Modification proposal:	**Uniform Network Code (UNC) 388: Fixed parameters for determining Shipper contribution to Unidentified Gas (UNC388)**		
Decision:	The Authority[1] has decided to reject this proposal[2]		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	24 November 2011	Implementation date:	N/A

Background to the modification proposal

Shippers are liable for gas and transportation charges for balancing their gas requirements and using the Gas Transporters (GTs) services for transporting gas to the end user. The charges that apply to individual shippers for using the gas transportation network are based on a shipper's daily energy input and offtake volumes from the network.

For Daily Metered sites[3], daily gas and transportation charges to shippers are allocated based on daily meter reads. For Non-Daily Metered (NDM) sites, these charges are allocated based on an estimate of the gas consumption at that site – the Annual Quantity (AQ)[4]. NDM Larger Supply Points (LSPs) allocations are reconciled whenever an actual meter read is obtained. However there is no meter point reconciliation for NDM Smaller Supply Points (SSPs)[5]. This means that for SSP sites, the allocation of charges is always based on the estimated consumption obtained through the AQ. The aggregated increase or decrease in the LSP consumption volumes that results from the reconciliation process will flow to the SSP market, in a process known as Reconciliation by Differences (RbD).

Unaccounted for Gas (UAG) refers to gas which is supplied to the gas network, but whose use[6] cannot be directly attributed to a shipper[7]. Until the implementation of modification UNC229[8] all UAG was allocated to the SSP sector through the RbD process. UNC229 introduced a mechanism for apportioning UAG between the SSP and LSP sectors. This proposed the introduction of a table to the Uniform Network Code (UNC) that would apportion a fixed volume of UAG to the LSP sector[9].

Further to the process introduced with UNC229, every year by the end of September the Allocation of Unidentified Gas Expert (AUGE) will determine a fixed annual quantity of UAG attributable to the LSP sector in the following AUG year[10]. The annual quantity of gas will be pro-rated for the 12 months of the AUG year, and for each month converted into a financial amount by using the average daily System Average Price (SAP)[11] for the previous month (the reconciliation month). Each shipper with LSP customers will be

[1] The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of Gas and Electricity Markets.
[2] This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.
[3] Sites fitted with meters that allow for the total quantity of gas consumed to be measured on demand, on a daily basis. Such meters have data-loggers, which are electronic devices that automatically record, store and transmit meter readings. Sites fitted with meters where gas is not measured on demand on a daily basis are known as Non-Daily Metered (NDM) sites.
[4] The AQ is an estimate of the expected annual consumption of a site. It is set once a year based on historic metering data.
[5] SSPs are sites with an AQ below 73.2MWh. Sites with an AQ above this threshold are LSPs.
[6] After correcting for the volume of gas lost in the network (eg due to leakage), known as shrinkage.
[7] For example, gas theft or unidentified meter errors are sources of UAG, as the meter would not record the units of gas actually consumed.
[8] UNC229: Mechanism for correct apportionment of unidentified gas had an implementation date of 1 April 2011. Available at http://www.gasgovernance.co.uk/0229. The effect of UNC229 will be from April 2012 onwards. UNC317 was raised to allocate gas in the interim (from April 2011).
[9] It also proposed a requirement for an independent expert (the Allocation of Unidentified Gas Expert, or AUGE) to determine a methodology to identify and estimate the sources and amounts of unidentified gas, and to determine accordingly the values to populate the UNC table on an enduring basis. Every year the AUGE will publish its methodology and an estimate of the amount of UAG, for each source and market sector, in a document referred to as Allocation of Unidentified Gas Statement (AUGS).
[10] The AUG year runs from 1 of April to 31 of March.
[11] SAP is the weighted average price of all trades for the relevant gas day on the On-the-day Commodity Market (OCM), an anonymous trading service to which offers or requests for gas at a nominated price can be posted.

allocated a proportion of this amount based on its share of the total volume of gas (based on the sum of AQs for sites in its customer portfolio) in the LSP sector over the reconciliation month.

The modification proposal

Modification UNC388 was raised by Total Gas & Power (the proposer) on 8 July 2011. The proposer considers that the AUG process makes it difficult for suppliers to determine a unit price for UAG to pass through to their LSP customers. This is a consequence of the monthly variability around both the average SAP and the volume market share of the NDM LSP and DM LSP sectors.

The proposer notes that customers in these sectors are usually supplied on the basis of contracts which allow for the pass through of transportation costs. According to the proposer, the uncertainty around the monthly UAG financial amount means that, to pass through this cost, shippers would have either to:

- charge customers based on an estimate of the monthly price for UAG, and subsequently reconcile this when the actual price is known; or
- invoice customers with a month lag in relation to the invoicing period, in order to have certainty about the average SAP and market shares.

The proposer considers these solutions are not ideal and result in additional uncertainty and risk to shippers operating in the LSP market, and to their customers. It may also lead to significant costs[12] to shippers with administering any reconciliation process for customer billing.

UNC388 proposes to change the AUG process so that it is possible to create a fixed unit price for UAG each AUG year, which could then be passed through to the LSP customers. The solution advanced by the proposer comprises three main features:

- To use a commonly available forward reference price instead of the rolling average SAP calculated after the reconciliation period has concluded;
- To fix each market sector volume for the NDM LSP and DM LSP sectors at the 1 October each year, rather than using a rolling monthly market volume;
- To make consequential changes to the redistribution process from the LSP sector to the SSP sector so that all the due debits from the former are passed through to the latter. These are discussed in more detail below.

Replace the rolling average SAP by a reference price

UNC388 proposes to replace the rolling average SAP with an average price derived from the forward prices published by ICIS Heren[13]. More specifically, it proposes to use the daily average closing prices, over the month of August, for the forward quarterly prices of gas. These would be the four quarters for the period commencing 1 April of the following year, as published by ICIS Heren[14].

Fix each market segment volume for the NMD LSP and DM LSP sectors

Using a reference price would enable parties to have certainty about the price of UAG. However, the payments that each shipper on the LSP sector would have to make to the SSP sector may still vary, as the monthly UAG financial amounts would still depend on LSP's own market shares in the NDM and DM sectors.

---

[12] The proposer argues that implementing in their business either a reconciliation or a lagged invoicing process would lead to IT development costs of circa £100,000, and then further ongoing administration costs of £100,000 annually.

[13] ICIS Heren publishes natural gas, power and carbon market information.

[14] In the event that prices are not available from ICIS, it is proposed that the GTs would be required to source a suitable alternative set of published information. UNC388 also proposes that the AUGS could specify the source used for this calculation.

To address this remaining variability, UNC388 proposes to fix the total market volume for the NDM LSP and DM LSP sectors for the forthcoming AUG year. This would be achieved by aggregating all AQs for each qualifying site in each market sector on 1 October each year. During the AUG year, for each month, each Shipper's current aggregate AQ for the NDM LSP and DM LSP sectors would be divided by the appropriate fixed market volume. Each shipper's monthly financial liability would then be calculated by applying this ratio to the monthly UAG financial amount.

Redistribution of UAG

Dividing each Shipper's monthly aggregate AQ for the NDM LSP and DM LSP sectors by a fixed market volume may result in over- or underpayments being made from the LSP to the SSP sector[15]. This means that any resulting debits from the LSP sector may not be mirrored by corresponding credits to the SSP sector, as happens with the current AUGE process.

UNC388 proposes therefore to introduce a mechanism to ensure that all the debits received from the LSP sector are passed onto the SSP sector. To achieve this, any over- or underpayments would lead to a readjustment of the monthly UAG financial amount.

Implementation costs and potential benefits

The proposer does not consider that there would be any material costs associated with this modification, as it proposes a replacement of rolling variables with fixed parameters. If there was an indication that any costs would be involved[16], however, the proposal indicates these should be met by those organisations that benefit from this change and should therefore be targeted at the LSP sector.

The proposer has also indicated that the resulting process would lead to greater price transparency. It adds that the process would be simpler to administer, in particular by removing the need to undertake reconciliation of UAG costs contained in pass-through supply contracts. According to the proposer, the benefits may also include less uncertainty to shippers about what the financial impact of the UAG process would be. The proposer notes that this could reduce costs to customers as no additional risk premiums would need to be built into prices.

UNC Panel[17] recommendation

At the Modification Panel meeting held on 20 October 2011, five votes were cast in favour of implementation of the proposal, two votes were cast against it and there were three abstentions. The UNC Panel therefore recommended the implementation of the modification proposal.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 20 October 2011. The Authority has also considered and taken into account the responses to the UNC consultation on the modification proposal.

[15] This is because the sum of all shippers' AQ, for each market sector, may not be equal to the fixed market volume (eg due to customer switching, or AQ amendments). For each market sector, when the sum of all AQs is above the fixed market volume this would result in an overpayment from the LSP sector to the SSP sector. The opposite would result in an underpayment.
[16] Xoserve noted that if implementation of UNC388 occurred before November 2011 it would be possible that the change required could be incorporated within the current development phase with minimal impact to cost. However, xoserve noted that the implementation cost could be higher if implementation were to occur later.
[17] The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

The Authority has concluded that implementation of the modification proposal will not better facilitate the achievement of the relevant objectives of the UNC[18] and has decided not to direct the implementation of the proposal.

Reasons for Authority decision

We have assessed the proposed modification against the UNC Relevant Objectives. We consider this proposal will not further objective (d) and is neutral with regards to the other Relevant Objectives. We have in reaching our decision considered two main aspects of the proposal:

- Transfers of risk from the LSP to the SSP sector;
- Cross-subsidy between the LSP and SSP sectors

We consider each in more detail below.

Standard Special Condition A11.1 (d): the securing of effective competition between relevant Shippers, between relevant Suppliers, and between Distribution Network Operators and relevant Shippers

Respondents to the consultation raise two main issues: the potential for a transfer of risk from the LSP sector to the SSP sector, and the introduction of a cross-subsidy between the two sectors.

A number of respondents consider that the proposal, by fixing the price that LSP shippers are exposed to for UAG, would pass price risk (and therefore cost) from LSP shippers to SSP shippers. They note this is contrary to the intent of UNC229, which sought to remove the cross-subsidy from SSP shippers to LSP shippers and to target risks appropriately. These respondents also note that shippers are able to purchase financial instruments to hedge against the risk posed by UAG. They consider that UNC388 is an attempt to avoid the costs of hedging price risk and to move this risk from LSP to SSP shippers. It therefore would not facilitate competition.

The proposer and a number of other respondents consider that UAG financial readjustment and the volume of gas purchased by the shipper to cover its SSP portfolio are not linked[19]. They argue that shipper exposure to imbalance costs would therefore not be varied by any aspect of the AUGE process and so risk would not increase or decrease. Instead, if UNC388 is implemented, SSPs would have certainty on the unit rate that they will be reimbursed for UAG, instead of a varying rate based on SAP. These respondents note that this certainty could reduce risk for SSPs. They add that the proposal would lead to increased transparency and minimisation of risk premiums and administrative costs arising from reconciliation.

We consider that under the current AUG process, both SSP shippers and LSP shippers would face risk arising from uncertainty around the UAG financial amount each month. The average SAP would be the main source of such uncertainty. If UNC388 is implemented, the price for UAG would be fixed in advance and this source of uncertainty would be removed for LSP shippers. SSP shippers would continue to face uncertainty, as they incur costs for UAG at SAP, but would get a financial repayment from the LSP sector at a different price (the fixed reference price)[20]. As the fixed reference price is known in

[18] As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://epr.ofgem.gov.uk/index.php?pk=folder590301
[19] The proposer indicates that shippers would therefore not reduce their wholesale gas purchases in line with the likely reimbursement they will receive under the AUGE process
[20] The uncertainty would arise from any difference between the fixed reference price and the average SAP.

advance, the source of uncertainty (and risk) for SSP shippers would be the SAP. We note that this is the same source of uncertainty that SSP shippers currently face.

However, noting the views of respondents, we do not consider that sufficient assurance has been provided that there would be no risk transfer from the LSP to SSP shippers. In particular, it is uncertain how shippers would respond to the UAG information, and how this may impact their wholesale market behaviour. The proposal does not address the issue of how any potential transfer of risk could be dealt with, or whether it would be proportionate taking into account all of the circumstances. We therefore consider that the possibility of disproportionate risk being transferred from the LSP to the SSP sector is not excluded[21]. The proposal therefore could have a detrimental effect on competition.

A number of respondents noted that in the long term this proposal would result in an ongoing cross-subsidy from the SSP to the LSP sector, to the detriment of SSP customers. UNC388 would lead to an effective cross-subsidy whenever the average SAP is different from the fixed reference price. The proposal acknowledges this effect, and indicates that as a result there would be times where SSP shippers could make a profit[22].

In the long term, differences between the average SAP and the fixed reference price could be marginal, and therefore it is not clear whether there would be an ongoing cross-subsidy between the LSP and SSP sectors. We consider that within a year (period for which UNC388 fixes the UAG price) the differences in prices may be significant, and therefore may lead to significant transfers of cost between sectors. The proposal does not address how this cross-subsidy could be dealt with. We consider that this cross-subsidy may be detrimental to securing effective competition.

We agree that the proposal could lead to benefits to the LSP sector. However, we are concerned with the transfer of risk and have not been provided with robust evidence to explain why any such transfer would be beneficial to the market. UNC388 does not explain how it would contribute towards risks being allocated to the parties best placed to manage them. We therefore consider that implementation of this proposal would not better facilitate relevant objective (d), and therefore do not direct it to be implemented. We are also mindful of the fact that the AUGE process has yet to complete a full cycle. If a new modification is raised on this issue we would expect it to be based on a compelling case and on robust evidence. Otherwise we consider it would be prudent for the industry to consider any future modification on the basis of evidence, ie after the AUGE process has operated in practice for a complete a full cycle.

Further issues

Some respondents noted that the legal text has been amended to introduce a reconciliation process subsequent to the proposal discussion and development. We share this concern, and would expect that in the future the industry is given the opportunity to consider properly any such amendments.

Colin Sausman
Partner, Smarter Markets

Signed on behalf of the Authority and authorised for that purpose.

[21] To the extent that there may be a risk transfer from the LSP to the SSP sectors, this could result in a transfer of cost from the LSP sector to the SSP sector. We consider this could constitute a cross-subsidy.
[22] This would occur when the reference price is above the average SAP for a given month. The reverse (SAP above the reference price) would mean that SSP shippers faced a cost for UAG that was greater than the financial amount received from LSP shippers. In this case LSP shippers would make a profit.