Modification proposal:	**Uniform Network Code (UNC) 642 & 642A: '*Changes to settlement regime to address Unidentified Gas issues*'; and 643: '*Changes to settlement regime to address Unidentified Gas issues including retrospective correction*' (UNC642, UNC642A and UNC643)**		
Decision:	The Authority[1] has decided to reject these modification proposals[2]		
Target audience:	UNC Panel, Parties to the UNC and other interested parties		
Date of publication:	17 August 2018	Date of publication:	N/A

Background

The gas allocation arrangements introduced as part of Project Nexus calculate total gas consumption on a *bottom up* basis. This calculation combines shippers' nominations, using actual meter reads from Daily Metered (DM) supply points and an estimate of consumption at Non-Daily Metered (NDM) supply points. An allowance is also made for shrinkage and the Gas Transporters (GTs) own use of gas. To the extent there is any difference between this daily estimate of total consumption and total Local Distribution Zone (LDZ) throughput, the balance (which can be a positive or negative value) is considered to be Unidentified Gas (UIG). The daily UIG volume is apportioned across all supply points, in accordance with a weighted scaling factor determined by an independent expert, the AUGE[3].

The gas allocation process continues to be re-run for the next five days, at which point (D+5) the allocations are finalised. Re-running the calculations in this way allows Xoserve, acting as the Central Data Service Provider (CDSP) to take account of the latest available data, for instance additional DM reads or measurements of LDZ throughput. No further changes are made to allocations after D+5. The amount of gas allocated to each shipper, including the amount of UIG apportioned to them, will be invoiced the following month.

Subsequent adjustments to the invoiced amount of energy may be made as and when meter readings are made available, allowing actual gas consumption at each supply point to be reconciled against its allocation. This reconciliation process can continue up to four years after the day on which the gas was consumed.

Since the introduction of the new arrangements, replacing the previous Reconciliation by Difference (RbD) process for NDM supply points, UIG volumes have generally been greater and more volatile than some shippers anticipated. This unpredictability is making it difficult for those shippers to determine how much gas they should purchase in order to balance their daily positions. The issue is compounded by uncertainty over how much of the UIG value will be resolved through subsequent reconciliation, and when this will occur.

[1] References to the "Authority", "Ofgem", "we" and "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day to day work. This decision is made by or on behalf of GEMA.
[2] This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986
[3] The Allocation of Unidentified Gas Expert, see: www.gasgovernance.co.uk/augenex

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The modification proposals

UNC642 and UNC643

Both **UNC642 and UNC643** seek to revert to the pre-Nexus gas nomination and allocation process for NDM supply points. Both proposals seek to separate UIG into a fixed volume of unidentified gas and a new variable volume of '*settlement error*', which would be any residual volume of gas (whether positive or negative) once known or fixed values have been removed from LDZ throughput. The unidentified gas volume would revert to a fixed percentage of throughput.

The primary difference between **UNC642** and **UNC643** is that the latter seeks to have retrospective effect from 1 June 2017, in effect unwinding all of the UIG allocation that has occurred under the prevailing arrangements.

UNC642A

UNC642A would maintain the existing gas allocation methodology, i.e. continue to derive NDM demand from a bottom up calculation, rather than apportion all LDZ throughput once DM demand, shrinkage and own use gas are removed. However, **UNC642A** would also separate the existing UIG value, replacing it with a fixed UIG volume and a variable balancing factor. The UIG volume would be allocated across all shippers according to throughput market share, with initial values beings set to 0.01% for Class 1 (mandatory DM) and 2.5% for Classes 2-4. To the extent these calculated volumes do not match LDZ throughput, a balancing factor would apportion the difference (whether positive or negative) to shippers with Class 2-4 supply points, pro-rata to their share of throughput.

UNC Panel[4] recommendation

At its meeting of 15 February 2018, the UNC Panel voted to recommend the rejection of UNC642, UNC642A and UNC643.

Impact assessment

Having considered the Final Modification Report (FMR) on the modification proposals, our initial conclusions were in summary, that the current gas allocation arrangements appeared to be operating in accordance with the intent of the UNC modifications that introduced them. Issues appeared to arise from the volume and volatility of UIG since its introduction as the daily balancing figure being greater than many parties anticipated, rather than the use of a daily balancing figure *per se*.

We recognised that some shippers would prefer the certainty of a fixed allocation of UIG. However, we did not consider that any of the proposals would offer immediate or effective relief from this issue. We were particularly concerned that the proposals may be detrimental to competition, with any additional certainty that the proposals may offer to some DM focused shippers being limited, and coming at the expense of greater volatility for other market participants. We further considered that it would be premature to conclude that the current gas allocation arrangements are inherently flawed, and that

[4] The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

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the focus should instead be on identifying and addressing the root causes of UIG, rather than simply seeking to redistribute it.

We were therefore of the view that none of the proposals would further the relevant objectives of the UNC if implemented, and were minded to reject them. However, recognising the level of concern that has been expressed with the current arrangements and the importance that stakeholders place on the UIG issue, we considered it appropriate to provide further opportunity for stakeholders to comment on our assessment of the proposals. We published our provisional thinking and an accompanying impact assessment (IA) on 8 June 2018, seeking views and any supporting evidence by 5 July 2018.

A summary of the IA responses is provided at **Appendix E**. Non-confidential responses have been posted on the Ofgem website at: www.ofgem.gov.uk.

Our decision

We have considered the issues raised by the modification proposals and the FMR, dated 15 February 2018. We have considered and taken into account the responses to the Joint Office's consultation(s) on the modification proposals[5] and responses to our initial impact assessment and have concluded that none of the modification proposals would, if implemented, better facilitate the achievement of the relevant objectives of the UNC.[6]

Summary of the reasons for our decision

As we have published a final version of the IA appended to this decision, this section provides only a summary of our reasons.

The Joint Office received a strong response to its consultation on these proposals, with 27 interested parties submitting representations. In addition to gas shippers and GTs who are Party to the UNC, representations were also received from metering agents, consumer groups, and directly from consumers themselves.

We note that none of the three proposals were supported by the majority of respondents and all were recommended to be rejected by the UNC Panel. All respondents who referred to the UNC relevant objectives, whether in favour or opposed to any of the three proposals, made their arguments in the context of relevant objective (d). We therefore agree with respondents and the UNC Panel that the proposals should be considered against relevant objective (d) and that they would have a neutral or relatively immaterial impact upon the other relevant objectives.

Relevant Objective (d) - securing effective competition between relevant shippers and between relevant suppliers

We recognise that some shippers may prefer the certainty of a fixed allocation of UIG, even if that certainty comes at a premium. However, we do not consider that any of the proposals would offer immediate or effective relief from this issue. Apart from the significant cost and lead time for any of the proposals to be implemented, unless the

[5] UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.co.uk
[6] As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://epr.ofgem.gov.uk/Pages/EPRInformation.aspx?doc=http%3a%2f%2fepr.ofgem.gov.uk%2fEPRFiles%2fStandard+Special+Condition+PART_A___-_Consolidated_-_Current+Version.pdf

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underlying root causes of UIG are addressed they would simply redistribute uncertainty and cost onto other supply points, the shippers who serve them and ultimately their customers.

Whilst we note the difficulty that some shippers are having in predicting and managing their exposure to UIG costs, we have seen nothing to suggest that the current gas allocation arrangements are operating other than as intended by UNC432 and UNC473[7]. Those modifications were the culmination of a lengthy and extensive period of development and consideration. The eventual implementation timeline for those modifications as part of Project Nexus was driven in part by the recommendations of the Competition and Markets Authority (CMA). In its Energy Market Investigation final report the CMA had identified the prevailing gas settlement arrangements, including those relating to the allocation of unidentified gas, as contributing to an adverse effect on competition.[8]

The current allocation of UIG is evidence-based, independently determined and already heavily weighted towards the NDM sector, reflecting amongst other things the importance of frequent meter reads to the accuracy of gas allocation. Improvements in this area have only recently been given full effect. For instance, UNC570 and UNC638 which give effect to the CMA Order to increase the frequency of meter read submissions into settlement were only implemented with effect from 3 November 2017 and 1 April 2018 respectively.[9] Such meter read submissions will, over time, improve the accuracy of the prevailing AQ. We note a number of other recent and still live modification proposals that seek to improve upon data accuracy, data submission to Xoserve and accuracy of NDM consumption estimation.

We consider that the implementation of any of UNC642, UNC642A or UNC643 would dampen incentives to address the root causes of UIG, undermine the equitability of the current arrangements and be detrimental to competition. We therefore consider that any of the proposals would have a negative effect on relevant objective (d).

Our assessment of the impacts on competition are set out in the attached final IA and so not repeated here.

Conclusion

We remain of the view set out in our 'minded to' letter, that industry attention should more appropriately focus on addressing the systemic root causes of UIG, mitigating impacts through reducing its volume and volatility rather than simply seeking to redistribute it. To that end we recently directed the implementation of UNC658[10], which several IA respondents referred to and expressed support for. UNC658 requires Xoserve to re-instate a UIG *taskforce*, with a mandate and the necessary resources to investigate the root causes and influencers of UIG, with a target of reducing its volatility and scale and developing a robust predictive model for daily UIG for use by all parties.

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7 UNC432: '*Project Nexus – Gas Demand Estimation, Allocation, Settlement and Reconciliation reform'* and UNC473: '*Project Nexus – Allocation of Unidentified Gas*'

8 Competition and Markets Authority: Energy market Investigation – Final Report, June 2016

99 UNC570: 'Obligation on Shippers to provide at least one valid meter reading per meter point into settlement once per annum' and UNC638: 'Mandate monthly read submission for Smart and AMR sites from or 1 April 2018'.

10 UNC658: 'CDSP to identify and develop improvements to LDZ settlement processes'

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We consider that Xoserve is not only best placed to undertake this role, but responsible for ensuring the accuracy of its allocation algorithms. To the extent that Xoserve depends on data provided by third parties, including the provision of frequent and accurate meter readings, we expect it to work with those parties and the Performance Assurance Committee to ensure that these requirements are identified and being met.

Decision notice

In accordance with Standard Special Condition A11 of the Gas Transporters Licence, the Authority has decided that modification proposals UNC642, UNC642A and UNC643 should not be made.

Rob Salter-Church
Interim Executive Director, Consumers and Markets
Signed on behalf of the Authority and authorised for that purpose

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