

Nigel Nash
Ofgem
9 Millbank
London
SW1P 3GE

25th January 2010

Dear Nigel

RE: Ofgem Impact Assessment on Identification and Apportionment of Costs of Unidentified Gas

1. British Gas does not agree with the conclusions of Ofgem's initial impact assessment for modifications 228, 228A and 229. Our reasoning is set out below, and specific answers to Ofgem's questions are provided in Appendix One.

The reasoning for the rejection of modifications 228/A is flawed

2. The deficiencies in modification proposals 228 and 228A that Ofgem give are as or more prevalent in the present regime. Ofgem appear to have determined whether these proposals can be improved upon rather than determining whether they are an improvement on, and therefore better facilitate the relevant objectives than, the present regime.
3. It is argued that modification proposals 228 and 228A may not deliver a completely accurate allocation of costs. Today **all** the costs of unidentified gas are allocated to the domestic sector. It is accepted by Ofgem that this is inappropriate, so the test should be "*is the proposed allocation fairer than the current regime?*" Whether a cross subsidy would remain in one direction or another is debateable, but would ultimately be more accurate than it is now.
4. Today's arrangements have **no** methodology whatsoever to underpin it. Modification proposals 228 and 228A both introduce a methodology that is supported by far more analysis than today's arrangements. We note however that modification proposal 229 introduces no methodology, and no guarantee that any future methodology will be an improvement on either today's arrangements, or the arrangements proposed by modification proposals 228 or 228A.

5. Today's arrangements have **no** review mechanism within them. Modification proposals 228 and 228A ensure that future reviews will be possible by allowing variation and refinement of the allocation of unidentified gas costs to be done through the rigours of the Uniform Network Code (UNC) change process as and when required, with each party retaining the ability to raise proposals. After an approval of modifications 228 or 228A it will be easier to secure change to allocation of unidentified gas costs.
6. We therefore conclude that for each of the two key reasons for rejection cited by Ofgem, modification proposals 228 and 228A are an improvement on today's arrangements. It is clear from these examples and many others throughout the impact assessment that, wrongly, Ofgem have not properly considered whether these proposals are an improvement on today's arrangements, and have overlooked serious deficiencies within modification proposal 229.
7. Unidentified Gas is by nature "unidentified". It is unreasonable to expect an explicit and traceable methodology for something that by definition cannot be identified. It is not acceptable for clearly deficient arrangements to persist when, in the absence of further information, an approach that is at least fairer has been proposed.
8. In developing modification proposals 228 and 228A British Gas and Scottish Power went to considerable lengths to ensure that any residual bias was in favour of LSP suppliers. For example, we assumed that the balancing factor is theft, rather than a more general as yet unidentified driver of unidentified gas. As a result a lower portion of imbalance cost is allocated to the LSP sector.
9. Ofgem's position here is illogical as on one hand it acknowledges that "*it is inequitable that costs are borne by one market sector (as at present) when they impact the industry as a whole*". Ofgem subsequently contradicts this point when incorrectly concluding that the use of theft as "*the balancing factor*" could be prejudicial to any one sector. This is not the case, and had modification proposals not used theft as the balancing factor, but for example shrinkage, then the LSP sector would have been allocated a greater portion of unidentified gas costs.
10. We are pleased that Ofgem have acknowledged that there will be a correction factor once all parts of RbD have been identified and that this correction factor should be shared by both sectors¹. We are however concerned that this is not explicit within the drafting of modification proposal 229. It would therefore be helpful if this point was re-enforced in Ofgem's subsequent decision letter.

¹ Ofgem Impact Assessment document, paragraph 10.6. "*we consider that employment of a 'balancing factor' may well be necessary*".

Modification 229 has significant potential for unacceptable implementation delay

11. We acknowledge that modification 229 is an improvement upon the present arrangements. However we have grave concerns as to how long it will take to implement this proposal.
12. LSP shippers have a strong incentive to delay the implementation of 229 because that delay will defer any reapportionment of costs to them. Throughout the development of modification proposals 194, 194A, 228 and 228A there were, in our opinion, repeated attempts by some industry parties to filibuster and frustrate progress. For example, we were particularly disappointed to note that Corona Energy raised modification proposal 194A on the very last day available for alternate modifications, despite the issue being discussed for several months before that.
13. We are extremely concerned that such practices may persist throughout the implementation of modification 229. If Ofgem are to approve 229 in isolation, then we consider the implementation route to be the single biggest issue that must be addressed. Safeguards must be put in place by Ofgem as part of any decision to ensure that deficiencies in today's arrangements are addressed speedily.
14. It is apparent already that tensions exist between Transporters and Shippers as to the contracting and procurement processes set out in modification proposal 229. Indeed it is difficult to see why such procurement processes are necessary given xoserve's existence as a neutral and expert authority who are best placed to provide the services of an Allocation of Unaccounted for Gas Expert (AUGE).
15. Indeed there may be merit in subsequent amendment to the remedy within modification proposal 229 to allow the appointment of xoserve without recourse to a lengthy procurement process. Care would need to be taken of course to ensure that such modification accelerated rather than slowed down the urgent re-distribution of costs that is required.
16. British Gas identified the problem of inaccurate cost allocation in March 2007 when it raised modification proposal 115, and eventually saw the proposals described in the impact assessment submitted to Ofgem in the 1st half of 2009. We could now face the prospect of a further 2 years delay before these proposals are implemented. For the industry and Ofgem to allow these problems to persist for over 5 years is unacceptable.
17. It is therefore essential that Ofgem provides a firm and urgent deadline for the implementation of improved allocation of unidentified gas costs. This will improve certainty for all parties and remove the incentive to frustrate progress that some parties presently have.
18. There are a number of ways that Ofgem can do this, for example.

- a. Ofgem can specify a final implementation date by which time the arrangements contemplated by modification proposal 229 must have come in to effect.
- b. Ofgem could approve modification proposal 228 or 228A as well as 229. For example, Ofgem could set a fixed implementation date of 1st January 2011 for modification proposal 228 or 228A, with those modifications immediately expiring as and when they are replaced by methodology devised under modification 229. This would ensure that interim relief is provided to SSP customers and any incentive to delay implementation of modification proposal 229 methodology is avoided.
- c. Ofgem could, for example, specify an implementation date for modification proposal 229 of 1st October 2010, whilst allowing any deliberations to continue past that point if required. Parties would then be reassured that when the methodology was eventually produced, any allocation would be backdated to 1st October 2010. We note that this would be different to retrospection as all parties would know of the implementation date in advance.
- d. Finally, Ofgem could give a strong indication (without fettering its discretion) as to the merits of an urgent modification that provided for the appointment of xoserve as the AUGE without recourse to the selection and procurement requirements specified by modification proposal 229.

19. Within the processes described in modification proposal 229 there is significant potential for delay between the Allocation of Unidentified Gas Expert (AUGE) making recommendations for revised energy allocations and the actual implementation of those proposals. We accept that an appeal process is important but that the appeal process should safeguard against attempts to unnecessarily delay the process. We therefore believe that any revised cost allocations should be backdated to the point at which, or soon after, the initial recommendations are made by the AUGE, unless those recommendations are subsequently determined to be invalid.

20. British Gas has taken a leadership role in this area, seeking to improve industry cost allocation, cut the volume of unidentified gas and reduce costs to customers. However we are now faced with the prospect of further protracted debate and delay about how and when to implement modification proposal 229. We now need clear leadership from Ofgem in order to ensure any reform is introduced as speedily as possible.

21. We expect that as a minimum Ofgem sets out in its final decision letter clear timetables for implementation change, and details the provisions it will put in place to make sure that they are followed; including any interim measures used to ensure relief for SSP customers.

If you wish to discuss any of the points raised by this letter or its appendices, please do not hesitate to telephone me on 07789 570501.

Yours sincerely

David Watson
Regulatory Manager, British Gas

Appendix One

CHAPTER: Three

Question 1: Do you agree with Ofgem's assessment that the likely impact of the Modification Proposals on charges made to consumers?

22.No. British Gas believe that Ofgem have failed to take in to account that the nature of the solution proposed under modification proposal 229 will result in significant delay. We consider that in order for this modification proposal to be implemented, an AUGE needs to be appointed, methodology agreed, conclusions reached and reallocation made; all of which could easily be delayed and obstructed by parties with an incentive to do so. Our best estimate is that implementation of modification proposal 229 could be as much as two years away.

23.Ofgem's own figures show that each SSP customer currently pick up £9.33 of RbD charges each year², meaning that modification proposal 229 will cost each SSP customer at least a further £18.66 each in the first two years.

24.We also believe that it is unlikely that the AUGE will be able to devise a more accurate scheme for reallocating unidentified gas than modification proposals 228 and 228A propose.

Question 2: Do you consider that the proposed governance arrangements under UNC229 offer adequate protection to the interests of consumers in their present form?

25.No. We are concerned that under modification proposal 229 the UNC Panel plays a fundamental role in both the appointment of the AUGE and the hearing of queries against their decisions. The constitution of the UNC Panel is currently weighted in favour of those suppliers predominantly active in the LSP sector³, and therefore those suppliers with an incentive to dilute and delay reallocation proposals. We consider that until such time as the UNC Panel is reformed to provide a more balanced representation of the industries interests, the governance regime proposed under modification proposal 229 is flawed and liable to increase the costs to SSP customers through delayed implementation and inaccurate allocation of costs.

Question 3: Do you anticipate any further impact upon consumers in addition to those considered in this chapter?

26.Yes. We strongly believe that Ofgem have under-estimated the impact of modification proposals 228 and 228A on theft detection. We accept that additional measures are also required to stimulate theft detection such as those proposed in UNC Modification 277, however by ensuring that

² Ofgem Impact Assessment, paragraph 3.4.

³ Presently 3 of the 5 Shippers on the UNC Panel have predominately LSP interests. We estimate that approximately 6% of the Panel member election votes are held by LSP shippers.

industry costs associated with all unidentified gas, including theft, are more accurately re-distributed across the market, a major disincentive to detect theft will be removed.

27. As above, we also believe that the implementation timeline for modification proposal 229 is considerably longer than modification proposals 228 and 228A, and that as such this disincentive will remain unchecked for at least a further two years. Theft of gas poses a serious safety risk to all consumers, and we therefore consider that LSP consumers will be negatively affected by the continuing safety risks of theft; something which could be resolved by implementing modification proposal 228 or 228A as a full or interim measure.
28. As mentioned above, Ofgem have not taken in to account of the fact that modification proposal 229 will result in a significantly delay the resolution of this issue, leading to a charge to SSP customers of approximately £18.66 each over the next two years. Clearly this amount could increase if modification proposal 229 is delayed further; something we believe to be a real possibility given the bias of representation on the UNC Panel towards LSP shippers.
29. These aspects are explored further below, but as a minimum we expect Ofgem to set out its thinking on how interim relief from inappropriate allocation of gas can be achieved.

CHAPTER: Four

Question 1: Do you agree with our assessment that any of these Modification Proposals will have an effect upon incentives for shippers to reduce the quantity of Unidentified Gas offtaken at LDZs?

30. British Gas fundamentally disagrees with Ofgem's assessment of this point and believes that by properly allocating costs within a market, parties will be incentivised to reduce the amount of unidentified gas.
31. Resolution by Difference (RbD) Shippers who pay unidentified costs typically attend industry groups on RbD related topics such as shipper-less sites, IGT off-take issues and so on. This is because they have a willingness to understand and address issues that are borne from the cost allocation arrangements. We note for example that even the prospect of cost allocation has already delivered some improvement in the engagement of LSP shippers in certain RbD related topics, for example UNC Review Group 0245.
32. We also consider that SSP shippers currently extract less value for their efforts to reduce exposure to unidentified gas than they should do, as they continue to pay for unidentified gas on LSP sites, gas which is lost by actions which are outside the control of SSP shippers. This also acts as a disincentive to invest in unidentified gas reduction measures, such as theft detection, and would be resolved through implementation of these modification proposals. We wish to emphasise however that only

modification proposals 228 and 228A ensure that this disincentive is removed immediately. Modification proposal 229 will maintain this issue for at least a further two years, placing the key industry reform of theft of gas arrangements at risk.

Question 2: Do you agree with our assessment of the likely distributional impact of the Modification Proposals?

33. We do not agree with the assertion that suppliers with a presence in both the SSP and LSP sectors will be able to distribute their costs in such a way as to provide themselves with an advantage. This argument fails to take in to account the veracity of competition in the UK domestic market, and suggests that suppliers in the SSP market will somehow be able to absorb these costs in order to maintain LSP margins. This is wholly inaccurate and inconsistent with Ofgem's own conclusions in the recent Market Probe.

Question 3: Do you believe that the potential benefits of the Modification Proposals justify the additional costs which may be imposed on customers?

34. We wish to make clear that modification proposals 228 and 228A will not add cost to customer's bills, and that modification proposal 229 will add a nominal amount associated with the costs of employing and managing the AUGE.

35. We recognise for LSP customers that there will be an increase in costs under any of the proposed models, but that this is merely a fair redistribution from the SSP sector, thus maintaining the total charge to the industry. We also want to stress that the nature of the solution considered by modification proposal 229 will lead to an additional cost of £343m to the SSP sector, as it delays a solution by approximately two years⁴.

Question 4: Do you agree that applying a variable RbD charge upon LSP shippers would potentially entail a negative impact upon competition? Do you feel that this potential impact justifies the imposition of a fixed rather than variable charge on LSP shippers?

36. The principal rationale behind the variable monthly allocation of RbD cost and risk to both sectors was to provide the strongest incentives and signals to address the issue of unidentified gas itself. Seasonality and throughput should be a secondary issue when compared to the misallocation of costs to the SSP sector that occurs today. Presently SSP shippers, and therefore the customers of the suppliers they act on behalf of, are misallocated costs regardless of throughput.

37. No. Unidentified gas is linked the throughput⁵; as more gas is taken, more gas will become unidentified and vice versa. We therefore believe that the

⁴ Calculation extracted from xoserve figures quoted in Ofgem Impact Assessment, Appendix 4, Table 1; total extrapolated RbD value over a 24 month period.

⁵ Gas Distribution Price Control Review 2008-2013

most appropriate reallocation methodology is one which is based on a variable charge to the LSP sector.

38. As a major supplier to the I&C market, we can also speak with some authority when we say that suppliers generally retain the right to “re-open” contracts so that they can take account of new regulatory charges such as the one being discussed. We do not therefore accept the argument which some have put forward that LSP suppliers would have to absorb any reallocation of RbD costs until such time as a contract was re-negotiated. Furthermore, we want to point out that as all LSP suppliers in the market will have proportionally similar charges levied at them, competition would not be distorted
39. Notwithstanding this from a simple cost allocation perspective we are agnostic to the approaches set out in modifications 228 and 228A. However we believe that a variable RbD charge provides a much stronger incentive upon parties to identify and tackle the causes of unidentified gas.
40. Furthermore, we are also pleased that Ofgem have acknowledged that there will be a balancing measure once all parts of RbD have been identified and that this correction factor should be shared by both sectors⁶. This point is key and should be re-enforced in any subsequent decision letter.

Question 5: Should any third party authority created under the terms of UNC229 be tasked to review incentives for investigating theft upon individual shippers?

41. No. This is outside of the scope of modification proposal 229 and would elongate the process for both the fairer re-distribution of gas allocation costs and the incentive schemes recommended by UNC Review Group 245.
42. The industry has made good progress on reforming the theft of gas arrangements since the inception of UNC Review Group 245, including the introduction of theft of gas incentive scheme proposals, and we would be very disappointed for such a successful example of self-regulation in action to be cast aside in favour of a more directed approach. We therefore support allowing the current theft incentive scheme proposals to progress through the change process.

CHAPTER: Five

Question 1: Do you agree with Ofgem's assessment that any impact on sustainable development as a result of these Modification Proposals is likely to be marginal?

⁶ Ofgem Impact Assessment document, paragraph 10.6. “we consider that employment of a 'balancing factor' may well be necessary”.

43.No. We strongly believe that Ofgem have under-estimated the impact of modification proposals 228 and 228A on theft detection. By ensuring that the industry costs associated with all unidentified gas, including theft, are more accurately re-distributed across the market, a major disincentive to detect theft will be removed. We do not understand why Ofgem say that this will not result in more investment in theft detection within the LSP sector.

44.Considering the scale with which this contributes to losses we believe that each of these modification proposals will positively impact sustainable development, although believe that as modification proposals 228 and 228A provide the largest incentive as they believe they have the most positive benefit in terms of encouraging theft detection.

Question 2: Do you agree with Ofgem's assessment of the relative impact on sustainable development of each of the Modification Proposals?

45.No, as above.

Question 3: Do you consider that there are any further impacts on sustainable development that are likely to result from the Modification Proposals?

46.No.

CHAPTER: Six

Question 1: Do you anticipate any impact on health and safety as a result of these Modification Proposals? If so, what?

47.As above, we believe that Ofgem has under-estimated the impact that these proposals will have on the level of theft detection within the LSP sector. As theft detection reduces risk to public and consumers, we believe that any proposal which either incentivises theft detection, or removes disincentives on theft detection (as these proposals do), will have a positive effect on the health and safety of customers.

CHAPTER: Seven

Question 1: Do you agree that implementation of UNC229 would leave parties with adequate recourse to query decisions made by the AUGE?

48.No. The current constitution of the UNC Panel and the voting arrangements for election of members to it ensure that such suppliers have a dis-proportionate voice over such matters, raising the risk of such delay. Modification proposal 229 therefore provides LSP suppliers with both the incentive and opportunity to delay progress and dilute the framework for any AUGE.

49.Furthermore, this same issue will ensure that any dispute over the decisions of the AUGE will tend to be resolved in favour those suppliers pre-dominant in the LSP sector; the same ones with a vested interest in

delaying the process. We therefore consider that without appropriate controls, SSP suppliers lack adequate recourse to query AUGE decisions.

Question 2: If not, how should any additional governance be implemented?

50. We believe that any decision to implement modification proposal 229 should be accompanied with an implementation date by when the scheme will come in to being, regardless of the progress made in appointing the AUGE, or delivering the methodology which the AUGE will use. At this point we suggest that any future reallocations made by the AUGE are back-dated to the date of implementation. We consider that it would be appropriate that if the AUGE's determination is successfully challenged in such a process, only charges to the revised amount are retrospectively applied.

Question 3: Are there any additional risks which may be placed upon industry parties by implementation of the Modification Proposals within scope of this Impact Assessment which we have not identified in this document?

51. Ofgem suggest that there might be less theft in the LSP sector because meters are read more often; there is no evidence to support this. Ofgem also describes the meter complexity in the LSP sector, but overlook that such metering complexity often includes an inherent "meter bypass" function that make theft far easier from these metering systems than smaller domestic ones.

52. We do not agree that the correct allocation of costs will have minimal impact upon the level of imbalance. The initiation of the proposals themselves has stimulated increased debate and focus on the causes of unidentified gas. These proposals therefore have already resulted in significantly improved engagement.

53. The principal rationale behind the variable monthly allocation of RbD cost and risk to both sectors was to provide the strongest incentives and signals to address the issue of unidentified gas itself. Strictly from the perspective of cost allocation we accept the merits of an annual process.

54. We are however surprised that Ofgem seems to attach more credence to any potential misallocation of costs across timing periods than it does to the misallocation of costs per se. Seasonality should be a secondary issue when compared to the misallocation of costs to the SSP sector that occurs today. Presently SSP shippers, and therefore the customers of the suppliers they act on behalf of, are misallocated costs in **every** season.

55. We understand the importance of predictability and certainty of costs. It is however unfair for one sector to enjoy more predictability and certainty of costs than another. The contract renewal cycles are simply responses to commercial pressures and prevailing market arrangements, if those change so will the contractual arrangements. Even if the present contractual renewal cycles are fixed this does not prevent the introduction

of terms and conditions that could respond to changing costs. For example, the terms of all I&C contracts we agree provides a route for us to reopen price negotiations in the event of new regulatory costs. We expect that all other suppliers in this sector will have similar provisions.

56. As we have mentioned above, the present voting arrangements for the appointment of panel representatives place more votes with LSP suppliers than SSP suppliers and as a result a bias of panel membership in favour of LSP suppliers is likely. The dynamics of the UNC modification panel therefore could be prejudicial to fair outcomes for SSP suppliers. This needs to be addressed by ensuring that the balance of voting supplier representatives on meters relating to AUGE determinations is evenly split between predominately LSP and SSP suppliers.

Question 4: How could the Governance Arrangements for appointment of an AUGE be structured to minimise impact upon shipper parties? Should GTs be indemnified from any risks from holding this contract, and if so how might this be implemented in practice?

57. As mentioned above, we believe that the current constitution of the UNC Panel places those parties with most to gain from delaying the appointment of an AUGE in a position of power. This needs to be properly addressed in order to ensure shippers are not adversely impacted by continuing inappropriate allocation costs during the appointment process.

CHAPTER: Eight

Question 1: Do you agree with Ofgem's assessment that the benefits of appointing an independent third party to assess Unidentified Gas would accrue to the industry?

58. We agree with Ofgem that modification proposal 229 will benefit the industry, although as above, we are very concerned that the benefits will be delayed by approximately two more years. Furthermore, we remain of the view that modification proposals 228 and 228A avoid this issue and therefore deliver more benefit to industry parties.

CHAPTER: Nine

Question 1: Do you believe that a post-implementation review will be necessary for the Modification Proposals which Ofgem is minded to implement?

59. Yes. There is considerable value at stake with each of these modification proposals and a post implementation review would help ensure that the right result has been achieved.