Making a positive difference
for energy consumers

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Dear Colleague,

Unidentified Gas allocation

I am writing to make you aware of, and inform you of the steps that are being taken to resolve, a number of issues relating to the allocation of unidentified gas costs. We have been working closely with Xoserve on this and would like to ensure that the gas shipping community and wider stakeholder are engaged with what we are doing and have opportunity to put forward any further suggestions.

Background

On 1 June this year, Xoserve successfully implemented the replacement of its ageing UK Link IT systems. The final stages of its implementation was overseen by Ofgem, although the new arrangements were developed by industry. Alongside and facilitated by the system changes, certain industry processes were reformed, particularly those relating to gas settlement.

Whilst reforms to these arrangement had been signalled to and welcomed by gas shippers and other parties several years ago, having previously be constrained by the capacity of legacy IT systems, they took on a new urgency when identified as having an adverse effect on competition by the Competition and Markets Authority.[1]

One aspect of the reforms was to replace the process known as Reconciliation by Difference (RbD). Under this process, the Non-Daily Metered (NDM) sector of the market, which typically includes domestic and other smaller consumers, was allocated any gas that had been used within the Local Distribution Zone (LDZ) that could not be attributed to Daily Metered (DM) consumption, shrinkage or use of gas by the Gas Transporter (GT). Whilst the amount of gas allocated to the NDM sector would be adjusted over time as meter readings came in and/or estimates were refined, individual supply point reconciliation only took place for the Larger Supply Points (LSPs) within the NDM sector.[2] Therefore, Smaller Supply Points (SSPs) continued to pick up the cost of any gas that could not be reconciled to metered consumption, for instance due to theft or metering errors.

[1] All documentation relating to the CMA's Energy Market Investigation can be found here: https://www.gov.uk/cma-cases/energy-market-investigation
[2] A Larger Supply Point is one with an Annual Quantity of 73,200 KwH – around six times that of a typical domestic consumer.

Whilst in recent years, a further process facilitated by an independent expert known as the Allocation of Unidentified Gas Expert (AUGE) has sought to reallocate some unidentified gas and associated cost to the NDM LSP shippers, this was based on the residual amount of gas once the Code Cut-Off date for any further reconciliation has been reached, 3-4 years after the day of consumption. This meant that these costs continued to fall predominantly upon SSP shippers, passed through as a smeared charge based on the AQ of their portfolio. DM supply points were entirely exempt from these costs. This inefficient allocation of costs was at the heart of the CMA's conclusions that the old gas settlement arrangements were an Adverse Effect on Competition.

RbD was initially introduced as a temporary measure in 1998 in order to facilitate the opening of domestic competition, as prevailing systems and procedures could not have handled the individual reconciliation and settlement of a further 20 million supply points. The replacement of legacy UK Link systems as part of Project Nexus finally removed this constraint and allowed for the individual reconciliation of all supply points. Whilst daily gas allocation is still subject to estimation based on an NDM demand algorithm, the removal of RbD meant that it could no longer be used as a balancing mechanism. Instead, the calculation of UIG is now done each day, being the balance (whether positive or negative) once values are subtracted for DM and NDM demand, shrinkage and GTs own use gas.

Post-June 2017 arrangements

The new arrangements were developed through industry working groups and codified in February 2014 in UNC modification 432. Under these arrangements, all meter points, are reconciled individually and a new factor – Unidentified Gas (UIG) – has been introduced which represents the gas which cannot be attributed to metered or estimated consumption, shrinkage or use of gas by the GT. UIG is calculated on a daily basis using an algorithm, which incorporates predictions of gas consumption and a number of other complex inputs.

A new role has been given to the AUGE: to determine an appropriate weighting of UIG allocation. They do this based on both consumption category (which is considered to have a bearing on relative levels of theft) and settlement product (which is determined largely by meter read frequency and therefore indicates the time-lag between Gas Day consumption and reconciliation). In this way, the new arrangements are intended to make important improvements to both the accuracy and fairness of how these costs are allocated, placing incentives on all shippers to tackle the underlying causes of UIG, such as theft. The current UIG factors are set out as an appendix to this letter for information.

While the changes to the gas allocation processes have long been signalled, in practice the volumes of UIG have been unexpectedly high since the new arrangements came into effect. This has been compounded by its volatility day to day, making gas shipper's exposure and subsequent gas purchasing decisions harder to manage.

Some of the root causes of UIG volumes and volatility are undoubtedly due to transitional issues, such as those which have caused reads from DM supply points to fail validation. We also note that whilst rules on the submission of meter reads have been strengthened in line with the recent CMA Gas Settlement Order, these changes have yet to take effect. In the meantime, the relatively limited volume of read data is affecting both the quality of sample used to derive NDM profiles, and the lead time between supply points being reconciled. Therefore, a gas allocation process that was conceived to be ready for a smart-world is still reliant upon old-world quantity and quality of data.

Whilst even the current frequency of reads would in due course ensure that supply point reconciliation occurs, returning any over allocation of UIG back to contributing shippers, we are sympathetic to the concerns that this process is both too slow and may not be sufficiently transparent for shippers. There are also concerns about the impacts of the new UIG algorithms, the volatility they create because of the limitations of predicting a day

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ahead the total gas consumed by NDM sites. This volatility appears to be driving additional costs as shippers manage this risk, over and above the costs of the underlying UIG.

We are concerned about the potential impact on consumers and the prices, should shippers seek to pass through additional charges arising from UIG.

Since the introduction of the new arrangements in June, Xoserve has been demonstrating leadership as the operator of the central systems on this issue. They have shown a strong customer-focus in helping their customers to understand the issues and seeking to identify whether there are industry-wide solutions to the issue. This is an example of the kind of customer-focussed, proactive approach that the CMA envisaged in making their recommendations on improving code administration and the delivery/operation of central systems in the energy sector.

Given this positive track-record, I welcome Xoserve undertaking further analysis on the NDM algorithm and I have asked them co-ordinate a whole industry approach to considering these issue and assessing any improvements and/or possible alternatives to the current arrangements. We are keen to ensure that we preserve the benefits of cost-reflectivity, while reducing the volatility-driven issues which have developed.

I understand that a range of industry parties have been considering alternatives to the current UIG arrangements, and as such **call for any suggestions to be urgently put forward to Xoserve so they can help co-ordinate their consideration in an appropriate manner**. I asked Xoserve expedite its assessment of any proposals, whether raised through the UNC modifications process or directly to them. This is without prejudice to any of the current UNC modification proposals relating to UIG or any that may emerge from any discussion facilitated by Xoserve.

As these are matters linked to the rules set out in the UNC, Xoserve will need to work closely with the Joint Office and UNC Panel to ensure an appropriate approach is taken. Whilst as mentioned above, these UIG costs are not in themselves new, they are for the first time fully transparent and arguably more volatile than anticipated. Had UIG volumes been lower and more predictable, normal UNC governance might have provided an appropriate route to deal with any transitional issues or consideration of improvements to the UIG algorithm.

Next steps

I understand Xoserve will be communicating to industry parties to arrange a discussion on **Monday 13 November**. We think this is an issue that needs addressing urgently, in order to mitigate the risk of detrimental impacts upon consumers, particular if shippers seek to pass through UIG cost in the short-term, which may or may not have subsequently been unwound through the reconciliation process. If you would like to attend the meeting on Monday, please contact Linda Whitcroft (linda.whitcroft@xoserve.com).

Separate to the initiative above, we note that individual shippers have tools to mitigate and manage these risks. Both profiling accuracy and the speed of reconciliation will improve with increased frequency meter reads submitted to Xoserve. Shippers could also reduce their exposure to volatility through the migration of customer sites from settlement product 4 to products 1-3, which attract lower UIG allocation, in line with the AUGE-recommended scaling factors. This would also help improve the overall accuracy of the gas settlement arrangements.

Ofgem will continue to observe and support industry's efforts to resolve this issue in a speedy manner.

Yours faithfully,

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Appendix: UIG Factors

As from 1 October 2017, this daily UIG allocation also includes DM supply points.[3] The current UIG factors are as set out in Table 1 below.

Table 1: UIG Factors for 2017/18 as determined by the AUGE (uplifted by x10 to reduce decimal places to 2)[4]

	Settlement Product (Class)			
	Product 1	Product 2	Product 3	Product 4
EUC Band 1	0.18	52.39	52.43	111.94
EUC Band 2	0.18	51.6	51.5	115.73
EUC Band 3	0.18	53.16	53.11	114.52
EUC Band 4	0.18	54.94	55.05	54.25
EUC Band 5	0.18	54.82	55.13	59.18
EUC Band 6	0.18	50.69	51.14	54.23
EUC Band 7	0.18	40.41	40.89	39.5
EUC Band 8	0.18	21.87	22.19	18.53
EUC Band 9	0.18	0.18	0.18	0.18

[3] Supply points with an AQ above 58,600 MWh fall into in EUC Band 9, and are mandatorily categorised as settlement product 1. Whilst there are currently supply points in the other EUC Bands within Product 1, this is scheduled to end 1 December 2017. However, there is currently a UNC modification to extend this deadline.
[4] See: www.gasgovernance.co.uk/sites/default/files/ggf/page/2017-06/Final%20Factor%20Table%20Letter%2030%20June%2017.pdf

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