

27 January 2011

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Dear Andrew,

Response to consultation 154/10: Reducing supplier disincentives to detect and investigate gas theft – uniform network code proposal UNC231V and other changes

Thank you for providing us with an opportunity to provide input in to the decision process for UNC231V. We do not have views on all of the questions posed, but where we do these are provided below. Prior to doing so, we will set out our high level view of this proposal to give these views some context.

Overview

Theft of gas is an enduring problem that the industry has struggled to tackle.

Zero unresolved theft is an unrealistic target in terms of practicality, and an undesirable target in terms of consumer impact – both because of the uneconomic incremental cost of resolving the hardest and/or the lowest materiality cases (i.e. that it may cost honest consumers more to see those cases solved than to see them unsolved) and because of the social cost if suppliers are encouraged to become hyper-aggressive in their debt collection policies (because this is likely to result in “can’t pay” customers being pursued alongside “won’t pay” ones).

But it is reasonable to expect, and to try to deliver, a much lower level of theft than currently exists. The materiality of gas theft is unclear, and hotly disputed, but your consultation suggests that cost of energy stolen may be somewhere in the bracket of £40-£200m per year.

These costs are ultimately picked up by the vast majority of customers who are honest. Assuming the industry seeks to pass these costs through to other customers, the cost of theft may therefore be adding approximately £3-£15 to the average annual gas bill – purely to cover the stolen energy.

Consumers will pick up the tab for additional indirect costs on top of this – apportionment of bad debt, cost of revenue protection services, court costs etc. We also note the broader debate about unaccounted for gas suggests that the industry, both suppliers and networks, have surprisingly little understanding of where large volumes of gas are being lost. Failure to understand and

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optimise how assets are used suggests wider inefficiency; which will ultimately be passed through to consumers' bills.

UNC231V proposes to tackle gas theft by allowing suppliers to claim larger amounts from gas networks (and by extension, from consumers) to cover the costs incurred in cases where they unsuccessfully pursue gas theft. It suggests that claimable costs are currently too low to provide suppliers with adequate incentives to rigorously pursue theft, as there would be too high a risk that they would end up out-of-pocket if they did so.

As previously noted, we agree that gas theft is a problem that needs more attention. We also agree that the proposal does provide suppliers with stronger incentives to do something about it.

We are however somewhat worried that UNC231V may swing the pendulum too far to the other end of the scale – replacing one type of inefficiency with another (reducing gas theft, but by allowing gas suppliers to claim for costs that are disproportionate to the scale of the theft pursued, and reducing the incentives on them to manage their revenue protection costs). This is not an inevitable outcome – but it is a significant risk, and one we think you should be mindful of.

231V is a genuinely marginal modification with significant merits and risks. The balance between these is hard to call, and we remain agnostic on it at this time. For the avoidance of doubt, this response should not, and may not, be interpreted as supporting or opposing the overall proposal in any summary of responses that you prepare.

For our views on the specific consultation questions, please see the appendix in the following pages.

This submission is entirely non-confidential and we are happy for you to publish it on your website or otherwise circulate it as you see fit.

Away from the policy content, I would like to pass on my compliments on the consultation document – it sets out the issues and impacts in a very clear and coherent way.

If you would like to discuss our views in more depth please call me on 020 7799 8042.

Yours sincerely,

[Unsigned as sent by email]

Richard Hall
Principal Policy Advocate, Energy

Appendix – response to consultation questions

Chapter Four

Question 1: Do you agree that the £1,000 cap per allowance (apart from Allowance (vii)) is reasonable? Please provide supporting arguments.

On the basis of the evidence provided, no, we do not agree that a £1,000 cap per allowance is reasonable.

This is not because we believe it is inappropriate to raise the cap, but because we do not believe there is adequate evidence to justify the cap proposed. Put simply, we are more convinced that the current figure is wrong than we are that the proposed figure is right – that the case for a change is made, but the case for *this* change has not yet been.

The current cap, £125, appears arbitrary and it may not bear much relation to suppliers' actual costs. But exactly the same can be said of the proposed figure of £1,000.

As you highlight in the consultation document, UNC231V increases the total cap on claimable costs from £620 to £4,000 (a 645% increase) and changes the values from fixed to actual amounts in each claimable category. We agree with the proposition that this would increase incentives on suppliers to detect and tackle theft by reducing their risk of irrecoverable revenue protection costs. That is a material, positive aspect of the proposal. But we think there is a material risk that it might simply replace the weaknesses in the current arrangements (on supplier incentives) with new, different weaknesses (on supplier efficiency).

The principal areas of risk are that it may lead to consumers paying for revenue protection activities that are inefficient in one or both of the following ways:

- **Disproportionate theft pursuit**, for example spending several thousand pounds to pursue a several hundred pound debt. Suppliers may become 'neutral' to such costs – but consumers would not be, and may face socialised costs that are worse than if the supplier had not pursued the theft (at all, or as far).
- **Poor cost management**. Allowing actual costs to be claimed feels inherently fairer, but it does reduce incentives on suppliers to keep these costs down (because they have no real reason to do so provided they remain below the category cap).

These risks may be mitigated and, if you remain minded to approve, you should look at ways to achieve this aim. We suggest some possible approaches below; there may well be alternative approaches.

To prevent disproportionate theft pursuit, there may be value in including an explicit constraint prohibiting suppliers from claiming costs in excess of the deemed societal benefit of preventing that theft. At its simplest level this could cap the claim at the direct cost of the theft (i.e. if £1,000 of gas is stolen, a claim would be capped at £1,000). A more complicated model could apply a multiplier or other form of uplift to cater for any perceived additional indirect benefits of tackling theft (for example, deterrent effect).

To prevent poor cost management, we would like to see some independent assurance of suppliers costs to make sure that costs claimed for are not only legitimately claimable (valid) but also efficiently incurred (proportionate). This could take the form of procuring an independent expert to establish a benchmark 'reasonable cost' for a supplier taking a course of action (or using an audit process to derive such a cost). Supplier claims could be allowed based on actual costs, but up to a cap set by this 'reasonable cost' estimate rather than the arbitrary figure of £1,000. This would mean that suppliers were still exposed to some risk where they have acted inefficiently in pursuing a theft case, reducing the risk that customers pay over the odds for a 'gold-plated' revenue protection service.

We appreciate that enhancements such as those outlined above, or alternative protective measures, may require further modifications to the UNC beyond those contained within UNC231V itself if they are to be binding. But in its current form, the modification does bring material risk of unintended consequences. At best these may simply dilute its benefits. At worst, these may flip the overall impact on consumers from positive to negative.

As the regulator you are in a strong position to set out future expectations for industry work, and under legal obligations to protect the interests of current and future consumers. We would therefore expect to see you setting out robust ideas on how you will protect consumers from inefficiency risks contained in UNC231V if you remain minded to approve it subsequent to consultation.

We provide no views on Question 2, which is an information request for suppliers.

Question 3: Views are invited on whether the audit and compliance arrangements for the payment of allowances to suppliers are appropriate. In particular, are they sufficient to meet the implied

requirement under SLC7 of the gas transporters licence to only make payments when the relevant criteria are met?

As previously highlighted against question 1, we would like to see some independent assurance of suppliers costs to make sure that costs claimed for are not only legitimately claimable (valid) but also efficiently incurred (proportionate). This is particularly necessary if you are moving from a fixed payment to an actual cost scheme, because the latter approach reduces incentives on suppliers to act efficiently.

A full independent audit of all claims would probably be disproportionate but some kind of audit regime appears necessary. It may be appropriate to have an annual random spot check audit of a fixed percentage of claims to check that they are in order; the percentage could be increased or decreased in line with experience (i.e. clean bills of health reducing the percentage; dubious claims increasing it). Aside from monitoring pure compliance (i.e. validity) the auditor should be tasked to report on supplier claims in a manner that allows them to be broken down by category of cost and by supplier. This should highlight if there are any anomalies (for example, one supplier claiming for much higher costs in one category than its competitors, or lodging large numbers of claims very close to the category caps) and therefore act as a diagnostic tool to understand the cost and effectiveness of the tools being used by the industry. As far as commercial confidentiality allows, we would like audit results to be publicly reported to increase scrutiny and accountability.

It may be possible to use this kind of exercise to create benchmark costs for how much different activities may cost that are more realistic than either the existing £125, or the proposed £1,000 caps – both of which appear highly arbitrary. This could form the basis of a subsequent revision to more realistic category caps (for example, based on median claims). Realistic category caps may reduce the inefficiency risk of moving from fixed to actual cost claims too – because it would expose suppliers to some costs if they exceed those caps.

Whatever your final view on the within-code audit regime, if you remain minded to approve, we would like Ofgem to commit to a post-implementation review of the effectiveness of the new regime after it has had a reasonable period to bed in, perhaps 12-18 months.

Question 4: Do you agree that an equivalent modification should be raised to the IGT UNC?

It would make sense to have consistent arrangements across the main and IGT UNC codes unless there are specific issues that would make this unmanageable, or would mean that the

case for change was materially weaker on the IGT UNC. We are not aware of any reason to believe that this would be the case.

Question 5: Views are requested on the compatibility of UNC231V with the proposed National Revenue Protection Service (NRPS), SETS or any other industry developments?

We agree with the implicit view contained in 4.36 of the consultation document that UNC231V and the NRPS may not be an ideal combination because suppliers would not be able to respond to the incentives of the former because of the latter (as the decision to detect or investigate theft would be outside their individual control). It is important that incentive regimes are only applied where the parties subject to them can actually respond to the signals they send – if they cannot, the ‘incentive’ may simply be a windfall gain or loss.

We think the case for UNC231V can be argued either way were it to be an enduring solution, but is more likely to be negative if it were simply an interim solution pending the introduction of an NRPS. Incurring costs implementing a scheme that may rapidly become redundant is generally undesirable on implementation efficiency grounds (and also on grounds of good governance, regulatory and compliance complexity and certainty etc).

We consider that UNC231V and a SETS scheme are compatible, although both schemes share highly similar strengths and weaknesses. In principle, both may materially improve incentives on suppliers to tackle gas theft, but both may arguably mark a shift from under-incentivising to over-incentivising. There is a risk that in combination these proposals may displace consumer detriment rather than reducing it – i.e. reducing the socialised cost of gas theft while increasing the socialised cost of revenue protection and encouraging disproportionate debt pursuit. Both schemes appear on the generous side to suppliers.

We think it may help you with your decision, and us and other stakeholders with our understanding, if your subsequent impact assessment on the wider suite of theft initiatives contains some modelling on the estimated costs/benefits of the different interventions in different scenarios (numbers, materiality, success rate and costs of claims etc) – in the absence of this it is difficult to gauge what you think success may look like, and how plausible it is that these initiatives may deliver it. From our perspective, as a minimum we would expect the total cost to consumers to reduce for us to be able to regard any scheme as successful – if the socialised costs faced by honest customers were to increase it will have failed, even if it delivered larger numbers of theft detections/preventions/prosecutions.

Chapters Five and Six

We have no comments on the questions posed in these chapters.