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Dear Andrew,

### **Theft of Electricity and Gas – Next Steps**

I write in response to the paper you published in January giving further thoughts on the development of your thinking on the theft of energy. As you know we have been participating in the ENA/ERA Working Groups that are seeking to provide more detailed suggestions by the middle of the year. In the meantime, I would like to offer some comments on the main issues arising from your paper.

Ofgem have consistently argued that most revenue protection obligations should rest with suppliers. This reflects both their direct relationship with customers (reinforced by the supplier hub principle behind the market design) and the statutory and licence obligations that currently exist. This does seem to be the most appropriate long term goal. However it is also important to ensure that whatever arrangements are decided, they are effective in minimising the overall cost to honest customers of any theft of electricity or gas.

It has been our experience that the numbers of leads identified by electricity suppliers has fallen considerably in recent years (particularly since we ceased to own an electricity supply business). This suggests that the fundamental issue to address is the incentives faced by suppliers to raise their suspicions and ensure they are effectively investigated. If a suitable incentive framework can be put in place, it should be possible to rely on markets to provide the appropriate level of skill and resource to pursue investigation and follow up of detected theft.

However, with this as a medium term objective, it may still be worthwhile for Ofgem to oversee the transition to competition in the same way as it has done for supply, metering or connections. In all these areas it was felt necessary to identify a 'last resort service provider' while competition was being encouraged. We would therefore suggest that in electricity DNOs should be obliged to offer a revenue protection service to suppliers until Ofgem is satisfied that such services are available from a truly competitive market. The development of that market will depend primarily on suppliers facing incentives that actively encourage the investigation and remedy of suspected theft. It may not be appropriate to suggest a direct parallel in the gas market, where obligations are more clearly established and defined.

This is not an easy area and it is encouraging to note that a number of suggestions are now coming forward from various quarters. We now need to build a model that will allow appropriate comparison of different schemes and assist in the choice of one that is likely to be effective. Such a model needs to look across the whole market to identify the value of revenue protection activities. Honest customers (and their suppliers) must bear the cost of all energy that is produced but not metered and billed to the appropriate user. The benefits of revenue protection will therefore cover both the correct attribution of 'stolen energy' and a deterrent effect that reduces the amount that is stolen in the first place. All suppliers and honest customers gain from both these effects, but the supplier who holds the registration for the meter point where theft is discovered has an offsetting loss if the culprit cannot be identified or cannot pay for the energy taken. The heart of any incentive arrangement should therefore be to take some of the positive value to the market and use it to change the balance of incentives for the supplier directly affected. This should not be an impossible task, but it does need to be underpinned by an agreed framework for evaluation. This is a task presently underway in the ERA/ENA Working Group.

Turning now to the specific content of your paper, I would add the following detailed comments.

### 1. Principles

The modifications made to the draft principles represent improvements. However it is not clear what should be done where principles turn out to be unachievable goals. Principle 3 may be a sound basis on which to construct a regulatory regime (ie intervention is only appropriate where markets are not working), but it is not helpful where market failure already exists. I cannot see how progress can be made without Ofgem taking a role in monitoring performance and intervening where necessary to ensure compliance.

### 2. Obligations

One of the main tools available to you to assist in delivery of your policies is the ability to impose obligations on market participants. Until there is evidence of an effective market in revenue protection services we think it is entirely appropriate for Ofgem to ensure a last resort provider is available. Such an obligation should be placed on each electricity distribution network operator, but there should also be a mechanism defined that would trigger the removal of that obligation as soon as market conditions permit. In gas, where obligations are more clearly established, we would not advocate a change at present.

### 3. Incentives

We can see some prospect of developing the 'reasonable endeavours' mechanism that currently exists in the gas market. However it is important to understand why it is not extensively used. We believe this reflects the inadequacies of the scheme as a device to rebalance incentives. It provides only partial cost recovery rather than positive rewards. It is less appropriate in electricity where suppliers must also pick up the energy costs in settlement associated with stolen units. A more sophisticated response to the different wholesale market arrangements is therefore needed. We are keen to continue working with ERA and ENA members to develop a more effective alternative.

### 4. Compliance

We believe an effective compliance regime must include transparent reporting by suppliers. This will need to include mandatory reporting of the kind of data that you have tried to collect to inform your project. The limited success of that data gathering exercise reinforces the need for regulatory powers to require such data to be provided. Only by understanding the levels of activity (and the remedies

adopted) across the market can it be demonstrated whether revenue protection is being provided to a sufficient extent. Past experience suggests that it is yet too soon to rely on 'self-regulation'.

#### 5. Codes of practice

It is the consistent application of good practice across the whole market that will deliver the greatest benefit for honest customers. We therefore recommend the continued use of industry wide codes that build upon past practice, but allow scope for refinement as experience identifies better ways to operate in the future.

#### 6. Way forward

In our view this project has not been given the priority necessary within Ofgem. The negative impact on honest customers of continuing levels of theft of energy represents an unnecessary loss of value. Furthermore, the longer the uncertainty in respect of responsibilities and obligations remains, the greater the risk that theft becomes a way of life, especially at times of rising energy prices, and the challenge to reduce or remove its incidence becomes much greater. The sooner we can establish appropriate incentives on suppliers supported by regulatory obligations where necessary the better.

Yours sincerely

**Mike Boxall**

**Electricity Regulation Director**