

23 February 2001

Transco, Shippers and Other Interested Parties

Our Ref: net/cod/mod/0419
Direct Dial: 0207 901 7437
Email: mark.feather@ofgem.gov.uk

Dear Colleague,

Modification Proposal 0419 'Avoidance or correction of shipper errors in purchasing and selling entry capacity'

Ofgem has considered the issues raised in modification proposal 0419 '*Avoidance of correction of shipper errors in purchasing and selling entry capacity*'. Ofgem has decided to direct Transco not to implement the modification because we do not believe that this proposal will better facilitate the relevant objectives of Transco's Network Code.

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

Background to the Proposal

In September 1999, Transco conducted the first auctions for the sale of entry capacity to its National Transmission System (NTS). The auctions provided for the allocation of monthly firm system entry capacity (MSEC) to successful bidders for a total period of six months from 1 October 1999 to 31 March 2000. The second series of auctions was held in March 2000 for the six month period of 1 April 2000 to 30 September 2000 and a third series was held in August. The fourth series of auctions for the period 1 April to 30 September 2001 is currently underway.

In addition to releasing MSEC, Transco also releases a monthly interruptible system entry capacity product as well as daily firm and interruptible products. A within day capacity market was introduced on 1 June 2000. This within- day capacity mechanism allows Transco to release and buy-back firm capacity on the gas day. All capacity sold by Transco is released through an auction process.

The introduction of the within day capacity market has generated a number of concerns from shippers that bidding errors may rise due to the increased speed of transactions. These concerns have resulted in a number of discussions and Network Code modifications that have been directed towards developing mechanisms for preventing errors from occurring and for addressing errors when they have occurred including the resolution of disputes regarding payment of entry capacity invoices.

In May 2000, Powergen UK (Powergen) raised modification 402 '*Referral of entry capacity disputes to the Energy Balancing Credit Committee*'. It proposed that all existing and future entry capacity disputes should be referred to the Energy Balancing Credit Committee (EBCC). This committee consists of both shippers and Transco. It was originally set up with

certain rights and responsibilities relating to the management of the industry's risks associated with credit and energy balancing.

Ofgem directed Transco not to implement this proposal because we considered that the EBCC was not an appropriate forum to deal with transportation disputes. Ofgem considered that the main role of the EBCC is to oversee the energy balancing credit risk of the industry, in order to minimise the industry's exposure to the financial risk of potential default by an individual shipper.

In the decision letter, Ofgem expressed its concern about the lack of provisions for dealing with manifest errors within the daily entry capacity regime. Ofgem encouraged Transco to initiate discussions with shippers in order to develop an effective systems solution for dealing with these errors.

Since these discussions commenced a number of modification proposals have been raised on the issue of shipper bidding errors. These proposals included Modification Proposal 0432 '*Definite Gate Closure times for Daily System Entry Capacity*' and Modification Proposal 0419, '*Avoidance or correction of shipper errors in purchasing and selling entry capacity*'. In addition, Transco has recently initiated the development of daily capacity bid validation screens for shippers.

On 31 January 2001, Ofgem approved Modification Proposal 0432. 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 bid allocations. As such, Ofgem 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.

The modification proposal

Powergen has proposed that error management arrangements, incorporating shipper error avoidance mechanisms and manifest error provisions similar to those operated by EnMo on the OCM, could be applied to Transco's daily system entry capacity products to enhance the efficient operation of the daily entry capacity market.

In particular, Powergen has proposed that Transco be required to develop optional volume and price warning limits when shippers enter data on to the RGTA capacity system. The proposal sets out the following minimum limits:

- upper and lower bid/offer price limits;
- upper and lower bid/offer volume limits;
- upper and lower percentage tolerance limits from the last trade price; and
- a display of the price of the last trade.

Powergen has also proposed shipper manifest error correction provisions to apply to daily capacity trades with Transco. These provisions would allow shippers to request for a trade to be unwound within [10] minutes of a bid or offer being accepted by Transco. In making such a request, the shipper in question would be required to pay a non- returnable 'administration' fee of [£5000] for each request to have a trade voided.

The proposal also requires Transco to develop 'Manifest Error Guidelines' describing typical circumstances under which Transco would declare a shipper trade void. Subject to these guidelines Transco would, at its discretion, void a trade within [10] minutes of a shipper submitting a manifest error request. For the purposes of Transco's Price Control, non-returnable 'administration' fees would be treated as normal transportation revenue.

Respondents' views

Shipper bid validation

Of the five responses received two expressly supported the inclusion of shipper bid validation mechanisms in the Network Code. Two other respondents expressed their support in principle for the development of capacity bid validation mechanisms. One of these respondents however indicated it was uncertain as to whether it was necessary for bid validation functionality to be included in the Network Code. One respondent expressly opposed the inclusion of formal bid validation requirements in the Network Code. This respondent indicated that it should not be a function of the Network Code to provide risk management services to shippers. This respondent also questioned the need for the inclusion of bid validation mechanisms in the Code when Transco had already undertaken to develop these measures.

Manifest error provisions

A number of respondents indicated their support for the introduction of a manifest error process.

One respondent expressly supported the proposal indicating that the manifest error arrangements that have been proposed are essential in helping to prevent distortions to the capacity market that may otherwise result in their absence.

One respondent indicated it may be appropriate to introduce a manifest error mechanism but commented that the charge associated with voiding a trade should be sufficiently high to ensure that it is used only for legitimate manifest errors. The respondent also noted that shippers and Transco should be capable of operating to the timetables required by any new procedures.

Whilst there was general support for the introduction of a manifest error process, several shippers outlined a number of reservations with the proposal.

One respondent suggested that the proposal could be simplified through the use of a paper-based process that would sit outside of the RGTA system. The respondent also expressed reservations about Transco fulfilling a central role in processing manifest error claims and using its discretion to void bids, particularly given the existence of its capacity incentive. This respondent also indicated that before a manifest error service is introduced the Manifest Error Guidelines must be developed in sufficient detail.

Two respondents indicated that they did not support this aspect of the proposal. Both indicated that it was not appropriate to support the proposal as the Manifest Error Guidelines have not been sufficiently defined.

One suggested that the current proposal failed to take into account the dynamic nature of the capacity market and the impact of Transco voiding a transaction on shippers through the capacity allocation process. This respondent also outlined concerns that there would be fundamental problems with allowing a counter-party to all trades to be the sole arbiter of whether a trade may be a valid manifest error, particularly when the arbiter has a capacity incentive to maximise daily capacity revenues.

Ofgem's view

As indicated in our letter approving Modification 0432, Ofgem shares the concerns of industry participants regarding the lack of provisions for dealing with manifest or system errors by Transco and shippers. In addition, we are supportive of the discussions that have occurred in recent months on the issue of manifest errors.

However, Ofgem has a number of concerns regarding the nature of the Powergen proposals.

Shipper bid validation mechanisms

In relation to the proposal to require Transco to develop capacity bid validation measures Ofgem does not believe that there is sufficient justification for these measures to be developed as a matter of contract through a Network Code provision. Indeed, Ofgem considers that the inclusion of detailed bid validation facilities may also restrict the ability of Transco to respond to requests to adjust or improve the capacity bid validation mechanisms should this be necessary. In addition, Transco has already made significant progress in the development of a range of capacity bid validation mechanisms thus rendering any Network Code obligation unnecessary.

If in the future it becomes apparent that Transco is not making sufficient progress in the development of the proposed capacity bid validation mechanisms, Ofgem would be willing to re-consider a proposal of this nature.

Manifest error provisions

Ofgem considers that there are a number of valid concerns raised by the industry regarding the development of manifest error provisions that require Transco to decide upon the validity of a bid. In particular, Ofgem believes that is inappropriate for Transco to act as the sole arbiter of manifest error requests. As a number of respondents have indicated, Transco is a counter party to capacity trades and has financial incentives relating to daily capacity revenues. As such, Ofgem does not believe Transco is in a position to act as a sufficiently independent sole arbiter on these matters irrespective of the nature of any Manifest Error Guidelines that may be produced.

In addition, Ofgem has concerns that the manifest error proposals raised by Powergen are not sufficiently suited to the capacity market which is largely dynamic in nature. In particular, Ofgem notes the concerns that have been raised regarding the impact of voiding a capacity trade on the capacity bid stack and allocation process. Ofgem is not convinced by the argument put forward by the proposer that capacity bids are considered independently. Indeed, Ofgem recognises that the voiding of a capacity trade is likely to impact on other shippers' bids. In this regard, Ofgem does not believe that the proposal has been sufficiently developed to address these issues.

Some participants have argued that Modification proposal 0419 should be implemented on the basis that it is similar in form to the Balancing Mechanism manifest error proposals being considered under NETA. Ofgem has however compared the two proposals and has identified some significant differences. Of most significance is that under the NETA proposals manifest error requests will not be assessed by the transmission system operator. Instead it is proposed that all requests will be assessed by an independent adjudicatory body.

Another difference is that under the Powergen proposals manifest errors in the capacity market would need to be corrected immediately whereas under the NETA proposals manifest errors are addressed on an ex-post basis, and where possible prior to any initial settlement run.

There are a number of reasons why it is more important that errors are corrected immediately in the capacity market compared to the Balancing Mechanism. First, unlike the acceptance of bids and offers in the Balancing Mechanism, capacity market allocations may be subsequently traded on secondary markets on the gas day. If manifest error provisions were to be included in the capacity market, it would therefore be necessary to rectify any volume-related errors as quickly as possible to minimise the impact on secondary markets.

Second, the Balancing Mechanism and contract notification arrangements under the Balancing and Settlement Code incorporate the concept of a 3½ hour Gate Closure. As such bilateral trading of bulk electricity will necessarily have ceased for the settlement period in which an erroneous price has been submitted. Further, all bids and offers will have been submitted into the Balancing Mechanism. As a consequence, the impact of an error in the Balancing Mechanism on bilateral contracts markets and subsequent trades in the Balancing Mechanism is likely to be limited when contrasted to the impact of a volume error in the capacity market.

By way of summary, Ofgem does not believe that the manifest error mechanism put forward in this modification proposal merits implementation. Notwithstanding this, Ofgem would encourage industry participants to continue to develop an appropriate set of manifest error provisions and to build on the progress that has already been made in this area. In developing these mechanisms Ofgem believes that careful consideration needs to be given to the following matters, drawing where relevant on the work that has been undertaken to develop proposals in NETA:

1. The establishment of sufficiently independent procedures to address manifest error claims;
2. The extent to which manifest errors claims in the capacity market need to be addressed in real time;
3. The time scale within which a shipper can apply for a trade to be unwound;
4. The value of any fee that would need to be paid;
5. The criteria by which a manifest error is to be identified;
6. The nature of the remedial action to be taken once a manifest error has been identified, particularly with respect to the capacity allocation process; and
7. The extent to which any manifest error correction mechanism should apply to both shippers and Transco.

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

errors, it is noted that these are currently the subjects of Modification proposals 0436, '*Correction of Transco errors on the RGTA capacity system*' and 0437 '*Remedies for Transco's failure to honour its entry capacity commitments*'. Ofgem will shortly be releasing its decisions on these proposals.

Ofgem's decision

Ofgem does not support this modification proposal as we do not believe that Transco should be the sole arbiter of manifest error claims on the RGTA capacity system. In particular, Transco's position as a counter party with a direct financial interest in the trades undertaken on this system would undermine the effectiveness of any manifest error determination process. As such, Ofgem does not believe that the manifest error mechanism that has been suggested will achieve its objective of reducing distortions in the capacity market or enhancing operations in the daily capacity market. As a result, Ofgem does not believe that it will better facilitate the securing of effective competition between relevant shippers and suppliers in the capacity market.

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 outlined under Standard Condition 7 of Transco's Public Gas Transporter's licence.

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

Yours sincerely

Mark Feather
Head of RGTA