

Modification proposal(s):	<b>UNC725: 'Ability to reflect the correct customer network use and system offtake quantity (SOQ)<sup>1</sup> during COVID-19'</b>		
Decision:	The Authority <sup>2</sup> has decided to reject this modification proposal <sup>3</sup>		
Target audience:	UNC Panel, Parties to the UNC and other interested parties		
Date of publication:	29 May 2020	Implementation date:	N/A

## Background

COVID-19 presents a serious challenge for the energy industry to tackle on behalf of the homes and businesses that depend on the sector for gas and electricity. The lock down of non-essential sectors of the economy, the re-purposing of some sites and changes in consumer behaviour means that energy consumption is varying from season normal patterns to an unprecedented extent. This is having a consequential impact throughout the energy supply chain.

Against this backdrop a specially convened session of the UNC Distribution workgroup was held 14 April 2020 to consider the likely impacts of COVID-19 on the Uniform Network Code (**UNC**) arrangements and potential mitigating actions. To date, five UNC modification proposals have emerged from those discussions. On 7 May 2020, we agreed that UNC725 should follow an urgent timetable. We acknowledge and appreciate the efforts of all who have contributed to the development of these proposals to date.

Capacity charges make up around 95% of applicable gas distribution charges, with the remaining 5% being a commodity-based charge, linked to actual consumption. Under the rules of the UNC, gas customers' Supply Points may be categorised as either Daily Metered (**DM**) or Non-Daily Metered (**NDM**). For DM Supply Points, the capacity charge is calculated using the Supply Point Offtake Quantity (**SOQ**) nominated by the Shipper/Supplier, as being the maximum daily demand.

If a DM consumer reduces the amount of gas it takes off the system it will reduce the commodity element of the charge but it is still liable for the capacity component of its charges unless it also reduces the SOQ, which can only be done within a specified time period between October and January each year.

## The modification proposal

UNC725 seeks to allow the SOQ for Supply Points that have seen a sharp reduction in consumption to apply for a temporary reduction to a level which is reflective of their peak daily demand in the period between 1 April 2020 and the date of application, being no later than 31 May 2020. That reduced SOQ would then apply until 1 October 2020, when it would revert to the previous value. At that point, the normal Oct-Jan window for SOQ reductions would open and the shipper would be free to seek a more enduring reduction, if appropriate.

<sup>1</sup> Although commonly used in gas industry documentation, SOQ is not itself a UNC defined term. Whereas the UNC725 refers to the 'System' Offtake Quantity, the Gas Transporters' charging statements refer to the SOQ as being the Supply Point Offtake Quantity, which we therefore consider to be the correct term.

<sup>2</sup> 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.

<sup>3</sup> This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.

## **UNC Panel<sup>4</sup> recommendation**

At the UNC Panel meeting on 21 May 2020, the vote was evenly split. As no clear majority was reached, the UNC Panel did not recommend UNC725 to be implemented.

## **Our decision**

We have considered the issues raised by the modification proposals and the Final Modification Reports (**FMR**) dated 21 May 2020. We have considered and taken into account the responses to the industry consultation on the modification proposals which are attached to the FMR<sup>5</sup> and concluded that implementation of the modification proposal will not better facilitate the achievement of the relevant objectives of the UNC.<sup>6</sup>

## **Reasons for our decision**

Of the 16 representations that the Joint Office received on this modification proposal, ten supported its implementation, with a further one offering qualified support. Four of the five respondents who opposed the implementation of UNC725 are Gas Transporters.

In coming to our decision we have been mindful of the particular challenges posed by COVID-19 and the fact that gas demand has in some cases been restricted by the necessity to comply with statutory requirements aimed at mitigating the spread of that virus, rather than at the discretion of the consumer. We have sought to balance the recognition of these circumstances against the principles which underpin the transportation charging arrangements, and the gas transporters own financial circumstances. We have also had regard to the potential precedent that several respondents suggested had been set through UNC modification(s) which followed the financial crisis of 2008.

We agree with respondents and the UNC Panel who considered that this proposal should be considered primarily against relevant objectives (a) and (d), but that relevant objective (c) is also pertinent. We consider that it would have a neutral impact on the other relevant objectives.

### ***(a) efficient and economic operation of the pipe-line system;***

We recognise that there has been a sharp and unexpected reduction in gas demand as a result of COVID-19. Whilst this will be reflected in energy and network charges that are levied on the basis of usage, consumers will not automatically avoid network charges that are levied on the basis of year-round capacity. In cases where the consumption ceases entirely, the relevant gas shipper may seek to avoid the commodity element of the charges by effecting an isolation of the supply point. Our recent acceptance of UNC723<sup>7</sup> will, for a limited period linked to the COVID-19 lock down, allow such isolations without the usual requirement of an on-site inspection. UNC723 also extends the arrangement to circumstances where there may be a small residual amount of consumption rather than

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<sup>4</sup> The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.

<sup>5</sup> UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at [www.gasgovernance.co.uk](http://www.gasgovernance.co.uk)

<sup>6</sup> As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, available at: <https://epr.ofgem.gov.uk/Content/Documents/Standard%20Special%20Condition%20-%20PART%20A%20Consolidated%20-%20Current%20Version.pdf>

<sup>7</sup> UNC723: '[Use of Isolation Flag to identify sites with abnormal load reduction during COVID-19 period](#)'.

needing to have ceased entirely. However, capacity charges will continue to apply. Under current arrangements, if DM customers seek to reduce their capacity charges outside the specified October to January time period, the only routes open to them is to vacate the site or disconnect from the gas network. However, if this course of action was taken by a significant number of such customers it could lead to a significant part of the network being under-utilised with no corresponding reduction of network costs.

Several respondents to the consultation on UNC725 noted that this was similar to the issues which the industry sought to address through UNC275<sup>8</sup> in the aftermath of the 2008 financial crisis. UNC275 allowed amendments to customers' capacity holdings in certain circumstances. In particular, it allowed a time-limited reduction in the SOQ below the otherwise minimum level referred to as the 'Bottom Stop SOQ' (**BSSOQ**). Although UNC275 was introduced as a time-limited measure, the effect of that modification was subsequently extended by UNC405<sup>9</sup> and UNC478,<sup>10</sup> with the BSSOQ being removed in its entirety by UNC445.<sup>11</sup>

However, an important distinction between UNC275 and UNC725 as noted by some respondents, is that UNC725 would preserve the users' rights to all existing capacity, with the SOQ reverting to previous levels with effect 1 October 2020, despite the fact that the consumer has not been paying for that level of capacity. Whilst this is consistent with the proposer's intent that this is a purely short term measure that should not require the customer to relinquish capacity, the implications of this would be that:

- customers do not face a trade-off between the avoidance of charges and securing their medium-term capacity requirements; and,
- the unused capacity will not be available to the gas distribution network (**GDN**) to re-allocate and potentially obviate the need for further investment.

Analysis undertaken as part of the assessment of UNC445 found that the use of the capacity reduction initially made available on a time-limited basis through UNC275 (and subsequently extended by UNC405 and UNC478) had a limited take up and a negligible impact upon GDN revenues. However, the absence of an appropriate trade-off under UNC725 may incentivise consumers to reduce SOQ more than absolutely necessary. This may distort the important signals that capacity bookings provide to the GDNs. Knowing what the SOQ of a site will be, in advance, helps facilitate the efficient and economic planning of the pipe-line system. For example, where SOQs are falling due to significant and sustained changes in usage, knowledge of this in advance could prevent inefficient investment taking place. More immediately, it would make the GDNs recovery of charges less predictable and in the extreme, could redistribute the liquidity problems that we acknowledge consumers may be facing, from them to the GDNs. Neither of these outcomes would promote the efficient operation of the network.

Balanced against these concerns is the prospect that some DM consumers may otherwise cease using the network, either through choice or necessity, and make no further contributions to the costs of its operation. To the extent that these consumers are not replaced entirely or within the same locality, the existing capacity may become under-utilised, which would reduce its efficiency and require cost to be recovered from all other users of the network. However, we are currently unable to quantify this risk, or the extent to which the short term relief from charges which UNC725 may offer would

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<sup>8</sup> UNC275: '[Reduction in DM LDZ Exit Capacity for Supply Points with Significant Changes in Usage](#)'

<sup>9</sup> UNC405: '[Bottom Stop SOQ Appeal Mechanism for 2011/12](#)'

<sup>10</sup> UNC478: '[Filling the gap for SOQ reductions below BSSOQ until Project Nexus](#)'

<sup>11</sup> UNC445: '[Amendment to the arrangements for Daily Metered Supply Point Capacity](#)'

mitigate that risk. We also consider that the risk may be true of consumers who have not currently reduced their gas demand and would not benefit from UNC725, but nonetheless face existential challenges from COVID-19 or other economic factors. We also note that many companies will currently be benefitting from Government support which will, at least to some extent, offset the impacts of COVID-19 upon their business.

Data provided to us by Xoserve shows that of the circa 1,000 DM supply points, around 20% were currently showing zero or *de minimis* levels of gas consumption. This correlates with a circa 20% year-on-year drop in consumption across the DM sector consumption during April. However, this data also suggests that the consumption across many other sites has not dropped significantly, and in many other cases actually increased. We assume this may be reflective of whether the activity at each supply point is considered to be essential and therefore continuing during the lock-down period. It is not clear from the available data whether those sites which have reduced consumption is due to COVID-19 or some other reason. Although UNC725 is predicated on being a response to COVID-19, there is nothing in the legal text to limit its use in this way, rather than being open to all supply points currently operating below their peak capacity requirements to avoid or reduce associated charges.

We therefore consider, on balance, the implementation of UNC725 and its potential application to SOQ reductions beyond those mandated by the COVID-19 regulations would not better promote relevant objective (a).

***(c) so far as is consistent with sub-paragraphs (a) and (b) the efficient discharge of the licensee's obligations under this licence***

We note that two of the respondents considered that the implementation of UNC725 could have an adverse effect on the gas transporters' ability to discharge their licence obligations. In particular, Standard Special Condition A5 of the Gas Transporters licence requires that licensees' charging methodologies are cost reflective. We agree that this is a relevant consideration.

As noted above, capacity charges are intended to recover the costs of making the gas transportation infrastructure available to use all year round, and to do so in a stable and predictable manner over a number of years. A temporary reduction in the SOQ may be reflective of the consumers' demands in the short term, but would not be reflective of the cost the gas transporters incur in providing that capacity, or the consumers' use of it in the longer term. Whilst any short-term reduction in GDNs' revenue arising from UNC725 would, in due course, be recovered through future transportation charges, in the absence of a more targeted recovery, this cost would fall to all consumers, rather than only those who benefit from the short-term reduction in charges. Whilst there may be exceptional circumstances in which this may be justified as noted above, without certainty of the basis for such exceptions and an assessment of the potential application to circumstances beyond those envisaged in UNC725, we are concerned that its implementation may undermine the current basis of the capacity charging regime. UNC725 would not therefore better facilitate relevant objective (c).

***(d) so far as is consistent with sub-paragraphs (a) to (c) the securing of effective competition between relevant shippers and between relevant suppliers;***

UNC725 is particular to DM consumers. We understand that transportation charges are typically passed through directly to these consumers as a separately identifiable invoice

item with no uplift from the relevant shipper or supplier, who compete for contracts on the basis of the unit price of energy and levels of service. Given this direct pass through and the fact that it would be available to all DM consumers and to the same extent, irrespective of their chosen shipper and supplier, we do not consider that the implementation of UNC725 would have any material impact upon competition between shippers and suppliers.

Whilst there may be an argument that the availability of a more flexible capacity product may have implications for viability of the DM sector and/or gas market as a whole, we do not consider that this would be applicable to or within the scope of the short term arrangement envisaged by UNC725. We therefore consider that UNC725 would have little or no impact upon relevant objective (d).

## **Conclusion**

Whilst we have concluded that on balance, it would not be appropriate to direct the implementation of UNC725, we are sympathetic to the situation of customers who have entered into appropriate capacity commitments in accordance with prevailing requirements, and subsequently found that they were unable to utilise that capacity due to the imposition of COVID-19-related regulations. Whilst many parts of the economy are now emerging from the initial restrictions, it is still uncertain when normal activity will fully resume. There is also a possibility of future, and potentially location-specific restrictions being introduced.

We would therefore encourage further consideration by the industry, and GDNs in particular, on whether relief from capacity charges should be afforded to those consumers who continue to be affected by the COVID-19 related regulations which prevent them from making use of the network capacity allocated to them. As set out in our decision on UNC275, we did not consider that the additional flexibility introduced by that modification in response to the financial crisis represented a fundamental shift from the prevailing arrangements, it simply brought forward capacity reductions that would have been available to the customer in the following gas year. This was in contrast to the earlier proposals that had been raised in response to the financial crisis, which had been rejected in the form of UNC244 and its alternatives.<sup>12</sup> We note that UNC275 had strong support from UNC Parties, including some who were opposed to UNC725.

We consider that there is a reasonable case to develop a process which entails the release of capacity earlier than would be allowed through the annual process, and enabling the GDNs to utilise any relinquished capacity in furtherance of the overall efficiency of the network. However, such a deviation from the standard capacity reduction arrangements would have to be based on exceptional and unforeseen circumstances, such as the closure of premises being mandated by regulations. This should also be verifiable by the CDSP and/or relevant network operator without undue administrative burden. Such an approach should also ensure that any relief from existing charging obligations is appropriately targeted to those customers directly impacted by the restrictions, proportionate to that impact and, importantly, would be fair to other network users and would not simply redistribute potential financial distress to other parts of the supply chain or their customers.

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<sup>12</sup> UNC244: [‘Amending DM Supply Point Data for sites with significant changes in usage’](#)

We consider that such an arrangement should appropriately recognise the exceptional circumstances imposed by COVID-19, whilst being consistent with charging principles applicable to gas distribution capacity and elsewhere. It would also mitigate the risk that some DM consumers might otherwise unnecessarily isolate and withdraw from the network, and without risk of the potential consequences of a widespread and artificial reduction in SOQ levels.

### **Decision notice**

In accordance with Standard Special Condition A11 of the Gas Transporters licence, the Authority hereby directs that modification proposal UNC725: '*Ability to reflect the correct customer network use and system offtake quantity (SOQ) during COVID-19*' should not be made.

**Frances Warburton**

**Director, Energy Systems Transition**

Signed on behalf of the Authority and authorised for that purpose