Transco, Shippers and other Interested parties

Our Ref: net/cod/mod/0436
Direct Dial: 020 7901 7437
Email: mark.feather@ofgem.gov.uk

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Dear Colleague,

Modification Proposal 0436 ' Correction of Transco Errors on the RGTA Capacity System'

Ofgem has considered the issues raised in Modification proposal 0436 '*Correction of Transco Errors on the RGTA Capacity System'*. Ofgem has decided to direct Transco not to implement the modification because we do not believe that this proposal better facilitates the relevant objectives of Transco's Network Code.

In this letter, we explain the background to the modification proposal and give reasons for making our decision.

Background

Events of 4 July 2000

On 4 July 2000, during Transco's processing of bids for daily capacity for the following day (5 July 2000), a software error occurred on Transco's UK/RGTA capacity System that resulted in a duplication of identical shippers' bids. In addition, the daily firm auction for capacity at St Fergus terminal was processed twice thereby allocating additional capacity to the terminal.

Having identified the error, Transco took the decision to datafix the RGTA capacity system at 18.05 hrs (D-1) effectively resetting the allocations to remove the effects of both duplicate bids and dual processing of the day ahead auction at St Fergus. The result of this was that a number of Transco capacity sales were effectively voided.

Following these events a number of shippers expressed concerns that Transco's actions in resetting the capacity allocations constituted a breach of its contractual obligations under the Network Code and that shippers should be compensated for any damages suffered as a consequence of the breach. In particular, some shippers indicated that they had traded gas on the basis of capacity that they had been initially allocated and that a subsequent unilateral cancellation of these allocations exposed them to significant overrun charges and other related costs associated with the reduction in capacity.

Modification 0413

In July 2000, Powergen raised urgent modification proposal 0413 *'Compensation Payments Following Transco's Failure to Meet Entry Capacity Contractual Commitments'*. The modification proposal was raised to establish a mechanism for compensating shippers in respect of Transco's errors in buying or selling capacity on the RGTA capacity system. The proposal was intended to apply both prospectively and retrospectively, such that it would incorporate events of 4 July 2000.

Under modification proposal 0413, in instances where Transco sold or bought capacity on the RGTA capacity system and where it then subsequently amended or voided such actions, Transco would compensate all holders of capacity at that particular terminal. The proposal suggested that Transco would pay the equal of [2] times the overrun charge at the particular entry point or [1.706 p/KWh] which ever was the greater for each KWh of capacity that Transco had failed to buy or sell.

Ofgem rejected this modification because in general it is not supportive of modifications to Transco's Network Code that include retrospective elements. As stated in our decision letter, Ofgem agreed with those respondents who expressed a view that the compensation mechanism proposed was not necessarily related to the losses suffered by individual participants. Ofgem also noted that since the compensation mechanism was arbitrary, some participants could have received excessive compensation, while others would have been under compensated. Taking these concerns into account, Ofgem did not direct Transco to implement modification 0413 either retrospectively or prospectively.

However, Ofgem stated that it shared shippers' concerns about Transco's actions on 4 July 2000 and supported the urgent need for Transco and shippers to seek to put in place alternative suitable operational and contractual arrangements to deal with this situation going forward. We suggested that Ofgem's preference would be that Transco should use the buy back mechanism to deal with any erroneous capacity releases and that it would then be necessary to determine what Transco's exposure to the costs of any buy-backs should be. We considered that Transco is best placed to mitigate the risks associated with the systems and software it develops and operates. As such if Transco is exposed to the costs associated with systems and software errors this should ensure that it has appropriate incentives to develop robust systems that mitigate the risks of these errors occuring. Ofgem also stated that it recognised that no system is infallible and that therefore it may be appropriate to cap Transco's exposure, or only expose it to a proportion of the costs incurred under the circumstances.

Ofgem view of Transco's actions on 4 July 2000

In its decision letter on modification 0413 Ofgem indicated that it would be considering further whether there was any breach of the Network Code by Transco with respect to the actions it took on 4 July 2000. Subsequently on 24 January 2001, Ofgem issued a letter to Transco, shippers and other interested parties indicating that Transco was in breach of the Network Code by releasing more capacity than what was physically available. Ofgem also indicated that Transco may have been in breach of Standard Condition 7 of its licence. However, as Ofgem can only currently impose a monetary penalty as part of a Final Order issued where the Authority is satisfied that the licence holder is contravening or likely to contravene its licence, Ofgem was unable to take any further action. In addition Ofgem indicated that it had written to Transco making it clear that if this situation occurred again in the future it would expect Transco to use the provisions of the Code relating to capacity buy-backs to deal with any overselling of capacity.

Other modification proposals

Following Ofgem's rejection of Modification proposal 0413, Powergen has raised modification proposal 0436 *'Correction of Transco errors on the RGTA capacity system'* and modification proposal 0437 *'Remedies for Transco's failure to honour its entry capacity commitments'*.

Ofgem has released its decision on modification proposal 0436 jointly with its decision on modification proposal 0437.

In addition a number of other modification proposals have been raised relating to shipper manifest errors in the capacity market.

On 31 January 2001, Ofgem approved Modification proposal 0432 *'Definite Gate Closure times for Daily System Entry Capacity'.* This proposal was raised by Transco and provided for the implementation of fixed gate closure times for daily system entry capacity bids. In accepting the proposal, Ofgem indicated that the introduction of a definite gate closure time should reduce the uncertainties faced by shippers in the daily entry capacity regime regarding the timing of Transco's bid allocations. Ofgem stated that it believed that the proposal would provide shippers with a better opportunity to plan and review their bids for capacity prior to the fixed gate closure time, thus reducing the potential for errors to occur.

In addition, on 23 February 2001 Ofgem rejected Modification proposal 0419, *'Avoidance of correction of shipper errors in purchasing and selling entry capacity'*. This proposal provided for the introduction of optional volume and price warning limits when shippers enter data onto the RGTA capacity system. In addition, the proposal provided for the introduction of a shipper manifest error correction mechanism to apply to daily capacity trades with Transco whereby a shipper could, subject to the payment of a fee, request for a trade to be voided.

In rejecting the proposal Ofgem indicated that it did not believe that there was sufficient justification for capacity bid validation measures to be developed as a matter of contract under the Network Code, particularly when Transco has already made substantial progress in developing a range of bid validation mechanisms outside of the scope of the Code.

Second, Ofgem identified a number of concerns regarding the proposed manifest error correction mechanism. In particular Ofgem had significant concerns with Transco acting as a sufficiently independent sole arbiter in determining whether or not a manifest error had occurred in view of its capacity incentive. Ofgem also considered that the proposals were not suited to the capacity market which is dynamic in nature. In particular the proposals did not sufficiently address the impact the voiding of a capacity trade is likely to have on other shippers' bids in the capacity market.

In reaching its decision Ofgem outlined a number of issues that any future manifest error correction mechanism would need to address. These included, amongst other things, the establishment of sufficiently independent procedures to address manifest error claims, the criteria by which a manifest error is to be identified and the nature of any remedial action that is to be taken once an error is identified.

The Proposal

Modification 0436 proposes that should Transco commit to sell or buy capacity on the RGTA capacity system in error, (whether due to system failures or human errors in placing or accepting bids/offers on that system) it will be obliged to correct such errors by means of counteracting transactions.

The proposal suggests that:

- in the event of the sale of too much capacity at an aggregate system entry point (ASEP), Transco shall buy back an equivalent amount of capacity within one hour of the error occurring and shall bear [20%] of the cost; and
- in the event of a buy back of too much capacity at an ASEP, Transco shall sell an equivalent amount of capacity within one hour of the error occurring and shall only be entitled to receive [20%] of the benefit from this sale.

It is further proposed that the principle of Transco bearing all (100%) of the costs of an erroneous transaction should be enshrined in the Network Code. However the proposal acknowledges that in practice there is no straightforward manner by which legitimate and erroneous capacity sales can be distinguished. As such Transco's liabilities and revenues associated with undertaking counteracting transactions are aligned with the existing Transco capacity incentive sharing factors.

Respondents' views

Eight responses were received in relation to this proposal. The majority of respondents did not support the proposal.

Views against the proposal

The majority of respondents who were against the proposal suggested that requiring Transco to buy-back capacity within one hour is too restrictive and may result in extreme prices that do not take into account market liquidity or operational changes. This would result in significant costs being passed back to shippers. One shipper commented in this context that the least cost solution may not be to oblige Transco to take an action of the same magnitude in the reverse direction.

A number of respondents indicated that Transco should be exposed to 100% of the costs associated with correcting its errors. Shippers indicated that this would align Transco's exposure to the exposure that shippers face with respect to their own errors. However, a number of shippers also noted in this context that Transco could have a perverse incentive to disguise errors and that audit procedures should therefore be implemented to determine whether or not a genuine error has been made.

One respondent stated that the proposal offers no advantages or incremental incentives over the current regime to the extent that it utilises the current incentive sharing factors. Indeed it may actually increase capacity costs by forcing Transco to buy or sell a specific amount of capacity within an hour.

Views supporting the proposal

A number of those respondents in support of the proposal welcomed the clarification it attempts to provide of the actions that should be taken by Transco in the event of an error occurring in the operation of the RGTA capacity system.

One respondent welcomed the proposal and provided qualified support, suggesting that the 20/80 cost/revenue split needs to be reviewed as it is inappropriate for holders of monthly system entry capacity to incur 80% of the cost of an error.

Another respondent suggested that the modification proposal should be amended and clarified to ensure that Transco's obligations and the allocation of costs/revenues to Transco under the proposal have ascendancy over the exemptions from liability contained in Section U of the Network Code.

Transco's view

Transco does not support the proposal. It argues that the probability of such failures is subject to diminishing returns as the costs of preventative measures rise, and that the complete elimination of such failures can never be guaranteed. Transco argued that the Network Code already acknowledges this, and reflects an appropriate balance of commercial risk having regard to assumptions made as to development costs and time scales. Transco also refer to Network Code provisions that exempt it from liability for the consequences of any failure in the performance of UK-Link. Furthermore they believe the Network Code already has arrangements that can be used to remedy operator error, in the form of buy-back or sales of Daily System Entry Capacity. Transco argued that system performance levels cannot be set to 100% without a matching acceptance of the need for further investment in these systems.

Transco also indicated that there is no straightforward way to distinguish legitimate capacity sales from capacity sales made in error. Transco also agreed with other respondents that if the proposal was implemented costs would be generated by requiring it to accept shipper offers for buying-back capacity within a limited time frame.

Ofgem's view

Ofgem welcomes the debate that has occurred surrounding the numerous modification proposals relating to both Transco and shipper manifest errors including modification proposal 0436. Further, Ofgem recognises that this proposal has raised a number of important issues with respect to the treatment of Transco system errors. However, Ofgem has also identified a number of significant concerns with this modification proposal.

First, whilst Ofgem considers that Transco should utilise the existing capacity market mechanisms to address any manifest errors we do not believe that it is appropriate to require Transco to take counter acting transactions in the capacity market. Ofgem has always made clear that Transco should have discretion over the need for, and timing of, its actions both in the capacity and the energy market within the framework of the commercial incentives in place. Ofgem has also made clear that in its view, Transco would in future be obliged to use the buy back provisions within the Network Code in the event of a constraint following the sale of more capacity than is physically available on the day, whatever the cause. Ofgem does not believe that it would be in shippers' or customers' interests to fetter Transco's discretion over the timing of such buy-back actions.

Ofgem believes that by forcing Transco to take counter acting transactions in the capacity market, the proposal may actually increase the costs of managing manifest errors particularly in the buy-back market. By depriving Transco of the discretion to buy-back capacity only where necessary, the proposal may increase costs under the capacity regime by artificially forcing Transco to buy-back where there are no system constraints present. Further, by requiring Transco to take these actions within a one hour period, the proposal may require it to accept extreme prices which it would not otherwise accept under the normal operation of its capacity incentive where constraints are present. In this context, the proposal may create

incentives on Transco to disguise errors to avoid being forced into a costly buy-back situation.

Ofgem also agrees that by utilising the existing capacity incentive sharing factors the proposal does not provide any incremental benefits or advantage over the current capacity incentive regime. Instead it creates significant potential for costs to increase with 80% of these costs being passed through to holders of monthly system entry capacity in the event of Transco having to buy-back capacity. Ofgem however also notes that the alternative proposal of requiring Transco to bear 100% of the costs associated with errors may create perverse incentives on it to disguise the occurrence of genuine errors. Ofgem is also concerned that because of the operation of the current annual and monthly cap and collars, a 100% pass through could effectively leave Transco with no capacity incentive for up to a month following a manifest error incident. The current cap and collar were put in place for one year from October 1999 and Ofgem has always indicated that it believes that any review of the incentives should look at the sharing factors and caps and collars.

Ofgem acknowledges and agrees with the concerns of those respondents who considered that Transco should be exposed to the costs associated with the risk of system software or human error. As Ofgem indicated in its decision on Modification 0413 Transco is best placed to mitigate the risks associated with the systems and software it develops and operates. As such if Transco is exposed to the costs associated with systems and software errors this should ensure that it has appropriate incentives to develop robust systems that mitigate the risks of these errors occuring. However Ofgem also recognises no system is infallible and that therefore it may be appropriate to cap Transco's exposure, or only expose it to a proportion of the costs incurred under the circumstances.

In its letter to industry participants of 21 January 2001 concerning Transco's action of 4 July 2000 Ofgem clearly indicated that Transco was in breach of the Network Code in selling more capacity than what is physically available. Clearly, it is up to individual shippers to take their own advice on this issue and determine whether or not there are sufficient grounds to claim compensation from Transco as a consequence of such a breach.

However, irrespective of the current legal position, the events of 4 July and their subsequent impacts raise a policy issue regarding the mechanisms and procedures that should exist within the Network Code to formally address the occurrence of Transco manifest errors and efficiently allocate the costs associated with these errors. Ofgem believes that there would be considerable merit in developing such arrangements given that the existing capacity regime has not been designed with these circumstances in mind.

Ofgem would encourage industry participants to develop these arrangements as a matter of urgency. In developing these arrangements Ofgem considers that Transco and shippers should give consideration to the following factors and issues:

1. The extent to which Transco should utilise the existing capacity market to address its own errors. Ofgem's initial view, as outlined above and in its decision on Modification proposal 0413 is that wherever possible the capacity market should be used to correct these errors for efficiency reasons;

2. The extent to which Transco should be exposed to the costs/revenues associated with any manifest errors;

3. The extent to which this exposure should be aligned with existing and future incentive arrangements that may be introduced in the next price control period under Ofgem's long term investment proposals. Ofgem's initial view is that an alignment of any incentives would be preferable to avoid undesirable distortions in behaviour;

4. Whether or not it is necessary for Transco's actions to be subject to independent monitoring or determination and the extent to which any such process can be introduced given the dynamic and real time nature of the capacity market;

5. Where necessary, the criteria by which a manifest error is to be identified and the nature of any remedial action to be undertaken (whether through the capacity market or otherwise);

6. The extent to which the manifest error mechanism should be consistent with any similar mechanisms developed to address shipper manifest errors.

Ofgem believes that these features of any Transco manifest error regime must be consulted upon prior to the introduction of any manifest error correction mechanism.

Ofgem's decision

Ofgem does not support this modification proposal as we do not believe that the proposal will provide for the efficient correction of Transco manifest errors. In particular requiring Transco to take counteracting transactions within a defined time period following a manifest error is likely to increase the costs of managing such errors. In this context, Ofgem does not believe that the proposal would better facilitate the efficient and economic operation of the NTS.

In addition, the mechanism proposed may be unduly detrimental to holders of MSEC at those terminals where Transco is required to take a counteracting transaction within the defined time period and is therefore contrary to the objective of securing effective competition between relevant shippers and relevant suppliers.

Accordingly therefore, Ofgem has decided to reject this modification, as we do not believe that it better facilitates the achievement of the relevant objectives as stated in Standard Condition 7 of Transco's Gas Transporters Licence.

If you would like any further information in relation to the issues raised in this letter, please feel free to contact me on above telephone number.

Yours sincerely

Mark Feather
Head of RGTA