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26th October 2011

Dear Margaret

Ofgem Consultation on Tackling Gas Theft and accompanying Theft Impact Assessment document

We estimate that between £220m and £400m of gas is stolen in the United Kingdom each year. This represents a significant risk to the health and safety of both those who steal and those who live around them. It also increases the cost of energy for the law-abiding majority of customers, and thus creates inequalities and distortions in the market. This consultation is therefore a welcome and unique opportunity to address a serious issue.

We have led the debate about theft reform since 2005 and have consistently backed up our words with firm actions. We have been the only Supplier to have developed fit for purpose theft detection capabilities, and even today our theft detections represent 78% of the total for the entire gas market. This is a product of our deep understanding of what it takes to detect theft. Consequentially we are also in a position to make the most valid contribution to this consultation process.

We fully support reform and have proposed both an incentive regime and a wider framework for it to operate in. Indeed, it was our proposal within UNC Review Group 0245 which identified that there was potential for a centralised body to offer some facilitation and co-ordination services to the market. Our proposals reflect this, balancing the need to reinforce the existing revenue protection market where a competitive solution is possible, and introduce a less interventionist version of the National Revenue Protection Service (NRPS) to support this market with facilitation and co-ordinate industry efforts where necessary.

Whatever the reform option chosen by Ofgem, an incentive regime must form part of the overall package. As we show in Appendix One of this response¹, Suppliers currently face a significant cost when they choose to move from doing nothing to doing something. This is both in terms of the initial capital and operational expenditure required to develop theft detection capabilities and the additional cost a detected theft represents. Without directly addressing these financial disincentives to act it will always continue to make commercial sense for Suppliers to turn a blind eye to theft.

Using incentive regimes to tackle energy theft is consistent with Ofgem's thinking elsewhere in the industry. In 2005 Ofgem moved away from simply relying on centralised revenue protection monopolies in the electricity industry to detect theft and introduced an incentive regime to drive theft detection performance². This immediately led to a large increase in investment on theft detection capability.

Ofgem have also introduced similar incentives on gas Network Owners to manage theft from the network, and have used, and then reinforced incentive mechanisms, to address poor Supplier behaviour in the User Suppressed Reconciliation Values (USRV) process³. This latter example is particularly relevant given these incentives were successfully implemented by Ofgem in order to address specific financial disincentives Suppliers faced when taking action which was in the interests of the wider industry.

We recognise there are many ways that an incentive scheme may be constructed. Our only aim in this process is to find a robust and effective incentive mechanism which drives Supplier performance and avoids any unintended consequences. To that end, we have no specific demands over what the right incentive scheme value should be, however we have provided some analysis within this response⁴ on alternative ways in which the Scheme value may be calculated. These build on the economic model Ofgem have compiled and so provide a robust alternative to the existing proposals set out in UNC Modification Proposals 0277 and 0346.

¹ See paragraphs 18 to 25 of Appendix One.

² The "Losses Incentive".

³ MOD637. Documentation, including Ofgem's decision letter can be found at the following link:

<http://www.gasgovernance.co.uk/sites/default/files/0637.zip>

⁴ See paragraphs 26 to 48 of Appendix One.

Given the variety of ways which an incentive scheme may be calculated, we also believe there is scope for Ofgem to provide guidance on the most appropriate way forward as part of their final decision letter. We use this response to propose a role for an independent annual assessment of the incentive scheme value⁵ with the aim of ensuring the value of the scheme changes in response to variations in the underlying costs and benefits. Ofgem could for example use their final decision letter to implement either SETS or Enhanced SETS, with an accompanying direction for independent review of the incentive scheme value to take place either immediately or annually from the end of the first Scheme year.

We remain convinced that the NRPS proposal's explicit rejection of financial incentives on Suppliers fundamentally undermines its ability to deliver the claimed benefits. It represents a proposal for a centralised body whose success is reliant on the support and co-operation of the very parties who are incentivised to frustrate it. This is not effective reform.

We have also identified a number of inconsistencies and inaccuracies in the NRPS business case. For example, the calculations about the overall cost of the NRPS proposal itself are incorrect, under-estimating the total ongoing running costs by as much as £2.387m⁶ per annum.

This has implications for the conclusions Ofgem draw regarding the "break-even" point for each proposal. Our conclusion is that the NRPS proposal will not deliver the step change reduction in theft we desire and represents worse customer value for money than the available alternatives⁷.

We continue to have serious doubts about both the ability and willingness of our competitors to deliver an NRPS solution within twelve months of an Ofgem decision. The NRPS proposal represents a significant industry change programme which will require the full support, resource and direction of the same Suppliers who have a financial interest in delaying and preventing it. It is relevant to note that it has taken the proposer some 25 months to develop the initial concept in to the high level proposal in front of Ofgem today.

Finally, and whilst we support the principle of new licence conditions which mandate Supplier action, we are concerned at some of the specific clauses Ofgem propose to introduce. In particular we believe that some of these may not strike an appropriate balance between the need to detect and prevent theft and the need to protect the interests of vulnerable customers⁸.

⁵ See paragraph 46 of Appendix One.

⁶ See paragraphs 77 of Appendix One.

⁷ See paragraphs 49 to 52 and 73 to 83 of Appendix One.

⁸ See paragraphs 95 to 104 of Appendix One.

British Gas is committed to delivering reform, as evidenced by both our words and actions over the last five years. We have presented a range of reform options to Ofgem, some of which can make an immediate impact on the scale of theft if implemented. We now need Ofgem to ensure further delays by the industry are not possible by introducing a framework which includes financial incentives.

If you have any questions or concerns regarding this response, please telephone me on 07789 570501.

Yours sincerely

David Watson
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