focuses on reallocating unidentified gas, it does not address volume or volatility. It provides a safe-haven for DM sites from unidentified gas levels above 2.5%, and reduces incentives to fix measurement and settlement issues in this market segment.

Summary of position on Modification UNC 0643

- We are opposed to this modification. It provides no clear benefits case for competition or consumers. The proposal focuses on reallocating and obscuring unidentified gas, it does not address volume or volatility. It provides a safe-haven for DM sites from unidentified gas levels above 1.1%, and reduces incentives to fix measurement and settlement issues in this market segment. The proposal introduces a period of retrospection between Nexus go-live and implementation that is contrary to accepted market principles, and is likely to have significant unintended consequences to consumers.

Implementation: *What lead-time do you wish to see prior to implementation and why?*

- If any of the proposed changes go ahead, we are concerned, amongst other things, about the potential impact on the current change backlog. Given the competing priority for change resource, there is the potential for delays to the implementation of RAASP, Faster and More Reliable Switching, Nexus Release 2, 3 & 4 and Gemini European changes.
- Xoserve's ROM estimates represent an optimistic scenario, in our view. It would be prudent in considering these proposals to consider the implications of any slippage in the estimated implementation timeframes (of 35 weeks for 642a, 46 weeks for 642 and 50 weeks for 643), given that 400 defects were identified during the Nexus implementation. Any slippage would have an even greater impact on other programmes, and would increase the time subject to retrospection for 642 and 643.

Impacts and Costs: *What analysis, development and ongoing costs would you face?*

Analysis, development and ongoing costs

- There is not sufficient time within the response period to properly assess system impacts and costs, however such estimates as we have been able to make will be provided confidentially and separately to the Authority.

Lack of benefits case assessment

- We are concerned that a full assessment of the changes, time-frames and costs associated with all the proposals have not been undertaken. To appropriately assess the impact upon competition and the financial impact to consumers and relative impact on suppliers and shippers, it is essential that this is undertaken. We do not support the approval of any proposals without a robust impact assessment being undertaken.
- We question whether there is any benefit to consumers. Whatever the expense to the industry of implementing any of these changes, the net effect will be the same volume of UG being in existence, but simply allocated in a different way.
- We challenge the logic of consumers being exposed to significant costs to 'stand still', and at the same time creating winners and losers in that some consumer groups would be better off and others worse off – this is not economically efficient.

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

We have no additional comments on the legal text.

Are there any errors or omissions in this Workgroup Report that you think should be taken into account? *Include details of any impacts/costs to your organisation that are directly related to this.*

See following section.

Please provide below any additional analysis or information to support your representation

1 <u>Overview</u>

1.1 We are opposed to reversing key market principles

- We are supportive of the principle of universal meter point reconciliation in the gas market, and we fully supported the decision made by the Authority when approving the implementation of UNC modification proposal 0432, 0434 (& 0473) – Project Nexus. Significant, costly changes to our systems, processes and our planning assumptions have all been based on the reforms implemented on 1 June 2017.
- Project Nexus arrangements were implemented following a significant period of industry development, governance and expense to consumers. The burden of proof to justify the reversal of these market changes should lie on the proposers and a clear and compelling argument as to the competitive rationale of doing so.

- We strongly believe it is inappropriate for these fundamental principles to be undermined or changed so soon after their implementation. It is essential that the integrity of the arrangements and principles introduced by Mod 0432 must be maintained and not distorted.
- We are concerned about the potential for changes to established rules to be progressed so quickly, in such a complex environment. The proposed changes may have significant, future unintended consequences to industry participants and consumers. Given the urgent time scales applied the industry have had insufficient time to properly assess these impacts, but we note that shifting volatility towards the non-daily metered (NDM) market can only be detrimental to competition and consumers.
- We are particularly concerned that two of the proposals (0642 and 0643) contain retrospection, which undermines the principle of regulatory certainty. Given these modifications have been raised because parties felt they had insufficient certainty about likely costs to be prepared for implementation of Nexus, it seems disingenuous to subject the whole market to a similar uncertainty associated with retrospective allocation of very material costs when parties could have better prepared for this.
- The findings related to gas settlement of the CMA energy market review were predicated on the implementation of universal meter point reconciliation on an enduring basis. Any change that reverses universal meter point reconciliation will retroactively undermine the CMAs assessment of the market.

  Insufficient evidence of the issue to be addressed, and the way in which the modification proposals achieve the Relevant Objectives has been provided. The proposed changes undermine, rather than support, effective competition between shippers and suppliers. For example, the proposals largely remove incentives to address contributors to unidentified gas in the daily metered (DM) market, and as we have seen from recent DM read rejection issues, this will reintroduce a source of impairment to effective competition.

  For clarity, throughout this section, we will use UIG to refer to the levels of unidentified gas at initial allocation, UG to refer to the levels of permanent, underlying unidentified gas. We will use unidentified gas as a term when there is not a need to be specific between the two definitions.

2 Identifying and sizing the issue

2.1 The proposals are not clear about the issue they are trying to resolve

- We are concerned that some parties are conflating the post Nexus concerns that have been raised about volatility with the move to correct allocation of unidentified gas across the market.
- The problem that these modifications are seeking to address is inadequately defined and evidenced as a cross-market issue. Any change proposed should address this problem, without undermining the integrity of the settlement arrangements introduced by Mod 0432 under Project Nexus.
- As demonstrated by Xoserve analysis, daily volatility is not new (and is therefore not a by-product of Mod 0432) and has always been present. Some industry

parties (due to their portfolio mix) have historically been shielded from this volatility, but are not shielded now.

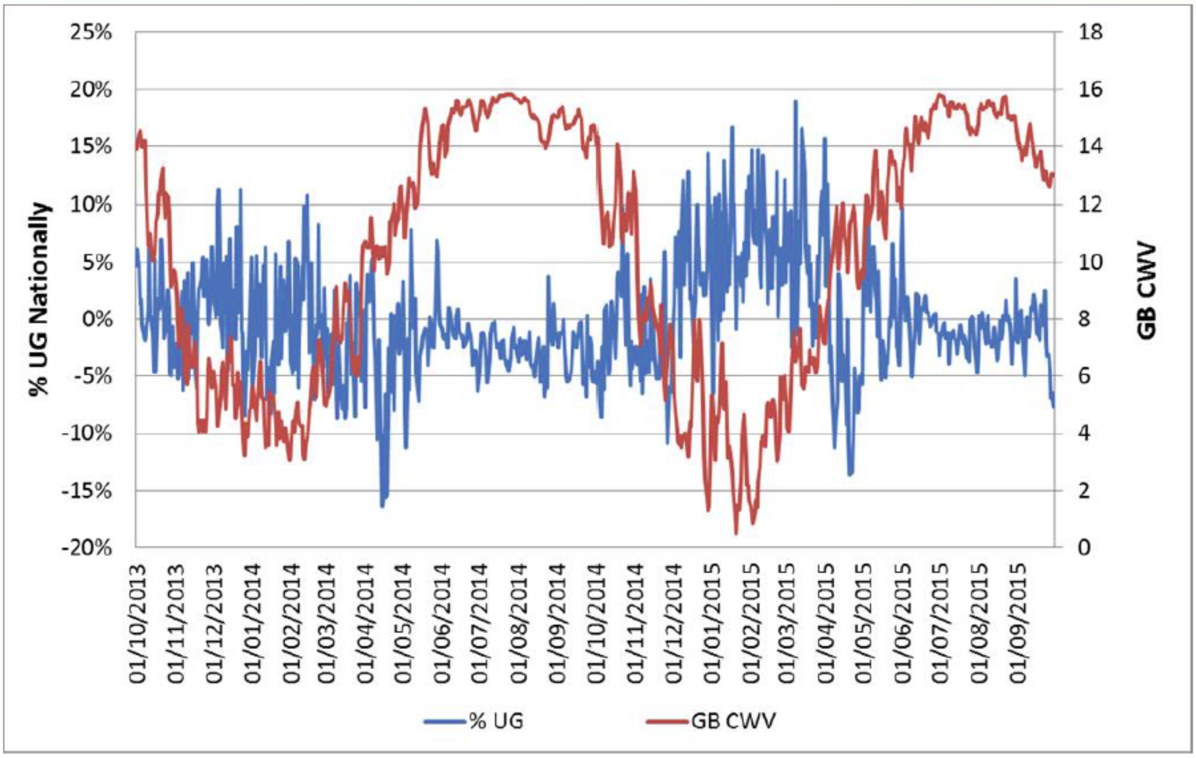
- The implementation of Project Nexus and associated changes were well signposted to all gas industry participants. All participants should have been fully prepared, both technically and commercially, for implementation and associated changes to market operation.
- Development of the business requirements and subsequent legal text was carried out in collaboration with all industry parties over many years, with robust transparent, independent governance of the implementation.
- A small number of industry parties, which may not have adequately prepared for the changes introduced on 1 June 2017, should not be permitted to seek changes (particularly with retrospective effect) to address failures in their own planning.
- There is effective competition across all sectors of the gas market and that competition should be allowed to play out, without regulatory intervention.
- Historically, one sector of the market has subsidised the other sector in terms of UG cost allocation. The industry should not seek a return to practices which negatively impact competition or penalise one market sector (or subset of consumers) over another.
- Prudent suppliers have been able to adopt approaches to insulate customers from the impacts of volatility. It is important that the modification process cannot be used to retrospectively protect suppliers from inappropriate or incautious pricing decisions.
- Exempting the DM sector from reconciliation is a fundamental shift from universal meter point reconciliation. The proposals seek to use the post-reconciliation regime to avoid initial allocation volatility. This approach is more of a “mask and move” than any kind of enduring solution. The proposals do nothing to address or reduce the causes of unidentified gas, but simply seek to reallocate its distribution.
- It appears unreasonable to progress a change that will cost the industry and consumers a significant amount of money to implement, that will not achieve an overarching consumer benefit (this will be in addition to the tens of millions of pounds already spent by the industry to introduce Project Nexus).

2.2 Unidentified gas levels and volatility are no higher than historic levels

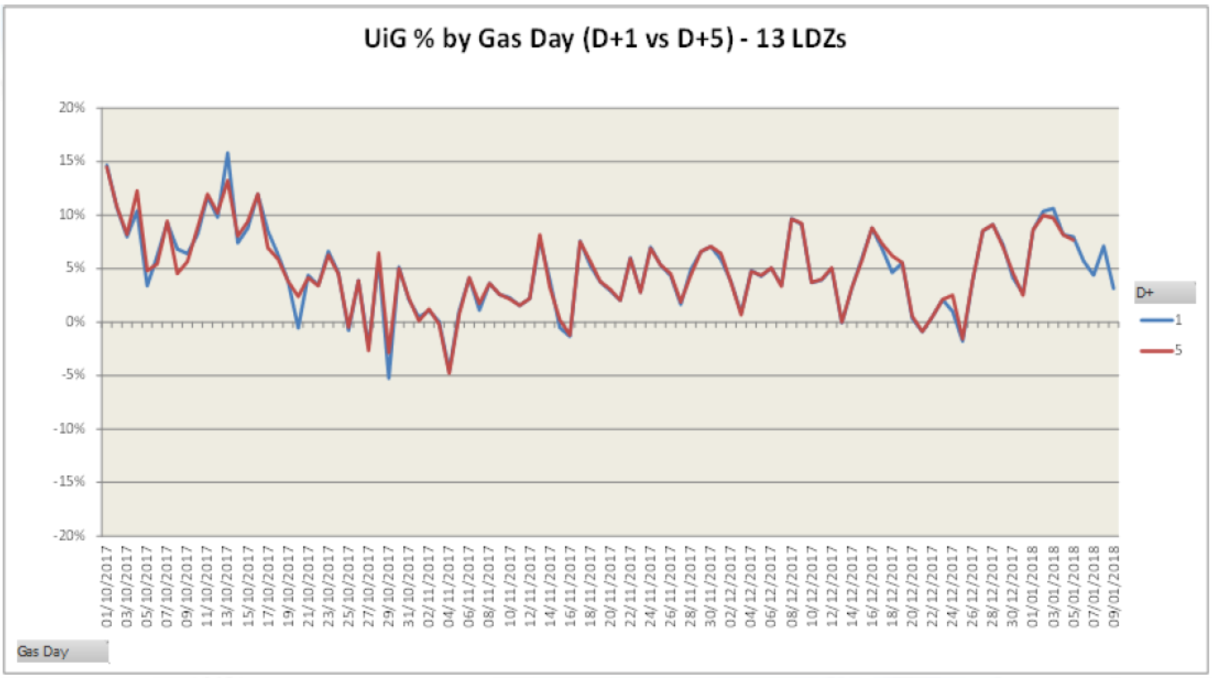
- It is not accurate that the Nexus related changes somehow caused an increase in the volatility of UIG. It also not true that the levels were not adequately communicated. This is evident as the current issues are only impacting some market participants. In particular, the winter of 2014/15 showed levels of volatility and volume of unidentified gas comparable to that seen in the post-Nexus period – see Figure 1 below.

Figure 1: The volatility of unidentified gas currently seen are consistent with those seen historically

Unidentified Gas % Levels by Gas Day: October 2013 – September 2015



Unidentified Gas % Levels by Gas Day: October 2017 – January 2018



Sources:
Xoserve, Updated Simulation of Unidentified Gas levels, DESC 16th Feb 2016
Xoserve, UIG Resolution - Weekly Progress Update 12 Jan 2018

- The levels of UG have been in the public domain and readily accessible well before Nexus Go Live. We note the following from Ofgem decision letter on UNC473:

  '21. The costs of UG are significant. In the four years that the AUGE has operated, it has consistently assessed UG to be over £100m. Its latest statement gives an UG figure of £118.71m for 2015/16, with £30.27m being allocated to the LSP sector.

  22. Some parties consider that the true costs of UG may be much greater. In its response, ***British Gas estimated the costs of UG to be nearer to £300m annually,*** *based on analysis of its own portfolio extrapolated to the rest of the market.'*

2.3 The impact of volatility has been overstated

- We accept the assessment of estimated levels of UIG of around £18m a month provided (4.65% of total LDZ throughput) that have been based on Xoserve data for the period June to November 2017.
- We do not accept the assessment that 75% (£160m over the assessed period) should be attributed solely to settlement error. We disagree with the simplistic division of UIG into a permanent UG of 1.1% and a residual settlement error. One could rightly separate out several other error components to represent metering errors, daily metered estimate reads, shrinkage errors, and so on.
- The proposed level of fixed UG of 1.1% is too low, and is modelling an underlying reality that we know has its own variability and volatility.
- The value of the UIG gas does not represent the cost to the market – this cost should be notably less, and suppliers should be able to carry volatility on behalf of their customers, just as NDM suppliers have done in the pre-Nexus regime. It should be noted that a portion of the ~£18m per month should already have been reduced as reconciliation progresses.
- Managing volatility on behalf of customers should be a core competence of an I&C shipper. Due diligence on the sources of volatility and the assessment of the impact of market changes is part of this competence.

2.4 We support efforts to improve allocation accuracy and more accurately identify sources of UG

- Addressing the sources of UG must become an industry priority, with appropriate industry focus placed on this activity rather than expending energy on the consideration of how best to allocate it. Only genuine progression of the former will drive real benefits to all consumers.
- Consumption is volatile and the deeming algorithm is potentially only reflecting that fact i.e. allocations are potentially more accurate now than they were prior to the implementation of Project Nexus. There is no guarantee that increased volatility means increased inaccuracy, and there has been no evidence provided during the modification process to suggest otherwise.
- The industry would ideally need to see at least years' worth of data to ascertain with a degree of certainty, how the existing methodology performs in its allocation

and reconciliation of gas over a full year. NDM allocation is not designed to be accurate on a daily basis, but over the year it should be broadly allocating costs to the relevant market participants.

- It is already within the remit of existing governance arrangements, the UNC Demand Estimation Sub Committee, to ensure the best allocation of energy, AQ derivations etc. Any other changes should be focusing on read provision to the industry so that we are updating AQs, that AQs are accurate and where appropriate the reconciliation of volume is captured as close to delivery as possible.
- We are supporting work under 0631R "Review of NDM algorithm post-Nexus", and are minded to support 0644 "Improvements to nomination and reconciliation through the introduction of new EUC bands and improvements in the CWV". It should be noted that only 0644 is seeking to and will result in an improvement to the NDM allocations. It would be a prudent approach to enable changes from these proposals to be embedded and their impacts assessed, before any fundamental changes are made, as proposed by 0642, 0642a AND 0643.
- The AUGE process continues to estimate the sources of UG and to what extent each of these are polluters of UG. Theft has consistently been viewed by the expert as being the main contributor, at assumed, high levels that we remain sceptical of.
- If, as the AUGE believes, theft is majority of UG (>90%) then the existing incentives related to theft detection are not high enough to incentivise the right behaviours, and need to be urgently reviewed ahead of making any changes to allocation.
- If the AUGE's assumptions are incorrect and theft is not the primary source of UG, then something else is, and permanent UG should not be allocated as though it is theft – this introduces manifest error into the cost allocation and impacts competition.
- We have long-standing concerns about the treatment of shrinkage error. Shrinkage error cannot possibly be a fixed daily quantity, and this 'forced consistency' is only pushing greater synthetic volatility into the initial allocation algorithm output.
- The GDNs should no longer be shielded from the volatility in the market – a full review and correction of the shrinkage estimate, including the volatile daily allocation, would be supported by Centrica. However, it is proving extremely difficult to progress a comprehensive, <u>independent</u> review on this matter without Ofgem support.

2.5 The proposals are not fit for purpose when considering the Smart Meter roll out

- The proposed modifications will be redundant once the Smart Meter roll-out is complete and suppliers have established a pattern of submitting monthly reads for all meters.
- These modifications exempt DM sites and monthly read sites from any UG above 1.1% of LDZ throughput. There is a material risk that during the transition to a full Smart Meter roll-out, the residual market not submitting monthly reads will be

increasingly and unfairly burdened both with permanent UG above 1.1%, and any temporary UG caused by exempted sites that avoid the impact of the settlement issues they cause.

- The proposed 'Reconciliation Target' in 0643 traps this situation, calling for a market wide smear using the AUGE weighting tables. However, this represents a material return to the previous regime – and underscores the redundancy of the proposed change.

3 <u>The proposals do not address the Relevant Objective (Securing Effective Competition)</u>

3.1 The proposals do not address the levels or volatility of unidentified gas

- The proposals do not address the root causes of UIG. The focus of the proposed changes is on different allocations of UIG, rather than addressing the levels or volatility. The proposals create 'safe havens' for segments of the market, leaving the unread NDM sites (predominantly domestic consumers) to soak up any volatility. This would reduce the effectiveness of competition in the market and does meet the Relevant Objective.
- Worse, the changes will impair visibility of UIG, reducing motivation for possible corrective action, and unfairly allocate volumes that should rightly be socialised across the market to specific customer groups, without solid evidence.
- The new regimes propose complex and less predictable models for NDM shippers. Given varying read cycles and the unpredictability of within month UIG allocations, the volatility for the market will increase, resulting in high tariff premiums to manage the unpredictable risk.

3.2 The proposals are based on a flawed understanding of unidentified gas

- The proposals are conceptually flawed, stemming from a fundamental misunderstanding of the concept of Unidentified Gas. The following errors are apparent from the extract below:

> Extract from Mod 0642/0643:
>
> - *"Unidentified Gas is the term given to any residual gas that is not directly allocated each day to a meter or transporters to represent network losses (Shrinkage). At allocation, the term Unidentified Gas is misleading; the vast majority of Unidentified Gas is in fact estimation error caused by inaccuracies in the NDM estimation process which is used for large portions of industry volume."*

  - The proposer of 0642/0643 believes that Unidentified Gas represents network losses/shrinkage – this is materially incorrect. There is, however, a component of Unidentified Gas that is the differential between actual shrinkage on the day and the estimates of shrinkage from the gas distribution networks. Additional sources of Unidentified Gas include unregistered and shipperless sites, Independent Gas Transporter

Connected System Exit Point (iGT CSEP) setup and registration delays, shipper-responsible theft and meter/measurement errors.

- Modifications 0642/0643 also state that *"The vast majority of Unidentified Gas is in fact estimation error caused by inaccuracies in the NDM estimation process which is used for large portions of industry volume"*, however no evidence is provided that this is the case. In fact, following the post-Nexus arrangements DM measurement errors were a major contributor to within-day volatility and a major source of UIG. Since the DM measurement error issue has been highlighted and action taken, we note that less than 20% of sites have had an adjustment submitted.

4 <u>The proposed modifications introduce new customer detriments</u>

4.1 The proposed level of permanent UG is not reinforced by data

- The AUGE did not specify an estimate of throughput in their latest statement, it is inferred from the output. This is still an estimate and has no data to reinforce yet 1.1% UG for all LDZs will be treated as an actual.
- It is evident that the AUGE Allocation Weighting Factors have not considered the poor levels of read submission for daily and monthly read sites previously masked by 'fuzzy matching'.
- Permanent UG looks set to be well in excess of the AUGE estimate and therefore historic assumptions made by the AUGE appear to be unsound.
- Attempting to apply this estimate as a known value upfront would introduce yet another 'fixed variable' which will have the impact of forcing volatility and the associated cost (which has not been removed) into a subset of the industry.

4.2 The proposed treatment of "Settlement Error" is a detriment to competition

- Using "Settlement Error" as a catch-all balancer is conceptually flawed, is inefficient and a detriment to competition. If permanent UG turns out higher (or lower) than 1.1%, this error spills over, incorrectly, to the "Settlement Error". Any DM Reads not submitted introduce another spill over to be picked up by the NDM market.
- The change provides a 'Safe Haven' for Product Classes 1 & 2 – this allows shippers to optionally avoid fair allocation of UIG costs, whereas there are actually no fundamental differences between the attributes of sites within PC2 or PC3.
- Engage Consulting's "Summary of Gas Settlements Risks" assessed the range of risk related to theft at £45m to allocation, and £43m to reconciliation. While this is broadly in line with a UG value of 1.1%, one must remember that the proposals allocate this 1.1% as per the AUGE weighting table, which attributes this theft cost to PC 4 sites at a rate 621 times higher than PC 1 – this is inequitable and a detriment to competition.
- Attributing the majority of UIG to "Settlement Error" represents flawed thinking, and could mask the true value of underlying UG. In our response to the CMA's Formal Consultation on the Energy Market Investigation (Gas Settlement) Order 2016 we stated: *"we are of the view that once meter point reconciliation occurs for all supply points and, as a result, the industry has a true understanding of the*

actual volume of unidentified gas, the overall volume may increase rather than reduce. Full reconciliation of supply point consumption will remove any anomalies introduced by existing AQ values/process and will result in a more accurate view of the total volume of unidentified gas which is attributed to issues such as theft, measurement error and shrinkage inaccuracy."

- It should be acknowledged that more frequent reconciliation of supply points alone will not necessarily equate into a reduction of total unidentified gas, however this continues to be, incorrectly, believed in certain quarters.

4.3 The proposals are predicated on domestic portfolios acting as absorbers of volatility

- Mods 0642 & 0643 both mention: *"This is having the greatest impact on the smallest shipper organisations in the market who do not have the benefit of a large domestic portfolio to absorb the effects of this volatility."*
- Given the intense political and regulatory scrutiny currently being given to energy costs and the impacts on consumers, it would appear to be inconsistent if Ofgem ultimately supported a proposal that is founded on the principle of domestic customers effectively providing a volatility buffer for I&C customers. We are concerned that the presumption that cross-subsidisation is the norm within multi-segment suppliers, is not evidence based.

4.4 The proposed retrospection in 0642 and 0643 is highly likely to introduce detriment to competition and consumers

- There is potential for detriments to competition associated with any form of retrospection introduced. Participants take balancing positions based on the rules of the day, and there is the likelihood that participants' balancing decisions would have been different under a retrospectively applied regime.
- The expected duration between the approval of 0643 (should this happen) and implementation, perhaps years, will place considerable uncertainty on shippers, as they will need to operate under one set of rules, while needing to assess the impact of their actions under the pending set of rules.
- This begs a serious question as to which set of rules shippers should optimise to? In addition, the market could be susceptible to gaming from market participants, in both their balancing and read submission behaviour. We would also expect issues where suppliers are unable to back-bill across the duration of the retrospective period, most likely to the detriment of NDM suppliers.
- Following development of the proposal, 0642 now also includes retrospection, during the period between the aggressive, proposed implementation date (1 April 2018, or 10 business days after approval) and a later date by which Xoserve systems can be updated - a duration initially assessed by Xoserve to be 46 weeks. Supplier systems are also unlikely be updateable in the timeframes proposed.

4.5 0642 removes market functionality that underpins critical accounting and auditing processes

Mod 0642 proposes to reduce implementation complexity and costs by removing the ability to track reconciliation amounts between months. We are concerned that this will impact any suppliers in the market that may have utilised this market functionality, whether as a financial control or as a method of trapping billing issues earlier in the life cycle. Given the urgent timescale, we have been unable to properly assess how this would impact our ability to check the accuracy of customer billing.

4.6 The proposals deliberately decrease allocation accuracy

- We do not support the proposed changes to the allocation algorithm, which are reducing initial allocation accuracy in order to decrease allocation volatility – this is not the primary purpose of allocation, and simply serves to increase reconciliation levels and volatility.
- The purpose of the allocation algorithm is to provide a best estimate initial allocation to minimise subsequent reconciliation volumes. Initial allocation accuracy has nothing to do with the final 'line-in-the-sand' cost apportionment of permanent UG and therefore this mechanism should not be used to 'influence' initial allocation volatility.
- The only way to impact initial allocation accuracy is via the allocation algorithm. We support all efforts currently underway to improve the allocation algorithm (such as 0631R and 0644).