Modification proposal:	**Uniform Network Code (UNC) modification proposals 117: Amendment to Invoice Billing Period, and 122: Restriction of Invoice Billing Period to Price Control**		
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:	20 December 2006	Implementation Date:	N/A

Background to the modification proposal

Both modification proposals were prompted by the discovery of a meter error at Farningham that resulted in the under-recording of approximately 2.4TWh of energy flows into the South East Local Distribution Zone (SE LDZ). This error went undetected from July 1999 until June 2005.

This discovery will trigger the reallocation of significant funds relating to Non Daily Metered Small Supply Points (NDM SSP) through the UNC reconciliation process. Broadly speaking, this will result in a flow of funds from Shippers with Reconciliation by Difference (RbD) portfolio in the SE LDZ to the NTS Shrinkage Manager, the current SE Distribution Network owner and to other Shippers on a national basis.

This reallocation will cover the entire duration of the error.

The modification proposals

UNC modification proposal 117 (UNC117) proposes to limit the period in respect of which a demand for payment can operate retrospectively to no more than 26 months from the date on which the relevant invoice is issued. There are exclusions to ensure that this period does not time out whilst an Invoice Query is lodged or Suppression of a Reconciliation Value is resolved. This overall time limitation would apply to all invoices issued, both credits and debits, including any reconciliation invoices or ad hoc financial adjustments.

UNC modification proposal 122 (UNC122) similarly proposes to limit the period in respect of which a demand for payment can operate retrospectively. Unlike UNC117 it does not propose a 'rolling' backstop date but a fixed one. The commencement of the last price control, 1 April 2002, would be used.

Whilst both proposals would mitigate the materiality of the Farningham reconciliation to RbD Shippers in the SE LDZ, they would constitute enduring provisions that would also be applied to future invoicing.

Both proposals came to us with a request that urgent assessment be granted. In both cases we agreed to such treatment, noting that the proposals were linked to a specific date related event (being the earliest date that an invoice can be issued to include a reconciliation of the significant SE LDZ metering error) and that there was a real likelihood of significant commercial impact upon Transporters, Shippers or Consumers if the proposal was not granted urgency.

[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.

UNC Panel[2] recommendation

Neither proposal was recommended for approval by the Panel.

At the Modification Panel meeting held on 16 November 2006, of the 8 Voting Members present, capable of casting 10 votes, 2 votes were cast in favour of implementing UNC117.

At the Modification Panel meeting held on 7 December 2006, of the 8 Voting Members present, capable of casting 10 votes, 5 votes were cast in favour of implementing UNC122.

Impact assessment

Section 5A of the Utilities Act 2000 requires the Authority to conduct an impact assessment, or publish a statement setting out its reasons for believing that it is unnecessary for it to do so, in defined circumstances. It further states that these requirements do not apply where the urgency of the matter makes it impracticable or inappropriate for the Authority to comply.

Both of these proposals were granted urgent status and seek implementation in advance of the reconciliation of the South East Local Distribution Zone metering error. Under the baseline, invoices to reconcile this error are due to be issued this month. We have concluded that it would be impracticable for us to conduct an impact assessment in advance of this event.

The Authority's decision

The Authority has considered the issues raised by the modification proposals and the Final Modification Reports (FMR) dated 17 November 2006 (UNC117) and 7 December 2006 (UNC122). The Authority has considered and taken into account the responses to the Joint Office's consultation on the modification proposal which are attached to the FMR[3].

The Authority has concluded that implementation of either modification proposal will not better facilitate the achievement of the relevant objectives of the UNC[4].

Reasons for the Authority's decision

The remainder of this letter sets out the reasons for our decision to reject both proposals. These reasons include consideration of the likely prospective and retrospective effects of the modification and are framed directly against the relevant code objectives. Given the similarity between the two proposals, many of the arguments that were brought forward by participants in their assessment, and many of the conclusions reached by us, are common to both. To avoid repetition, the arguments brought forward in the remainder of

[2] The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.
[3] UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com
[4] As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://62.173.69.60/document_fetch.php?documentid=6547

this letter may be considered equally applicable to either proposal unless specifically noted otherwise.

Both proposals would have retrospective effect as they would alter the cash-flows resulting from historic activity. Prior to considering the modifications against the objectives, we set out below our general views on retrospective changes to market rules and examples of the types of particular circumstance that could in principle, and subject to an assessment of all relevant factors, give rise to the need for a retrospective rule change.

Retrospection

This is not the first occasion on which a proposal that seeks to retrospectively change the application of any industry code has been raised. In view of this, it may be helpful if we re-iterate our views on this area.

In general, we consider that retrospective changes to industry codes will damage market confidence in, and the efficient operation of, the trading arrangements. Rather than protecting participants from "unforeseen unfairness" we take the view that signatories would generally prefer the assurance and certainty of rules that are unlikely to be changed retrospectively. We consider that there are generally accepted and well understood legal reasons why retrospective modifications are to be avoided. It is a general principle of law that rules ought not to change the character of past transactions completed on the basis of the then existing rules.

For these reasons, we are, in general, against approving modifications which have retrospective effects. However, despite the general principle against retrospective rule changes, we believe that there may be a small number of particular circumstances that could give rise to the need for a modification which would have a retrospective effect as evidenced in a small number of such modifications approved for the Network Code and Balancing and Settlement Code.

The particular circumstances which could give rise to the need for a retrospective rule change could, for instance, include:

- a situation where the fault or error occasioning the loss was directly attributable to central arrangements;
- combinations of circumstances that could not have been reasonably foreseen; or
- where the possibility of a retrospective action had been clearly flagged to the participants in advance, allowing the detail and process of the change to be finalised with retrospective effect.

In any event, the loss sustained would need to be material.

Relevant objective (a) - the efficient and economic operation of the pipe-line system to which this licence relates;

Arguments were framed against this objective in a number of areas, relating to: perceived impacts on the accuracy and efficiency of meter read and invoicing processes; on Transportation charges and price control impacts; on system balancing and security of supply (SoS); on incentives to read meters; and on implementation risk.

Proponents of the introduction of a historic limitation on invoicing argued that it would provide greater incentives on Transporters to record accurate flows of gas and also to identify and process under-billed errors. It was argued, particularly in the context of UNC122, that this would generate benefits in the areas of system operation and security of supply. One respondent argued that introducing incentives on Transporters to ensure that metering and invoicing processes are operating would assist in the operation of the Total System. Another argued that a failure to calibrate meters in a timely and effective manner can adversely impact security of supply.

Other arguments for change against this objective specifically related to the appropriateness of cash-flows under the current and proposed baselines. Several respondents suggested that Transporters benefited under the current baseline, with these payments referred to as 'windfalls' by one respondent. Several respondents suggested that it was inappropriate for Transporters to be able to benefit from a reconciliation to correct an error that went undetected for years and that they may have been causally linked to. One respondent argued that because the current baseline allows reconciliations to go back beyond the commencement of the current price control that it compromises the neutrality of the Transporters, by providing them with greater incentives to identify and correct under-billed errors than over-billed ones. That respondent also implied that UNC122 is more appropriate than UNC117 for price control reasons, as by limiting reconciliations to the start of the current price control it reduces the likelihood that Transporters will request Income Adjustments for events within it.

It was further argued that the introduction of a time limitation on reconciliations would lead to simpler industry arrangements, with reduced document storage and audit trail requirements and a cost effective and simple solution to administer.

Detractors of the proposals disputed the incentives and efficiencies suggested. One respondent argued that whilst incremental changes in meter accuracy that might be generated by the introduction of a time limit on reconciliations could theoretically improve the efficient and economic operation of the pipeline system, it was unlikely that this benefit would be delivered in practice as these incremental changes would be of indiscernible size. Another respondent argued that there would be no impact on system balancing as these actions are closed out within a day – making the treatment of earlier flows irrelevant. One respondent highlighted that Transporters are not responsible for information that allows invoices to be generated in a majority of cases – possibly alluding to the ownership of many LDZ meters by the Distribution Networks. One respondent, who supported the introduction of a time-cap, suggested that the one put forward by UNC122 was excessive and would provide no incentive above the baseline to ensure meter accuracy and effective invoicing.

Aside from querying whether incentives for more efficient operation of the pipeline system existed, there were also concerns on the impact on cash-flows. For UNC117, these concerns were aired by both Transporters and Shippers. One Transporter suggested that a reconciliation cut-off falling within a price control may impact on transportation activity revenue adjustment factors. Several Shippers saw potential for cash-flow impact, with one suggesting that there may be increased transportation charges if errors before the cut-off are not rectified, and another arguing that restricting revenue recovery within a price control could lead to more income adjusting event requests, resulting in inefficiencies and reduced regulatory and commercial certainty. One respondent suggested that the implementation impact and risk of introducing a time cap is large and has been insufficiently considered.

An argument was made that the proposals were essentially discriminatory against Transporters in favour of those Users that have had historically larger portfolios. Several respondents highlighted the comments we made on the appropriateness of allowing historical correction of errors through reconciliation in our decision on Network Code modification 642[5], arguing that these are consistent with the baseline.

We have considered the arguments put forward, and do not consider that a convincing case for either proposal better facilitating the efficient and economic operation of the pipeline system has been made.

We note that meter errors may be discovered in either direction: either under or over estimation. As such, the introduction of a time cap for correction would have the capacity to lock in over-reads as well as under-reads. This is not simply a notional or theoretical risk either – on two previous occasions[6] a major meter error has been corrected through the reconciliation process resulting in the flow of funds from the Shrinkage Manager to Shippers (rather than vice versa as is the case with Farningham). We note that past payouts to Shippers have not prompted claims that the baseline is unfair, whilst acknowledging that these were of significantly smaller materiality.

The bi-directional nature of potential cash-flows resulting from error correction means that we cannot have confidence that stronger incentives on Transporters to identify and resolve meter errors quickly would exist under either proposal. Additionally, we consider that the potential to lock in 'losses' to either Transporters or Shippers may detrimentally impact both communities.

We note the contrasting views on the impact on the operational efficiency of Transporters were either proposal approved, with some respondents arguing that a time cap would result in simpler, more efficient processes, and others counter-arguing that the scope of implementation and risk should not be underestimated. On the basis of the very limited evidence brought forward we have found it impossible to reach a firm conclusion on whether either proposal would be more or less onerous to operate than the baseline. We consider that this lack of evidence is unhelpful both to our decision making process, and to the assessment of the merits of the case for change that may be made by market participants. If further proposals are brought forward in this area we would expect to see greater transparency on and evidence of the likely costs, timetable and impacts of implementing and operating the change.

Relevant Objective (b) – so far as is consistent with sub-paragraph (a), the coordinated, efficient and economic operation of (i) the combined pipe-line system, and / or (ii) the pipe-line system of one or more other relevant gas transporters

Many of the arguments raised against objective (b) were essentially very similar to those raised against objective (a).

Shipper proponents of both UNC117 and UNC122 argued that these proposals would result in more accurate reflection of flows between the NTS and Distribution Networks. One Shipper linked this accuracy to a perceived improvement in the quality of investment

[5] Network Code modification 642: 'Withholding of Energy Charge where LDZ reconciliation has been disputed'.
[6] Affecting the Northern LDZ (reported to the February 2004 meeting of the Billing Operations Forum (BOF)) and the Northwest LDZ (reported to the May 2004 BOF).

decisions, possibly to the benefit of Security of Supply. One other respondent argued that the current regime may adversely affect Security of Supply.

More generally, a case was made that the introduction of a time limitation would incentivise Transporters to identify and resolve errors in a timely and efficient manner, thus ensuring that metering and invoicing processes operate as intended. It was perceived that this would assist operation of the Total System.

Similarly to objective (a), opponents of the proposals argued that there would no impact on system balancing or Security of Supply. It was further contended that either proposal would compromise cost reflectivity by discriminating against the Shrinkage Manager and those Users who had lost market share, to the benefit of those Users who had gained market share.

We agree with those respondents who contend that improvements to meter accuracy should assist with the co-ordinated, efficient and economic operation of the combined pipeline system. We further consider that more accurate allocation of gas flows would result in more cost reflective targeting of costs.

But we do not consider that either proposal will necessarily lead to accuracy gains and improved cost targeting. As highlighted against objective (a), the introduction of a time-cap for reconciliation may just as easily lock-in over-reads as under-reads. This being the case, we do not consider that either proposal provides a stronger incentive to identify and resolve errors than the baseline. In fact, there is a risk that a time limit may simply incentivise the asymmetrical identification and resolution of errors by Transporters, depending on whether the time-cap works in their favour or not for any given incident.

On balance, we therefore consider the case for this objective is at best neutral, and possibly negative.

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;

It has been argued that the perceived greater incentives for metering accuracy introduced by a time-cap would improve security of supply by giving the system operator a more accurate view of flows onto and off the NTS, thereby assisting the licensee in efficiently discharging its obligations in relation to security of supply. One respondent argued that it is appropriate for the licensee to incur the costs of inefficient maintenance of the system (i.e. any losses for LDZ meter errors).

One Transporter counter-argued that its ability to discharge licence obligations on it to appropriately target costs and benefits across appropriate parties would be frustrated by a limit on the reconciliation of past errors.

As highlighted against earlier objectives, we have not been persuaded that the introduction of a time limit for reconciliation would have any appreciable effect, positive or negative, on security of supply.

We further consider that the introduction of what, in the absence of a clear and robust rationale may amount to an arbitrary time limit on reconciling past errors would frustrate the ability of the licensee to accurately apportion costs as a proportion of some errors would remain inappropriately allocated.

We have therefore concluded that this objective would not be better facilitated by either proposal.

Relevant Objective (d) – the securing of effective competition between relevant shippers, suppliers and DN operators

Arguments raised in favour of this objective have centred on perceived improvements in cost reflectivity and reductions in uncertainty and barriers to entry.

It is suggested that capping the length of time that reconciliation may go back will result in the apportionment of volumes based on market share being 'fairer', by being more targeted on those who actually used the gas. It is also argued that there would be benefits in market certainty, as the potential size of any one-off reconciliation would be reduced. A respondent suggests that large unforeseen adjustments may cause participants audit and regulatory problems.

These issues are argued to form a perceived barrier to entry: because new participants may run the risk of accruing significant unforeseen liabilities for errors that occurred before they entered the market.

It is further argued that the perceived incentivisation of more accurate metering would increase incentives on Shippers to balance their positions.

Those who did not support these proposals focused their arguments in the area of cost reflectivity and targeting.

Opponents argued that the introduction of a time cap would impede the appropriate adjustment of charges in the light of new information. This could potentially result in cross subsidies, and discrimination against Users that cannot recover costs that they have borne. It was argued that cost reflectivity is impeded by the arbitrary close-out of correction windows.

We find the case for this objective to be mixed, with strong arguments in both directions.

We agree that the potential for significant unforeseen adjustments can have a detrimental impact on participants' ability to confidently predict cash-flows. We note the high materiality of the Farningham incident: the volumes that will be corrected are not nugatory, and we share concerns that the potential for repeat incidents under the current baseline does not aid market confidence. We agree that the introduction of a time-cap would reduce the likelihood, and scale, of reapportionments of energy resulting from the correction of errors through reconciliation. However, whilst stability in cash-flows may be improved, we disagree with the view that market uncertainty would be alleviated by either proposal.

Whilst in the case of the Farningham incident additional costs lie with RbD Shippers in the SE LDZ error as a result of the reconciliation, future incidents may see the reverse being true. It should be borne in mind that these reconciliations are corrections, not windfalls: RbD Shippers in the SE LDZ had the benefit of these energy volumes during the period when the error went undetected, with these missing volumes paid for by other participants at the time.

Because both proposals would take retrospective effect, participants' credits or debits may be significantly changed without their having the opportunity to change their

behaviour to maximise or mitigate these cash-flows. We consider that such a move would have a detrimental impact on market certainty.

We do not consider that either proposal passes the first of the three general tests for retrospectivity highlighted earlier in this letter. Whilst we are aware that at least one User disputes that the UNC is being applied correctly we have not been provided with any compelling evidence to suggest that the central reconciliation process is being applied in a flawed or erroneous manner.

We also do not consider that either proposal passes the third of the tests as the possibility of retrospective changes to the reconciliation regime has not been clearly flagged to participants. Indeed, the opposite view is more convincing. As highlighted by several respondents, at the time of introduction of the Reconciliation by Difference (RbD) regime we signalled that whilst significant and unforeseen energy reconciliations can reduce certainty for both Transporters and Users, it is correct that energy balancing revenues be adjusted in light of better information about the actual off-take of gas.

We do have some sympathy for the view that this is a combination of circumstances that could not have been reasonably foreseen. Although the correction of past errors through reconciliation was entirely foreseeable, we consider that most participants would not have expected an error as material as this to have gone undetected for so long.

It appears to us that much of the concern with the baseline relates to the manner in which gas flows are apportioned on reconciliation. This is based on contemporary market share, which may lead to anomalous outcomes if a participant's market share significantly changed during the course of an error straddling many years.

But whilst we recognise concerns that apportionment of historic errors based on current market share may not be optimal when applied to non-contemporary errors we note that neither proposal does anything to directly change this. They simply offset the risk that this poses to RbD Shippers onto the rest of the community through preventing the correction of past errors.

In view of this, we do not consider that retrospective application of either proposal would better facilitate the securing of effective competition.

We consider that there may be merit in further review of the apportionment mechanism.

Relevant Objective (e) – provision of reasonable economic incentives for relevant suppliers to secure that the domestic customer supply security standards are satisfied as respects the availability of gas to their domestic customers

It was suggested by one respondent that this objective would be facilitated by ensuring that Shippers are incentivised to balance against a more accurate view of demand, facilitated by greater metering accuracy.

As explained against previous objectives, we do not consider that these proposals provide greater incentives for metering accuracy than the baseline.

We do not consider that this objective will be better facilitated by either proposal.

Relevant Objective (f) – promotion of efficiency in the implementation and administration of the network code and/or uniform network code

It has been argued that the introduction of a time cap would encourage the reading and submission of meter reads more quickly, thereby leading to more efficient invoicing processes.

Other respondents counter-argued that efficiency gains may not be realised. In the case of UNC117, 26 months was perceived to be insufficient time to reconcile all adjustments. A concern was raised that the UNC117 approach may lead to confusion on process, with multiple 'backstop' dates for reconciliation.

It was also suggested that whilst an incentive to invoice might be created that Transporters are not responsible for all the information that allows invoices to be generated.

Both Shipper and Transporter respondents expressed concern on the cost of implementing and administering a time limitation on reconciliation.

We do not consider that any convincing arguments have been brought forward either for or against this objective. No evidence on the costs or timetable for implementing or administering a changed baseline has been brought forward by either Transporter or Shipper communities. We do not consider that we could conclude with any certainty or confidence that efficiency in the implementation of the UNC would be either facilitated or impeded by either proposal. We are not therefore persuaded that this objective is better facilitated.

Though views on these proposals have generally been polarised between Shipper and Transporter communities, one area of consensus has been in the need for a broader ranging review of the arrangements for providing assurance on metering accuracy. We concur with this view and welcome these efforts to consider how the baseline may be improved.

We note that the debate on these proposals has largely split along partisan lines dependent on whether the respondent would benefit, or suffer, as a result of the reconciliation of the Farningham error. Whilst this approach may, under the circumstances, be understandable, there may be insufficient consideration of the possibility that future errors discovered may generate entirely different patterns of winners and losers. We therefore welcome the fact that a review is being conducted under UNC126: 'Restriction of invoice Billing Period' has been raised and we encourage participants in that review to take a wider perspective in order to ensure that any solutions put forward are robust and enduring, rather than incident specific.

Yours sincerely,

Nick Simpson
Director, ECM Programme
Signed on behalf of the Authority and authorised for that purpose