SCOTTISHPOWER

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Dear Harpal,

TACKLING GAS THEFT: THE WAY FORWARD

This is a second response to your consultation of 26 March 2012 on “Tackling gas theft: the way forward”, covering Ofgem’s proposed Direction to implement a Theft Risk Assessment Service (TRAS) and incentive scheme to address theft of gas. We responded on 30 April 2012 to the statutory consultation on proposed licence conditions to address theft of gas. We are happy for both responses to be published on Ofgem’s website.

In our response to Ofgem’s consultation of 31 August 2011 (“Tackling gas theft”) we recommended a slimmed down version of the National Revenue Protection Service (NRPS) that retained the principles of data sharing across the industry but allowed parties to investigate theft in whatever was the most efficient and effective means for them, taking into account their customer base. We are pleased that Ofgem has gone some way to meeting this with its Direction to implement TRAS, but we still have a number of concerns that we expand on below and in Annex 1 attached.

Financial incentive scheme

We do not support introducing financial incentives linked to the detection of theft of gas, at least until there is a much better understanding of level and distribution of gas theft. We are concerned that such a scheme may:

- lead to inefficient and disproportionate levels of spend on costly investigatory activity if the true value of theft has been substantially over-estimated;
- create competitive distortions by penalising/rewarding different licensees if the prevalence of theft within their customer base (and hence their opportunity to secure financial incentives) is not reflected in the structure of the incentive scheme; and
- be incompatible with sharing of best practice, and create a perverse incentive on suppliers to withhold information (such as new techniques for detecting theft or intelligence) if it would affect their competitive position and the amount of money they receive at the end of the period.

We believe that Ofgem's current proposals address the issues identified in the wrong order, with the risk that an inefficient and poorly targeted incentive scheme is launched before the necessary data are available to underpin it. The extra costs would inevitably find their way to consumer bills.

As an alternative, we would suggest the following sequence of activities:

- The first priority should be to put in place measures for sharing best practice with a view to establishing a consistent approach to identifying gas theft in the field.

- The AUGE should also be encouraged to complete the additional analysis that we have requested, to provide a more robust estimate of the "Theft and Other" figure contained in their statement, and the proportion of this attributable to theft.

- Subject to the outcome of the AUGE analysis, a pilot incentive scheme should be launched focusing on the LSP market, which we believe would deliver a much higher return on investment than SSP.

- If the pilot proves successful in the LSP market, a similar approach could be adopted in the SSP market.

- Only following the AUGE analysis and the results of the pilots should Ofgem consider implementing an incentive scheme, which could then be more accurately targeted.

Unless this sequential approach is followed, suppliers will be required to invest in revenue protection activity regardless of the prevalence of theft in their portfolio. This could result in an unfair imposition of costs on suppliers who are obliged to investigate instances of theft where there are none to be found. If an excessive level of revenue protection is called for across the industry, this could increase costs for consumers. Requirements in this area may also act as a barrier to new market entrants and ultimately operate to the detriment of competition.

Our responses to the consultation questions are in Annex 1 attached.

I hope you find these comments useful and would be happy to discuss them further with you and your colleagues.

Yours sincerely,

Rupert Steele

Rupert Steele
Director of Regulation

Annex 1

CONSULTATION ON TACKLING GAS THEFT: THE WAY FORWARD
SCOTTISHPOWER RESPONSE

Comments on financial incentive scheme

We do not support introducing financial incentives linked to the detection of theft of gas, at least until there is a much better understanding of level and distribution of gas theft. We are concerned that competition for an incentive pot that is 'paid out to suppliers at the end of each period in proportion to the number of thefts identified in each market segment'[1] may:

- lead to inefficient and disproportionate levels of spend on costly investigatory activity if the true value of theft has been substantially over-estimated (see below).

- create competitive distortions by penalising/rewarding different licensees if the prevalence of theft within their customer base (and hence their opportunity to secure financial incentives) is not reflected in the structure of the incentive scheme; there is evidence to suggest that theft risk can vary widely between different geographic regions and types of customer[2];

- be incompatible with sharing of best practice, and create a perverse disincentive on suppliers to withhold information (such as new techniques for detecting theft or intelligence) if it would affect their competitive position and the amount of money they receive at the end of the period; this has wider public safety implications as theft of gas can endanger not only the offender but also innocent parties, who may be in or around the property where the offence is being committed.

We do not believe it would be appropriate to introduce incentives until the true level of theft is reliably known and affected parties have had a chance to share understanding and best practice on identification and investigation.

Estimating the level of theft of gas

Neither the industry nor Ofgem has yet been able to provide a robust estimate for the level of theft of gas that is taking place. Ofgem's consultations have cited four estimates for annual retail value of gas theft:

- £60m based on the gas price control shrinkage incentive mechanism;[3]
- £220m estimated by British Gas based on its view of the market;[4]
- £220m to £400m estimated by an unnamed supplier[5]
- £138m based on the Allocation of Unidentified Gas Expert (AUGE) estimate for the annual value of "Theft and Other" for 2011/12 of 4.6TWh.[6]

[1] Condoc paragraph 4.4
[2] ERA/ENA noted that 'whilst the geographic splits per DNO/LDZ are helpful, even within these areas there are major demographic differences. Suppliers who are concentrated in rural areas may be disadvantaged' ('Report of the Theft of Energy Working Groups, April 2006, page 68). This view is supported by data provided by Xoserve to the UNC modification 0277 workgroup.
[3] 'Tackling gas theft', Ofgem, 31 August 2011, paragraph 1.5 and footnote 1
[4] Ibid
[5] 'Tackling gas theft: Final impact assessment', Ofgem, 26 March 2012, page 10
[6] Condoc page 2 footnote 1, and "Allocation of Unidentified Gas Statement", GL Noble Denton, 23 December 2011, table 16.

The AUGE estimate is probably the most reliable of the four, but even this is of limited value without a better understanding of the contribution of ‘Other’. Xoserve data indicates that Annual Quantity (AQ) review performance for the past five years has been approximately 83% for Small Supply Points (SSP) and 67% for Large Supply Points (LSP)[7]. Furthermore, monthly meter reading performance is significantly below target[8]. This means that the AQ for a substantial portion of the market has not been updated in recent years – particularly in the case of LSP - and may be contributing to the value of unidentified gas[9]. Hence, the possibility cannot be ruled out that a substantial proportion of the ‘Theft and Other’ category may not in fact relate to theft.

We believe more work should be done by the AUGE to quantify the impact of this and other contributions to the “Other” figure in order to give a more robust estimate for theft of gas. We have raised our concerns with the AUGE[10] and requested more investigation and analysis to determine the potential impacts to unidentified gas volumes of ‘non-calculating’ AQs and failures to confirm to UNC obligations in relation to meter reading performance.

<u>Need to focus on LSP market</u>

If an incentive scheme is to be introduced, we think it would be prudent to pilot it first, and to focus the pilot on the LSP market rather than SSP. We believe that LSP should be the initial priority for the following reasons:

- our analysis leads us to think that the prevalence of theft in the LSP market may be greater than Ofgem supposes and similar in overall magnitude to SSP – albeit concentrated in a much smaller number of higher value cases;

- notwithstanding Ofgem’s modelling assumption that suppliers already have an incentive to investigate LSP theft[11], we think the reality is that a substantial proportion of LSP theft still goes undetected, and that increasing the incentive to detect theft should deliver higher detection rates;

- in the SSP market the expected benefits of detecting theft are similar to the expected costs – with a consequent risk that if the costs and benefits have been under/over-estimated, the societal impact of an incentive scheme could in fact be negative; this risk is far lower in the LSP market where the benefits comfortably exceed the costs.

The importance of LSP theft can be seen (at least circumstantially) from Xoserve data on theft performance.[12] The table below shows the reported gas theft statistics for two Shippers in 2010 and 2011. The number of theft cases detected is shown as a proportion of the total number of cases detected, and the volume of stolen gas as a proportion of the total volume stolen. The average volume per case clearly places these thefts in the LSP rather than SSP market.

[7] Xoserve AQ Operational Forum held in Nov each year following completed of AQ Review process.
[8] January 2012 performance 74% compared to a target of 90%. Information provided to UNC Distribution Workstream by Xoserve, 26 April 2012
[9] We also believe a large proportion of the unattributed error is caused by issues with the accuracy of data used in calculating each LDZ group take
[10] UNCC (AUGE) meeting held by 22nd May 2012
[11] Impact Assessment Table 14
[12] TOG Analysis, Xoserve, 2010 – 2012

Year	Cases detected by shippers (as % of total cases detected)	Volume of gas reported stolen (as % of total reported stolen)	Average volume stolen per case (kWh)
2010	7%	30%	129,918
2011	5%	48%	516,630
2012 (Jan – Apr)	8%	62%	365,856

Ofgem's impact assessment assumes that the number of cases of theft detected in the SSP and LSP markets is split 90%:10%, with average consumptions in these markets of 16,500kWh and 100,000 kWh respectively[13] - implying a volume split of 60:40. The average volumes in the table above clearly relate to the LSP market, and suggest that average theft volumes in the LSP market may be substantially greater than 100,000 kWh (at least based on this limited sample). If the average theft volume for LSP were 150,000 kWh, the volume split would be 50:50.

The possibility that more theft may be occurring at LSP sites than first assumed is further supported by recent Xoserve data which showed a monthly read performance for LSP of 74% against a target 90%.[14] It is crucial to understand the reasons for such poor access rates and whether there is a link to meter interference or theft being more prevalent at such sites.

In the absence of more detailed analysis from AUGE, we cannot reach a definitive conclusion on this matter. However, based on the limited analytical evidence currently available, we think that a pilot scheme which focuses on the LSP market is likely to deliver a far higher return on investment than one which focuses on the SSP market.

<u>Alternative approach</u>

We believe Ofgem's current proposals address the issues identified in the wrong order, with the risk that an inefficient and poorly targeted incentive scheme is launched before the necessary data is available to underpin it. As an alternative, we would suggest the following sequence of activities:

- The first priority should be to put in place measures for sharing best practice with a view to establishing a consistent approach to identifying gas theft in the field.

- The AUGE should also be encouraged to complete the additional analysis that we have requested, to provide a more robust estimate of the "Theft and Other" figure contained in their statement, and the proportion of this attributable to theft.

- Subject to the outcome of the AUGE analysis, a pilot incentive scheme should be launched focusing on the LSP market using the analytical insight gained from the AUGE, which we believe would deliver a far higher return on investment than SSP, for the reasons outlined above.

- If the pilot proves successful in the LSP market, a similar approach could be adopted in the SSP market.

- Only following the AUGE analysis and the results of the pilots should Ofgem consider implementing an incentive scheme, which could then be more accurately targeted.

[13] Impact Assessment, Table 4, page 58
[14] Data provided to the UNC Distribution workstream by Xoserve, 26 April 2012

Unless this sequential approach is followed, suppliers will be required to invest in revenue protection activity regardless of the prevalence of theft in their portfolio. This could result in an unfair imposition of costs on suppliers who are obliged to investigate instances of theft where there are none to be found. If an excessive level of revenue protection is called for across the industry, this could increase costs for consumers. Requirements in this area may also act as a barrier to new market entrants and ultimately operate to the detriment of competition.

Response to consultation questions

Question 2: Do you agree with our proposals to direct the implementation of the Theft Risk Assessment Service?

Not at this stage. In our response to Ofgem's consultation of 31 August 2011 we stated that any solution must be commensurate to the scale of the issue. We therefore welcome the "slimmed down" version of the NRPS that TRAS would appear to represent. However we do not believe that the TRAS concept has been considered sufficiently and are concerned that this proposal originated from Ofgem outside of industry governance and therefore has not been subject to the same rigour, scrutiny or transparency as the other theft scheme options.

We still believe that any solution must be commensurate to the scale of the issue. In the absence of a robust estimate of the current level of theft, we are unsure of the true value of directing implementation of the TRAS.

Question 3: Do you agree with our proposed requirements for the Theft Risk Assessment Service and the related drafting of the proposed Direction on:

a) The services provided by the Theft Risk Assessment Service?

The Direction states that the TRAS will "profile the risk of Unrecorded Gas and in particular Theft of Gas". This appears to be an extension to the scope of the TRAS and may duplicate efforts being made by the AUGE.

b) The Theft Target?

We do not believe that it is appropriate to establish the Theft Target up to one year after the introduction of the TRAS, in particular given the current range of the values of theft and the AUGE's limited progress in identifying theft levels. Following Ofgem's indicative timescales, the incentive scheme would have been in place for up to two years by this point. We believe that these milestones are in the wrong order. The true level of theft (and from this, the Theft Target) should be established before any other part of the proposal as this will form the baseline for the industry to work from

c) The governance of the Theft Risk Assessment Service?

Ofgem has indicated the governance of the TRAS could sit under SPAA. While at first sight this might seem in line with the development of the code of practice for theft investigations, we note that I&C Suppliers remain outwith this agreement. We are therefore seriously concerned over the ability to ensure that LSP Shippers are compliant with any TRAS. The concern is particularly pronounced given the details that we have outlined in our response, where we have shared our concerns over the level and volume of gas theft in the LSP market sector.

d) The appointment and operation arrangements of the Theft Risk Assessment Service?

We have no comments about the appointment and operation of the TRAS at this stage, as we would expect the detail of this to be developed by whichever group takes responsibility for this work. We would note however that any party appointed as the TRAS should be independent of any licensed Gas Supplier or Transporter.

e) The reporting requirements for the Theft Risk Assessment Service?

Paragraphs 36 to 39 set out the reporting requirements to be met by the TRAS. Paragraph 40 states that these reports must be produced by someone independent of the TRAS, Gas Suppliers, and Gas Transporters. There is no direction as to how the TRAS may delegate the obligations set out in clauses 36 and 39 so we are unsure how the requirements of paragraph 40 can be met. We are also concerned about the potential for dual governance between the reporting requirements introduced through the TRAS and SPAA Code of Practice, and the obligations introduced by Ofgem's approval of UNC modification 0399. We would ask that Ofgem investigate this issue to ensure that no such conflict exists.

Question 4: Do you agree that we should require the Theft Risk Assessment Service to be implemented by 31 December 2013?

It is more important to implement the best solution in an orderly manner than to ensure that a poorly developed one is implemented by a particular date.

The proposal set out in Ofgem's consultation would require significant development by the industry to be in a position to be agreed, receive Authority consent, and then go through a full tender and procurement process.

We note that the UNC modification 0277 (Creation of Incentives for the Detection of Theft of Gas (Supplier Energy Theft Scheme)) was first raised on 15 February 2010 and a Ofgem did not make a decision until 26 March 2012. Given the time taken to develop the modification proposals through the industry governance processes that were rejected by Ofgem, the date of 31 December 2013 will be extremely difficult, if not impossible, to meet.

We believe this time would be better used by the industry in addressing the issues highlighted earlier in this letter – sharing best practice and understanding the scale and prevalence of theft. Such work would deliver greater benefits by looking at all issues currently impacting gas settlement and the charges being incurred by the industry.

ScottishPower
June 2012