



**Consumer  
Focus**  
Campaigning for a fair deal

# **Consumer Focus response to Ofgem's Impact Assessment on unidentified gas**

**January 2010**

# Summary

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Ofgem consulted on a suite of proposals to allocate lost gas more fairly. We agree that change is urgently needed.

We are responding to Ofgem's regulatory impact assessment ('IA') on the identification and apportionment of the costs of unidentified gas (its reference: 143/09). This response is entirely non-confidential.

A significant number of questions are posed in the IA. We answer these directly at the end of this response, but start out by setting out our wider views on the implications of this suite of proposals in order to give our answers better context.

## The issue

Not all gas that enters a distribution network will be correctly attributed to the right customer. Factors such as metering and data errors, or theft, contribute to volumes of energy that cannot be correctly allocated to a specific site. This misallocated energy is significant – analysis presented in the IA suggests it is of the order of £120-200m per year.

This misallocated energy is currently entirely smeared on to Small Supply Points ('SSPs') through the Reconciliation by Difference ('RbD') process. SSP sites are those of residential and small business consumers.

There appears to be common agreement from all areas of the gas supplier community, including those who predominately serve industrial and commercial ('I&C') customers, that it is unfair to apportion all misallocated energy to SSPs. There is considerably less agreement on the methodology that should be adopted to re-apportion some of the lost energy on to I&C sites.

The IA considers a suite of competing proposals for how this re-apportionment should work.

## The proposals

Five proposals have been made to modify the Uniform Network Code ('UNC'). In simple terms:

- UNC194 seeks a regulatory determination on the principle that a **proportion** of lost gas should be picked up by the I&C market. It does not stipulate what this proportion should be – this would need to be determined by a subsequent modification
- UNC194A seeks a regulatory determination on the principle that a **fixed amount** of lost gas should be picked up by the I&C market. It does not stipulate what this amount should be – this would need to be determined by a subsequent modification
- UNC228 is an extension of UNC194 that would introduce the principle that a **proportion** of lost gas should be attributed to the I&C market, and additionally **stipulates** exactly what this proportion should be

- UNC228A is an extension of UNC194A that would introduce both the principle that a **fixed amount** of lost gas should be attributed to the I&C market, and additionally **stipulates** exactly what this fixed amount should be
- UNC229 would create the framework for the appointment of an Allocation of Unidentified Gas Expert ('AUGE'). This **independent expert** would **periodically re-determine** the volume of lost gas that should be attributed to the I&C market for the subsequent gas year without the need for any further modifications. Their findings could be appealed to Ofgem

Ofgem has indicated that it is 'minded to' approve UNC229 and does not consider any of the other proposals represents an improvement on the current regime.

## Key issues

We consider that the case for change, and which option is taken to enact it, comes down to three key considerations:

- Targeting costs fairly
- Encouraging those responsible for lost gas to do something about it
- Finding a future proof solution

### Targeting costs fairly

We strongly agree with the proposition that not all lost gas should be attributed to residential and small business customers. There is no logical rationale for holding such a view, and we note that even suppliers who predominately serve the I&C market acknowledge that some of the costs of lost gas should be borne by that market<sup>1</sup>.

These costs are significant. The IA suggests that £30-50m per year is being paid by residential and small business customers that should actually be paid by I&C customers and that this may unfairly inflate the cost to serve the former by around three pounds per site per year<sup>2</sup>. Residential customers should not be subsidising the energy bills of the I&C sector and there is a clear and pressing need to reform the current arrangements.

### Encouraging those responsible for lost gas to do something about it

All energy suppliers – and networks – should be encouraged to tackle the causes of lost gas. Only 229 would appear to do this.

Neither 194 nor 194A would directly re-apportion any costs of lost gas. As such, neither modification would introduce any meaningful encouragement on I&C suppliers to take additional action.

228 and 228A are little better. Although both of these proposals would introduce better cost reflectivity on implementation, recognising that some lost gas should be attributed to the I&C sector, neither allows for the ratio (228) or fixed amount (228A) apportioned to the different sectors to be changed without a future code modification. As such, neither introduces a clear linkage between success/failure in tackling lost gas and rewards/penalties for this. Without a clear link between behaviour and financial outcome these are fundamentally weak modifications.

229 would introduce better cost reflectivity and stable incentives on suppliers by providing an inbuilt mechanism for the volumes, and responsibility, for lost gas to be periodically reviewed and reset.

<sup>1</sup> Indeed 194A and 229 were both raised by I&C Shippers.

<sup>2</sup> Xoserve, Joint Office and Ofgem analysis shown in Table 1 (page 14) and Table 2 (page 16).

## Finding a future proof solution

The majority view of the UNC Panel was that only 228A better facilitates the code objectives. Regrettably it is unnecessarily difficult to understand why it reached that view as its modification report contains no record of the rationale for its recommendation<sup>3</sup>.

We suspect that the reason why that variant was favoured was because it is the only proposal that provides certainty *at the time the Authority reaches its decision* on the exact volume of gas that will be attributed to the I&C sector. These volumes could not be altered without a future modification and – noting that it has taken several years for the current suite of proposals to reach the current stage of the regulatory decision making process and that any future modification(s) may make similarly glacial progress – 228A gives I&C shippers the greatest certainty on what their future liabilities may be.

That does not make 228A the right option for consumers. As previously highlighted, this stability comes at the cost of cost reflectivity that will steadily erode over time and the absence of any new incentives on suppliers to tackle the causes of lost gas.

229 delivers better benefits in both areas. It is the only proposal tabled that guarantees periodic revision in the apportionment of lost gas to reflect and reward performance.

## Half a billion pounds and counting – the cost of inaction

The analysis presented in the IA suggests that the cross-subsidy paid by residential customers to I&C customers as a result of the current arrangements is of the order of £44m per year. These arrangements have been in place since 1998. A simple extrapolation suggests that residential consumers will have subsidised I&C customers to the tune of half a billion pounds since market opening.

We recognise that the materiality of the redistribution of monies between residential and I&C suppliers is sufficiently material that any regulatory decision on this matter may well be subject to some form of legal challenge.

Perhaps understandably, perceptions that the risk of legal challenge is high can tend to breed caution in decision making bodies, but we are nonetheless alarmed that there seems to be relatively little urgency from Ofgem in deciding on these proposals. The final modification reports for this suite of modification proposals were delivered to Ofgem in June 2009 and it has taken it six months just to produce an IA. There is no indication on when it will reach a final decision.

We urge Ofgem to act quickly in correcting this issue. This is a very important proposal for consumers, and it should be accorded a priority that reflects this.

## Summary of benefits

We summarise our views on the benefits of the competing proposals in the table overleaf.

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<sup>3</sup> It should be noted that we are not suggesting that this omission is evidence of a procedural error in the way the modification rules were applied – rather a frustration that there is currently no clear obligation on the UNC Panel to provide reasons for its recommendation to approve or reject any modification. While the UNC Panel meets in open session, it is neither practical, nor should it be necessary, for every party that may be affected by one of its decisions to attend every meeting in order to understand why it holds its views. They should be recorded and published as a matter of course.

Proposal	Impact on cost reflectivity?	Increased incentives to tackle lost gas?	I&C lost gas volume known in advance of gas year?	Periodic revision to reflect performance?
194	None – defers changes until a future mod	No	No	No
194A	None – defers changes until a future mod	No	No	No
228	Better than status quo, <b>but</b> will erode over time	No	No	No
228A	Better than status quo, <b>but</b> will erode over time	No	Yes	No
229	Better than status quo <b>and</b> maintained over time	Yes	Yes	Yes

# Views on consultation questions

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We set out our views on the specific questions posed in the IA in the same order that they appear in that document.

## Chapter 3

### **1. Do you agree with Ofgem's assessment of the likely impact of the Modification Proposals on charges made to consumers?**

We do not have the data to independently verify these calculations, but see no reason to believe that the assessment is inaccurate or misleading.

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

On balance, the protections are probably adequate to allow for approval.

The AUGE would be appointed by the UNC Committee. Consumer representatives currently do not have voting rights under the UNC but we note that Ofgem is currently consulting on proposals to rectify that defect as part of its final proposals on the Code Governance Review.

While, even with that change, consumer representatives would only have a minority voice on the UNC Committee, the same is also true for both residential and I&C shippers. It would not appear possible that either sector could engineer an impasse unreasonably preventing the appointment of an AUGE. At the same time, the strong natural tension between the commercial interests of these two sectors should mean that candidates for this role are subject to robust and vigorous scrutiny.

We note that shippers would have the right to appeal the AUGE's findings to Ofgem if they considered that it (the AUGE) had not correctly followed its mandate. This should provide an additional degree of comfort that the AUGE is acting credibly, though we consider that this right of appeal would offer better consumer protection if extended to include consumer representatives and not just market participants.

### **3. Do you anticipate any further impact upon consumers in addition to those considered in this chapter?**

We would expect to see the cost savings to residential gas suppliers resulting from these changes fully, and swiftly, passed through to their customers. Ofgem should monitor that this is happening, and apply the licence conditions prohibiting undue discrimination if this does not occur.

## Chapter 4

### 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?

No. For the reasons outlined earlier, we consider that only 229 would alter incentives on shippers to reduce the quantity of unidentified gas offtaken at LDZs.

### 2. Do you agree with our assessment of the likely distributional impact of the Modification Proposals?

We do not have the data to independently verify these calculations, but see no reason to believe that the assessment is inaccurate or misleading.

### 3. Do you believe that the potential benefits of the Modification Proposals justify the additional costs

194, 194A, 228 and 228A would not appear to result in any additional costs, but rather a redistribution of existing costs between residential and I&C shippers (and by extension, customers in those sectors).

229 would have a similar re-distributional effect, though it would require the appointment of an AUGE. The cost of their appointment is unknown, but we see no reason to believe that this will be substantive – we would be extremely surprised if this exceeded a five-figure sum.

The benefit of rectifying an unfair cross-subsidy that is costing residential and small business consumers tens of millions of pounds per year certainly justifies such cost.

### 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?

No, it would not.

In principle, a clumsy case could (and we suspect, will) be made by some market participants that variable RbD charges would adversely affect competition in the Large Supply Points (LSP) market. Because variable charges would be less predictable than fixed charges they would increase the uncertainty on costs associated with supplying this market. The argument may therefore be made that the cost to serve the LSP market will increase and that competition has been negatively impacted.

There is logic to such arguments but they must be seen in their proper context. The reduced cost to serve the LSP sector that comes with fixing lost gas volumes for that sector comes at the cost of leveraging the variability of lost gas within the residential sector.

This may be easily demonstrated with a very simple mathematical example. Let us create two methodologies:

- Variable methodology A applies a 50:50 split between residential and I&C sectors
- Fixed methodology B apportions 50 units to the I&C sector

We will apply these methodologies to two identical data sets, ie the same volume of lost gas in each year. The following tables show the outcomes.

Methodology A: variable charge to the I&C sector (50:50 split)

Year	Total Lost Gas	SSP share	SSP year on year variation	I&C share	I&C year on year variation
1	100	50	n/a	50	n/a
2	102	51	+2%	51	+2%
3	104	52	+1.9%	52	+1.9%
4	96	48	-8.3%	48	-8.3%

Methodology B: fixed charge of 50 units to the I&C sector

Year	Total Lost Gas	SSP share	SSP year on year variation	I&C share	I&C year on year variation
1	100	50	n/a	50	n/a
2	102	52	+4%	50	0%
3	104	54	+3.8%	50	0%
4	96	46	-14.8%	50	0%

As you can see, while fixing the charges in the LSP sector (ie methodology B) wholly mitigates the volatility in that sector, it results in a significantly more volatile charge in the SSP sector than would be the case were variable charges applied.

Risk is never free. Pushing the volatility from I&C to residential sectors simply results in the latter picking up responsibility for paying for more of it. This may well result in residential retail margins being higher than they should be.

We have seen no evidence to suggest that it is fair to push all lost gas risk premia on to the residential sector.

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

Yes. Though 229 would represent a great leap forward in requiring the I&C sector to pay for its fair share of theft, the logical next step would be to drill down to more correctly apportion theft *within* sectors. This step would help facilitate that goal.

**Chapters 5**

**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?**

Yes.



**2. Do you agree with Ofgem’s assessment of the relative impact on sustainable development of each of the Modification Proposals?**

Yes.

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

No.

## Chapter 6

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

No, we do not.

## Chapter 7

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

Yes, we do. An appeal right to Ofgem is built in to the proposal. In extremis, an Ofgem determination could be subject to judicial review, or a further modification proposal could be raised.

**2. If not, how should any additional governance be implemented?**

N/a – see previous answer.

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

Not that we are aware of.

**4. How could the governance arrangements for appointment of an AUGE be structured to minimise impact upon shipper parties? Should Gas Transporters be indemnified from any risks from holding this contract, and if so how might this be implemented in practice?**

The timing of AUGE determinations will need to be carefully considered. It will be influenced by the tension between two contradictory signals:

- **Accuracy:** the closer that a determination is to ‘real-time’ the more likely it is to result in an accurate apportionment of costs between the SSP and LSP sectors. This signal encourages reaching decisions as late as possible
- **Certainty:** the earlier a determination is reached, the greater the ability of a market participant to respond to it and the less risk it (and implicitly, its customers) will face. This signal encourages reaching decisions as early as possible

Finding the healthiest balance between these signals will be difficult. We believe that there should be a reasonable lead time between the AUGE making its determination and those values taking effect, in order to allow shippers to factor them in to their volume and pricing assumptions.

We agree that the Transporters should not be liable for risk associated with holding this contract – provided that they act prudently in managing it. As far as we can see, the Transporters cannot benefit financially from any determination made by the AUGE – so we agree that it would be a perverse outcome if the remedy route taken by a shipper disgruntled by an AUGE determination was to sue the Transporters. We do not have any views on how indemnity should be implemented in practice.

## Chapter 8

### **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?**

Yes, we do – although more important to us are the benefits that would accrue to energy consumers.

## Chapter 9

### **1. Do you believe that a post-implementation review will be necessary for the Modification Proposal which Ofgem is minded to implement?**

It depends which proposal is implemented.

229 has a degree of post implementation review built in to the proposal itself – the periodic reviews carried out by the AUGE should themselves highlight the extent to which lost gas is being successfully attributed and tackled.

228 and 228A do not have the same degree of built-in review and would merit post implementation review were either implemented.

Neither 194 nor 194A would have any direct financial consequence on market participants or consumers. A post implementation review would not be merited for either.

## **Consumer Focus response to Ofgem's Impact Assessment on unidentified gas**

Contact: Richard Hall, Principal Policy Advocate

Tel: 020 7799 8042

Email: [richard.hall@consumerfocus.org.uk](mailto:richard.hall@consumerfocus.org.uk)

[www.consumerfocus.org.uk](http://www.consumerfocus.org.uk)

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Deaf, hard of hearing or speech impaired consumers

can contact Consumer Focus via Text Relay:

From a textphone, call 18001 020 7799 7900

From a telephone, call 18002 020 7799 7900

Consumer Focus

4th Floor

Artillery House

Artillery Row

London SW1P 1RT

Tel: 020 7799 7900

Fax: 020 7799 7901

Media Team: 020 7799 8004 / 8005 / 8006