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Dear Ndidi

Centrica welcomes the opportunity to respond to Ofgem's consultation on Reconciliation by difference. With no review of RbD since it's introduction in 1998 we believe that it is important to fully consider the current gas settlement arrangements and how they can be improved in the short, medium and longer term.

Our response sets out Centrica's views of the current gas settlement arrangements in Part 1, goes on to answer Ofgem's specific questions in Part 2, and finally in Part 3 provides our views as to the most appropriate way of generating the reform to these arrangements which is required.

Centrica views the deficiencies in current gas settlement arrangements as material and we would welcome the opportunity to meet with Ofgem to further to discuss our concerns and provide any additional clarify you require with regards our detailed response.

Yours sincerely

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Review of Reconciliation by Difference (RbD)

A response by Centrica Plc

Contents

Part I: Introduction and Overview

1.1 The industry arrangements regarding Reconciliation by Difference (RbD) have not been reviewed since 1998 and are no longer fit for purpose. The underlying deficiencies in the RbD arrangements and related features of the gas settlement system are examined more fully in Part II of this response. That part sets out our answers to the specific questions posed in Ofgem's consultation document. Part III of this response sets out a possible approach and timetable for achieving and implementing the reform that is needed. That approach and timetable provides for a move to meter point reconciliation in the longer term. Meter point reconciliation would bring real and enduring improvements to the fairness and accuracy of gas settlements.

1.2 The RbD arrangements have, since their inception, resulted in a £715 million[1] charge to the domestic and small commercial (Small Supply Point - SSP) sector. In our view, a material portion of that charge represents an inappropriate allocation of costs to the SSP sector from the I & C (Large Supply Point - LSP) sector. For instance, under the existing arrangements, the SSP sector bears *all* the costs related to theft and "Shipperless sites"[2], including those arising from the LSP sector. This inappropriate allocation needs to be quantified and corrected.

1.3 The deficiencies in the RbD arrangements have been brought into sharp focus by the dramatic increase in wholesale gas costs since 2003. That increase in gas costs highlights the need for reform on an urgent basis. It would be unacceptable to continue with industry arrangements that unfairly penalise the domestic and small commercial sector. The unfair charges to the SSP sector adversely affect competition and increase prices for domestic and small commercial customers.

1.4 The RbD arrangements need to be modified quickly. Centrica believes that those modifications should have five key objectives, namely:

i) to strengthen the incentives on all market participants to reduce aggregate RbD volumes;

ii) to address the inequities regarding the manner in which RbD costs are apportioned solely to the SSP sector;

iii) to enhance transparency in respect of the Annual Quantity (AQ) review process;

[1] Since the inception of RBD there has been 79.5 TWh of energy charged through the RBD smearing mechanism. When multiplied by a system average price of c.0.3p/kWh for capacity (transportation), and 0.6p kWh for commodity (energy) this equates to a total cost of £715m.

[2] Sites recorded on the register of supply points as having no shipper, as well as sites which are not recorded on the supply point register.

iv) to strengthen the governance procedures in respect of data provision and other key processes in respect of RbD; and

v) to enable and encourage Shippers and others to correct errors in AQs on a timely basis.

1.5 Centrica is confident that these improvements to the RbD rules can be achieved in the near term without disproportionate cost to the industry.

1.6 Centrica also believes that any examination of the deficiencies of the existing RbD rules must recognise that those rules are but one component of the settlement arrangements governing the gas industry. Our view is that other deficiencies within settlement arrangements, in addition to those in respect of RbD, are also contributing to an inappropriate allocation of costs to the SSP sector. These other deficiencies include the following:

i) the lack of proper incentives for the prevention and detection of theft;

ii) the use of an inappropriate and arbitrary methodology for the determination of shrinkage;

iii) the lack of measures to address the phenomenon of those sites which are receiving gas but which are not recorded on the supply point register; and

iv) the weakness of governance and transparency in respect of settlements with Independent Gas Transporters (IGTs).

1.7 Our view is that the reform of gas settlements should resolve these deficiencies as well as those specifically related to the RbD arrangements.

1.8 Centrica agrees with Ofgem that many of the near term improvements that are needed in respect of RbD and other features of the gas settlement arrangements can be achieved through the industry change procedures provided for in the Uniform Network Code. However, we also believe that Ofgem has an important role to play in facilitating those improvements. In particular, Ofgem should:

i) ensure that the current Gas Distribution Price Control Review (GDPCR) includes a thorough review of the approach to gas losses;

ii) resolve any issues relating to the recovery of costs incurred by Network Owners in respect of any system enhancements needed to implement the improvements ultimately achieved in gas settlement arrangements; and

iii) maintain a close watch on the progress of reform through the industry change procedures and continue to support the implementation of the stronger governance arrangements that are needed with respect to gas settlement.

1.9 We recognise that not all features of a more comprehensive programme of reform can be achieved in the near term. Some features will take longer to implement than others. Accordingly we have, in Part III, outlined a proposal for addressing the deficiencies in gas settlement arrangements through three stages. We identify those modifications which can and should be made in the near term, namely, changes to address RbD apportionment, AQ review reform, shrinkage methodology, "Shipperless sites", theft, and IGT settlements. We distinguish these near term changes from those that can be pursued or considered in the medium or longer term.

1.10 This three stage approach to reform allows for a move to meter point reconciliation. As noted above, meter point reconciliation would bring real improvements to the fairness and accuracy of gas settlements. It would give Suppliers a strong incentive to improve the quality of the data they submit to industry settlement processes. Such improvements are critical to the implementation of a settlement system that is fit for purpose over the long term.

1.11 We recognise that a move to meter point reconciliation would represent a major change for the industry and, accordingly, stakeholders will need to examine the costs and benefits of that move before making a final decision to proceed. The need for such careful examination means that meter point reconciliation must be approached as a long term action. For this reason, the consideration of meter point reconciliation must not detract from the near term changes that we are recommending. Preliminary analysis regarding meter point reconciliation should nonetheless proceed in parallel with the implementation of the important reforms that are needed now. That analysis should include an assessment of the improvements to settlement accuracy achieved through the implementation of the near term reforms and should have due regard to the investment that the industry is making in Automated Meter Reading (AMR).

Part II: Centrica's Response to Ofgem's Questions

1. Given the original rationale and benefits of RbD, do you consider it remains valid under the current GB Gas arrangements?

2.1 The original design of the RbD mechanism reflected concerns about data quality, meter reading frequency and theft within the domestic and small commercial market sector, particularly as compared to the I & C market. As indicated more fully below, many of these original considerations are no longer valid. Data quality and meter reading frequency have improved within the SSP market. Moreover, many of the factors that are now known to contribute to measurement error are not the sole responsibility of the SSP sector. The more important contributing factors include theft, "Shipperless sites" and the lack of robust assurance in respect of settlements involving Independent Gas Transporters (IGTs). Accordingly, the allocation of *all* measurement error to the domestic and small commercial sector is no longer appropriate. The reasons why the original rationale for RbD is no longer valid are set out in further detail below.

Improvements in Data Quality in SSP Sector

2.2 Since the opening of the gas market several developments have led to improvements in the quality of settlement data within the SSP sector:

i) Centrica and other Shippers have invested substantially in improvements to their own systems and processes. Those improvements have enhanced the accuracy of the data in respect of the domestic and small commercial sector.

ii) xoserve has also enhanced the quality of data in the SSP sector through substantial improvements in its query management systems, the implementation of enhanced query management standards of service, and significant portfolio/data cleansing exercises .

Increase in Frequency of Meter Reading in SSP Sector

2.3 Part of the original rationale for attributing all RbD costs to the SSP market sector was that sites in that sector were read much less frequently than sites in LSP sector. However, meter reading frequency has improved within the SSP sector since market opening. Most Suppliers within the domestic and small commercial sector have increased the frequency with which they routinely read meters. The frequency of meter reading within a large portion of the SSP sector now matches that of a large proportion of the Non-Daily-Metered (NDM) Large Supply Point (LSP) sector. These improvements regarding the frequency of meter reads in the SSP sector are noted in Ofgem's

decision document in respect of energywatch's 2005 supercomplaint in respect of billing processes. Accordingly, differences in meter reading frequency no longer constitute a clear and compelling rationale for distinguishing between the SSP sector and the NDM portion of the LSP sector in respect of the apportionment of measurement error.

Prevalence of Theft within the LSP Sector

2.4 It is clear from the industry statistics that theft exists in both the SSP and LSP sectors. It is therefore inappropriate to target all of these costs to the SSP sector. Moreover, it is important to recognise that, since the SSP sector pays for all undiscovered theft, the LSP sector has little incentive to detect or prevent theft. This fact must be kept in mind when considering the relatively low rate for the detection of theft within the LSP sector.

Prevalence of "Shipperless sites" within the LSP Sector

2.5 Approximately 75,000 sites are recorded on the register of supply points as having no Shipper. The volume in respect of these sites is approximately 50GWh[3]. There are, in addition, a further unknown number of sites that are not recorded on the supply point register at all. A significant portion of these "Shipperless sites" are in the LSP sector. The costs in respect of these sites should properly be captured in the Distribution Network Owners' shrinkage costs. However, as explained more fully in the answer to Questions 6 and 7 below, the current approach to the calculation of shrinkage costs fails to reflect the full impact of "Shipperless sites". Accordingly, the remaining costs in respect of those sites, including those in the LSP sector, are apportioned to the SSP sector through the RbD arrangements. This circumstance further highlights the inequity of the existing RbD arrangements.

Lack of robust IGT Energy Allocation

2.6 The IGT sector has grown significantly since the introduction of the RbD arrangements. This growth means that RbD is increasingly influenced by any error in the measurement or estimation of the volume of gas allocated to the IGT sector. For this reason, our view is that the industry needs to adopt measures that would see closer and more regular analysis and oversight of the processes that allocate gas at the IGT off-take points.

2.7 In summary, the considerations above invalidate the principle that the entire cost of all measurement error should be allocated to the SSP sector. Improvements in data quality and meter reading frequency within the SSP sector, the demonstration that both theft and "Shipperless sites" are prevalent within the LSP sector, and the

[3] 50GWh from 1998 – 2005. Source: RBD Subgroup Update February 2006. This volume includes Late Confirmed sites.

increasing risk of measurement error with respect to IGT settlements indicate that the industry needs to modify the existing RbD arrangements.

2. Are the costs and benefits of the RbD process transparent to the industry, and if not what and how can transparency be improved?

2.8 The costs and benefits of the RbD process are not sufficiently transparent to the industry. Our view is that such transparency can and should be enhanced. In particular, we observe as follows:

i) The costs of operating the RbD process are not clear to the industry since they are presently bundled within the Gas Distribution Networks Price Controls (GDPC). Our expectation is that these operating costs are relatively small compared to the value of the energy reconciled under the RbD processes. However, greater transparency of such costs is warranted.

ii) Significant data is published by xoserve about the operation of the gas settlement system. However, that data is presently aggregated on a market-wide basis only. This aggregated approach to information disclosure masks the way in which the operation of the settlement system, including RbD and scaling factors, impacts different market sectors. We would welcome the publication of settlement data that is disaggregated by large and small supply point market. Providing access to data on this basis is an important and necessary first step to addressing the deficiencies in RbD and other areas of the gas settlement system.

iii) Paralleling the concerns in (b) above about the insufficient transparency of the *outputs* from xoserve's operation of the settlement system are concerns about the insufficient transparency regarding some of the key *inputs* into that system. In particular, Shippers receive insufficient data regarding key inputs such as LDZ Off-take Metering data, Unallocated Gas monitoring and reduction mechanisms, offline Reconciliation and Adjustment Processes, User Suppressed Reconciliation Values (USRV), Consumption Adjustments, and I&C Reconciliation Trends. Provision of this data would help Shippers and others to identify and address deficiencies in the settlement processes.

iv) The proper calculation of RbD is dependent on accurate measurement of gas leaving the NTS system and entering the Local Distribution Zone (LDZ). As matters stand, there is a significant incentive upon National Grid to reduce shrinkage from the NTS; this acts as a stimulus for detecting metering errors that understate gas leaving the NTS. It also acts as a

disincentive for detecting any Off-Take metering errors that overstate gas leaving the NTS. Given the impact that such metering errors can have on RbD, the industry needs increased transparency in this area. Independent inspection and auditing of the accuracy of this off-take metering equipment should be considered. In particular, each LDZ off-take meter could be independently checked on a 6 monthly basis. The results of any checks should be published to Shippers.

3. Do the various RbD related industry work groups provide sufficient governance and transparency of the RbD arrangements?

2.9 The key RbD industry work groups include the RbD Audit Sub-Committee and the RbD Sub-Group. These groups are administered by the Joint Office and xoserve respectively**.** In our view, these groups do not provide sufficient governance of the RbD arrangements. Their inability to provide the required level of governance is, in large measure, a function of the weakness of the data provision requirements imposed on the Distribution Network Owners (DNOs) and National Grid. Under current practice, questions about data accuracy arising in the work groups are answered at a very high level and without the detail needed to provide the appropriate level of assurance. Weak data provision requirements limit the ability of these key working groups to provide the level of oversight and governance commensurate with the materiality of the matters reviewed within those groups. This problem should be remedied.

4. Is there sufficient transparency of the data or the information xoserve provides to the Industry?

2.10 Our view is that xoserve's disclosure of information could be enhanced in the following ways:

i) As indicated in the answer to Question 2 above, xoserve should publish settlement data disaggregated by market sector. Publication of settlement data on this basis would enable market participants to assess the impact of RbD and other key features of the settlement arrangements.

ii) There is a need for much greater transparency with respect to the AQ Review process. Centrica has already initiated a proposal to modify the UNC (Modification 081). The adoption of that proposal would see the publication of significantly more data regarding the changes made as a consequence of the AQ review process. Modification 081 is discussed in more detail in the answer to Question 7 below.

5. Is the scope of the current RbD Audit appropriate?

2.11 The scope of the current RbD audit is not appropriate. A greater investment in performance assurance is warranted. When compared to the level of assurance in the electricity market (c.£5m per annum spend), the breadth and depth of gas settlement assurance activity is unacceptably low.

2.12 The narrow scope of the current RbD audit is illustrated by the audit completed for the year ending December 31, 2005. That audit examined only three processes from a list of ten Transactional Processes and four Standing Data Items. The three processes examined were:

i) Adjustments > 0.25 TWh

ii) AQ Formulae (Threshold crossers)

iii) Shrinkage Factor input accuracy

2.13 For each of the three processes examined, the audit tested only for: a) the reconciliation of input values (into RbD) to output (invoice) values, and b) the correct application of agreed formulae/calculation factors. The audit did not test whether the input values were in themselves correct. The absence of this is critical because, as noted in the answer to question 6 below, many market participants do not have an incentive to correct any errors in input data and, indeed, often have an incentive to refrain from submitting such data.

2.14 In our view, the RbD audit should be enhanced in the following ways:

i) Expand the scope of the audit to include all inputs to RbD processes, particularly manual activities and NTS off-take meter data;

ii) Expand the scope of the audit to include those processes operated by Shippers (such as the AQ review);

iii) Increase the duration and scale of the auditing processes and sample sizes; and

iv) Expand the testing of reconciliation processes to include LSP reconciliation trends from Shipper read submissions, USRV resolutions and Consumption adjustments.

2.15 The enhancement of the RbD audit should also be coupled with the consideration of new escalation and governance procedures designed

to address any errors or deficiencies discovered in the input data and to remedy the financial consequences on any market participants affected.

6. Are there sufficient incentives on all parties to limit the size of RbD?

2.16 In our view there are insufficient incentives on many parties to limit the size of RbD. Indeed, we believe some categories of market participant have an incentive to refrain from taking steps that would be expected to reduce RbD.

2.17 Set out below is our assessment of incentives regarding RbD in the following categories of market participants: Shippers in the SSP market sector, Shippers in the LSP market sector, IGTs, DNOs, and National Grid Transmission (NGT).

RbD incentives among Shippers in the SSP Market Sector

2.18 There is, at a general level, an incentive across the SSP sector to reduce *aggregate* RbD. However, the strength of that incentive is dependent, at the margin, upon a specific Shipper's share of the SSP sector, particularly in comparison to that Shipper's share of the LSP market. The incentive declines as the Shipper's relative SSP sector share declines and, as a consequence, that Shipper bears a smaller proportion of aggregate RbD costs.

2.19 Even if RbD is not affected in aggregate, a Shipper can also enhance its position vis-à-vis other Shippers by artificially reducing its AQs or by adopting a methodology to the AQ review that does not meet the even-handed approach, as prescribed within the UNC. This perverse incentive highlights the need for more robust AQ review governance, including greater transparency, better assurance, stronger remedies and enhanced escalation and rectification procedures.

RbD incentives among Shippers in the LSP Market Sector

2.20 The UNC requires Shippers in the LSP sector to maintain accurate settlement data. However, it must be recognised that LSP Shippers do not bear any RbD costs and that, as a consequence, those Shippers face no commercial incentive to reduce RbD costs. In particular, Shippers in the LSP sector do not face strong incentives to detect or prevent theft. As noted in paragraph 2.4 above, this fact must be kept in mind when considering the relatively low rate for the detection of theft within the LSP sector.

2.21 The weakness of the incentives in the LSP sector is illustrated by the experience with User Suppressed Reconciliation Volumes (USRVs).

Liquidated damages were introduced to improve performance in this area. Despite this step, a large number of unreconciled items remain outstanding. This experience indicates that even a financial incentive by way of potential liability for liquidated damages is insufficient to outweigh the commercial benefit to Shippers through reduced settlement costs.

RbD incentives among IGTs

2.22 The IGT sector has no incentive to see the adoption of measures that would reduce RbD. This is true because, while the IGTs do not bear RbD costs, they would incur, via the applicable transportation charges, the costs of any system enhancements designed to reduce RbD.

There are several key deficiencies in the settlement arrangements in respect of IGTs. They are as follows:

i) With the growth of the IGT sector, the quality of the data from IGTs is increasingly critical to the integrity of the gas settlement processes. Under current arrangements, the IGTs are responsible for forwarding to xoserve the data in respect of sites on their networks; this is data that Shippers forward themselves in respect of their sites on large Distribution Networks. This role of the IGTs regarding data submission leads to breaks in the data chain. Those breaks manifest themselves as measurement errors and contribute to inaccuracies in the determination of RbD. Arrangements should be introduced which allow Shippers to provide directly to xoserve the data in respect of their sites located on IGT networks. This would streamline the provision of details and reduce the risk of measurement errors.

ii) The likelihood is great that the supply point register does not contain all supply points located with the IGT networks. That assessment is based on the experience regarding the repeated discovery of unrecorded sites on the IGT networks. These unrecorded sites contribute to measurement error and thereby increase the RbD borne by Shippers in the SSP sector. IGTs have no strong incentive to address the deficiencies in their supply point registers because they do not bear the associated costs of measurement error.

iii) The IGT AQ review process is inadequate. Shippers have an insufficient opportunity to amend the relevant AQs to properly reflect their sites on the IGT networks.

2.23 Centrica and other Shippers have initiated modifications to the UNC with the objective of increasing the consistency and robustness of IGT AQ review processes. Centrica would also support a central industry solution to ensure that all IGT data is processed in one place, such as xoserve.

Incentives re RbD among DNOs

2.24 The DNOs are responsible, under the terms of their licences, for the effective administration of gas settlement arrangements. The existing arrangements under which the DNOs discharge that responsibility give the DNOs no clear incentive to reduce RbD. Indeed, the DNOs face some strong disincentive to refrain from taking steps that might reduce RbD. In particular, the dynamics between theft and LDZ shrinkage calculations give the DNOs a disincentive to detect upstream theft. This disincentive arises because the number of upstream thefts detected by DNOs is used to determine the amount of upstream theft that they must pay for by way of shrinkage. As a consequence, the fewer detections of upstream theft, the lower the value of shrinkage for which the DNOs must pay. This approach to the determination of the theft component of LDZ shrinkage means that such shrinkage is underestimated. The measurement error resulting from that underestimation serves to increase the RbD borne by SSP Shippers.

2.25 Centrica supports initiatives that would correct underestimation of shrinkage. Whilst the DNOs have an obligation to maintain a complete supply point register, there is no proactive auditing of the distribution networks to detect unrecorded sites. The absence of such proactive auditing is a serious weakness given the fragmented and manual nature of many new connection processes.

Incentives regarding RbD on NGT

2.26 As detailed earlier, the National Transmission System (NTS) shrinkage incentives act as a strong lever for identifying measurement errors that result in an under-recording of gas leaving the NTS, but also provides a disincentive for detecting measurement errors that overstate NTS outputs. An increase in NTS outputs increases the amount of gas entering LDZ along with the total amount of gas deemed to be distributed to Shippers. This in turn, increases the difference between measured inputs and measured consumption that is apportioned to SSP sector Shippers.

2.27 Some of the incentive issues identified in the answer to this question can be addressed through the modification of the governing industry codes. Others will need to be addressed during the current GDPCR, the pending Ofgem consultation in respect of theft, and the upcoming Ofgem consultation regarding IGTs.

7. Do you consider there is sufficient transparency in the operation and accuracy of industry processes such as the AQ review and shrinkage calculations?

2.28 There is insufficient transparency in the operation of both the AQ review and the determination of shrinkage calculations. This lack of transparency is particularly problematic because, in the case of both AQ review and the determination of shrinkage, there is a strong risk of gaming (i.e. the potential that market participants will seek to improve their own position simply by shifting costs to others). These concerns are addressed in more detail below:

Deficiencies in the Transparency of the AQ Review Process

2.29 While there is sufficient assurance that xoserve is operating the AQ review process in accordance with the provisions of the UNC, there is insufficient transparency regarding the performance of other key players in the process, namely Shippers. Centrica has already formally proposed a change to the UNC, Modification 081, to address that deficiency.

2.30 That proposed modification was reviewed with the Distribution workstream in March 2006. It proposes to deliver greater transparency regarding the AQ review process by providing for the publication of more detail of the changes made to AQs as a consequence of both: a) the annual review process, and b) the amendments and appeals that arise from the review. That information would be published on a "no names" basis and would include:

i) *Initial effect of AQ recalculation* - the recalculation process applied each year will amend a number of AQs. Information to indicate the overall impact of the process, including any bias toward increasing or decreasing AQs.

ii) *Number of amendments raised* - this would also be shown by direction, i.e. those amended upward and downward in order to show both the effect and any bias. This information would be published ex-post following issue of the final, amended AQs.

iii) *Number of amendments successful* - also shown by direction, i.e. those amended upward and downward in order to show both the effect and any bias. This information would be published ex-post following issue of the final, amended AQs.

2.31 Modification 081 in itself will not affect any element of the AQ calculation or process, but would provide for enhanced scrutiny and governance of the AQ process. Greater transparency of the process will reduce the potential for Shippers to gain competitive advantage, at the expense of other Shippers, from any biased approach to the amendment process.

Deficiencies in the Shrinkage Calculations

2.32 Shrinkage is estimated not measured. Consequently, the industry needs a high degree of transparency around the methodologies used to produce these estimates. Moreover, the methodologies need to be reassessed on a regular basis to verify that they remain fit for purpose. Ensuring this outcome is a significant challenge for the industry particularly because Shippers suffer from an information disadvantage as compared to the DNOs.

2.33 In addition to the general concern above, we are concerned with specific aspects of the shrinkage calculations, namely, leakage and theft. Those concerns are discussed in further detail below.

Concerns about Leakage

2.34 With respect to leakage, our view is that there should be a thorough assessment of the adequacy of the existing methodology. The current methodology is dependent upon a leakage survey carried out some years ago. The fresh assessment should take account of the time elapsed since the last assessment, the significant changes to the physical infrastructure (not least as a consequence of the accelerated mains replacement program) and the limitations of the original survey sample when compared to the real network under different operating conditions.

2.35 Consideration should also be given to specifying within the current GDPCR for leakage surveys at appropriate intervals. Such specification would help to overcome the significant DNO disincentives to undertaking such surveys at their own expense.

Concerns about Theft

2.36 With respect to theft, our concern is that the DNOs currently use an approach that systematically underestimates theft. That approach is based on an initial and arbitrary assumption about the total volume of theft. It then derives the theft component of the shrinkage factor from the proportion of thefts reported on the DNO side of the control valve. This approach systematically underestimates theft for the following reasons:

i) As explained in the answer to Question 6, the dynamics between theft and LDZ shrinkage calculations give the DNOs a disincentive to detect upstream theft. This underestimation of theft increases the RbD borne by SSP Shippers. In our view, the gas industry needs to adopt mechanisms that will, first, encourage better detection of theft and, second, provide more robust metrics regarding overall theft levels. Those metrics are needed to support

a fairer allocation of liability for theft between DNOs and the SSP and LSP sectors.

ii) As indicated in response to Question 1 above, approximately 75,000 "Shipperless sites" are recorded on the register of supply points and an unknown number of such sites that are not recorded at all. These numbers include sites within the SSP and LSP sectors. All these sites should be reflected in the theft component of the shrinkage factor. The failure to include those sites rests on what is, in our view, an erroneous interpretation of the UNC. This approach unfairly prejudices the SSP sector. It does so because the measurement error associated with the "Shipperless sites", including those in the LSP sector, is apportioned to the SSP sector under the RbD arrangements. This error has provided an ongoing windfall to DNOs at the expense of Shippers within the SSP sector.

8. Do you consider the existing governance arrangements around these processes to be appropriate?

2.37 In our view, the governance arrangements in respect of the AQ review and shrinkage calculation processes are not strong enough. The UNC provides limited remedies and few opportunities for redress. Under the existing market rules, the main recourse is a complaint or appeal to Ofgem.

2.38 As set out more fully in the answers to Questions 6 and 7 above, the following steps should be taken to strengthen the arrangements in respect of these processes:

i) enhance the effectiveness of the RbD working groups through the improvement of the data provision requirements imposed on the DNOs and National Grid;

ii) expand the scope of the RbD audit;

iii) implement new escalation procedures to address any errors or deficiencies discovered in the RbD input data and to remedy the financial consequences of such errors on any market participants affected;

iv) enhance the transparency of Shipper performance in respect of the AQ review process and strengthen the opportunities for Shippers to challenge anomalies;

v) actions be taken as described in question 7 b) with respect to leakage;

vi) implement an audit process for supply points on both the DNO and IGT networks;

vii) enforce the provisions of the UNC governing the treatment of "Shipperless sites" within shrinkage;

viii) proactive auditing of the distribution networks to detect unrecorded sites;

ix) improve the governance in respect of the settlement data submitted in respect of IGTs; and

x) introduce complaint and resolution procedures within the UNC.

9. Do you consider there are there appropriate incentives in place on relevant parties to ensure the timeliness and accuracy of these processes?

2.39 In our view, market participants do not face appropriate incentives to ensure the timeliness and accuracy of the key settlement processes.

Please see the answer to Question 6 above.

10. Do you consider that the timing and scope of the AQ Review is appropriate?

2.40 In our view, the AQ review process should be improved in several key respects. First, the transparency in respect of the AQ review process should be enhanced. Second, the governance procedures in respect of data provision and other key processes in respect of RbD need to be strengthened. Third, Shippers should be enabled and incentivised to correct errors in AQ data on a timely basis.

Please see the answers to Questions 5 through 9 inclusive above.

11. What would the likely costs and benefits be of introducing Meter Point Reconciliation to all supply points?

2.41 The three stage approach to reform outlined in Part III allows for a move to meter point reconciliation in the longer term. Meter point reconciliation in itself would improve gas settlements in a number of key respects. In particular, it would:

i) give Suppliers a strong incentive to improve the quality of the data they submit to industry settlement processes;

ii provide for a more precise allocation of costs across participants;

iii) provide a greater understanding of the performance of the gas network and market, particularly with respect to the causes of gas loss;

iv) reduce the scope for gaming in connection with the AQ review process; and

v) provide greater assurance regarding deemed charges.

2.42 The implementation of meter point reconciliation would constitute a significant change in the industry. This change would involve major modifications to the systems of xoserve and other industry participants. Accordingly, the next GDPCR should, as a matter of prudence, provide for such system enhancements. This provision is needed in order that price control issues do not become an impediment to any decision to proceed with meter point reconciliation. However, no expenditure would be committed until the industry has completed a thorough examination of the costs and benefits of a move to meter point reconciliation and determined, on the basis of that examination, that such a fundamental change is warranted.

12. What conditions would need to be satisfied in order for individual Meter Point reconciliation to be practicable, and to what timescale?

2.43 Please see both: a) the answer to Question 11 above, and b) the further discussion on Part III below.

13. Would it be feasible for Shippers to choose whether their supply point should be individually reconciled or processed through RbD?

2.44 Providing Shippers with this flexibility regarding settlement methodology may, at first instance, appear attractive as a matter of principle. However, this flexibility needs to be weighed against other considerations, including: a) the additional cost to the industry of operating two parallel settlement systems, and b) the risk that the operation of two systems side by side would create further distortions and instability in the market. In our view, such distortions and instability could arise because the relative attractiveness of the two methodologies to a particular Shipper would depend very much on the decisions of other Shippers about which methodology to use. In light of these considerations, our view is that the industry would need to complete a very careful analysis of the costs and benefits before deciding to allow for a choice between two parallel settlement methodologies.

Part III: A Proposed Approach and Timetable for Reform

3.1 Parts I and II of this response set out the case for reform with a detailed explanation of the adverse affect on the SSP sector of deficiencies in the RbD arrangements and other features of the gas settlement system. In our view, the challenge for the industry is to: a) ensure that those deficiencies are addressed as quickly as possible through the modification of the governing provisions of the UNC, and b) consider how best to achieve a settlement system that is fit for purpose for the long term. Our view is that, in the long term, the industry should consider an ultimate move to meter point reconciliation.

3.2 Our view is that reform should proceed through three stages. These stages, together with a suggested timetable for reform, are set out below.

Stage 1 - Near Term

3.3 There are a number of deficiencies that warrant urgent attention. These can be addressed through existing industry governance procedures and include improvements to:

i) the accuracy of the inputs to the RbD mechanism, by:

a) improving the methodology for the determination of shrinkage;

b) including “Shipperless sites” within the shrinkage calculations;

c) improving the incentives for the prevention and detection of theft; and

d) enabling Shippers to correct errors in AQ data in a timely manner (and certainly more frequently than on an annual basis);

ii) transparency in respect of the AQ review process;

iii) the governance and transparency in respect of settlements with IGTs; and

iv) the allocation of costs between the LSP and SSP sectors.

3.4 In addition to these Stage 1 reform measures, we also propose a set of reforms to implement a revised approach to gas loss incentives. Those

reforms are incorporated within Stage 2 (Medium Term), as set out below.

Stage 2 - Medium Term

3.5 Our expectation is that the reform measures detailed within Stage 1 will make a material improvement to gas settlement arrangements in the near term. We believe that the achievement of these reforms is critical to ensure that the adverse impact on the SSP sector is mitigated as quickly as possible.

3.6 In the medium term, and building on the improvements secured in the near term, Ofgem should initiate a review of the accounting for gas losses as part of the GDPCR. In particular, Ofgem should focus on ensuring: a) that sufficient incentives are placed upon DNOs to detect upstream theft, and b) that the Supply Point Register is complete.

Stage 3 - Longer Term

3.7 Stage 3 (Long Term) provides for an ultimate move to meter point reconciliation. Meter point reconciliation would bring real improvements to the fairness and accuracy of gas settlements. It would give Suppliers a strong incentive to improve the quality of the data they submit to industry settlement processes. Such Improvements are critical to the implementation of a settlement system that is fit for purpose over the long term.

3.8 A move to meter point reconciliation would represent a major change for the industry and, accordingly, stakeholders will need to examine the costs and benefits of that move before making a final decision to proceed. The need for such careful examination means that meter point reconciliation must be approached as a long term action. However, preliminary analysis regarding meter point reconciliation can proceed, through Stages 1 and 2, in parallel with the implementation of the important reforms that are needed now.

3.9. The analysis proposed in respect of meter point reconciliation should include an assessment of the improvements to settlement accuracy achieved through the implementation of the Stage 1 reforms. It should also have due regard to the investment that the industry is making in AMR.

3.10 The implementation of meter point reconciliation would also involve major modifications to the systems of xoserve and other industry participants. Accordingly, the next GDPCR should, as a matter of prudence, provide for such system enhancements. This provision is needed in order that price control issues do not become an impediment to any decision to proceed with meter point reconciliation. However, no expenditure would be made until the industry has completed its examination of the costs and benefits of a move to meter point

reconciliation and determined, on the basis of that examination, that such a move is warranted.

3.11 A recommended timetable for reform is outlined below.

Time table for Reform

Stage	Type of Reform/Analysis	Implemented no later than
1	Improve Shrinkage & AQ Review transparency	Qtr 4, 06
	Implement remaining near term reform measures	Qtr 2, 07
	Preliminary analysis of Meter Point Reconciliation	TBD
2	Implement further reform to managing gas losses as part of GDPCR	Qtr 2, 08
	Provision in GDPCR for potential Meter Point Reconciliation costs	Qtr 2, 08
	Further analysis/decision re move to Meter Point Reconciliation	TBD
3	Potential Move to Meter Point Reconciliation	TBD