

Direct Dial: 020-7932-6337

29 August 2000

BG Transco, Shippers and Other Interested Parties

Our Ref : Net/Cod/Mod/0413

Dear Colleague,

Modification Proposal 0413 'Compensation Payments Following Transco's Failure to Meet Entry Capacity Contractual Commitments'

Ofgem has considered the issues raised in Modification Proposal 0413: '*Compensation Payments Following Transco's Failure to Meet Entry Capacity Contractual Commitments*'. Ofgem has decided not to direct BG Transco to implement the modification, because we do not believe that this proposal will better facilitate the relevant objectives of BG 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

On 4 July 2000, during BG Transco's processing of bids for daily capacity for the following day, 5 July 2000, a software error occurred on BG Transco's UK/RGTA Capacity System that resulted in a duplication of identical shippers' bids. In addition, the daily firm auction for capacity at the St Fergus terminal was processed twice thereby allocating additional capacity to the terminal. Having identified the error, BG Transco took the decision at approximately 18.00hrs D-1 to data fix the RGTA Capacity System and reset the allocations to remove the effects of both duplicate bids and the dual processing of the day ahead auction at St Fergus.

Following these events a number of shippers expressed concerns that BG 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 the 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.

In this context, a modification proposal has been raised to establish a mechanism for compensating shippers in respect of BG Transco errors in buying or selling capacity on the RGTA Capacity System. The modification proposal is intended to apply both prospectively and retrospectively, such that it may apply to the events of 4 July 2000.

The modification proposal

It is proposed that in instances where BG Transco sell or buy capacity on the RGTA Capacity system and it subsequently amends or voids such actions, BG Transco shall compensate all holders of capacity at the particular terminal. The amount BG Transco shall pay, should be equal to [2*] the overrun charge at the particular entry point or [1.706 p/kWh], whichever is the greater for each kWh of capacity that BG Transco has failed to buy or sell. The overrun charge will be calculated with reference to 'constrained' days as outlined under Modification

408 '*Review of Entry Overrun Charges*,' which will be implemented on 1 October 2000. The compensation mechanism will apply to all errors made on or after 1 July 2000.

Respondents' views

The overwhelming majority of respondents were in support of the modification. Respondents generally felt that it was unacceptable that BG Transco should be able to unwind trades as a result of its unique position in the market, whereas shippers have to suffer the consequences of their own manifest errors. Most respondents suggested that BG Transco's actions on 4 July 2000 constituted a clear breach of its Network Code obligations and that a mechanism was necessary to ensure that BG Transco is exposed to the costs to shippers of its mistakes. Many of the respondents commented that BG Transco's action has led to significant direct costs for shippers.

One respondent did not support the modification on the basis that costs were not targeted at the party that caused the error, although it did agree with the general consensus that BG Transco's unilateral action was unacceptable. Another respondent indicated that it did not believe that the modifying the Network Code to establish a compensation mechanism would facilitate the relevant objectives when the Network Code does not actually address or set out the actions that BG Transco should undertake in the event that such an error occurs.

A number of respondents indicated that they were supportive of the modification in principle but expressed concerns regarding the compensation mechanism. One shipper commented that the mechanism was too penal whilst another indicated that it was potentially too weak. Several shippers also suggested alternative compensation mechanisms. One respondent raised concerns that the original bids for sale or purchase of capacity (prior to the resetting) will be included in the overrun calculations indicating that no consideration had been given to the secondary impact of this feature of the modification on shippers who were not directly involved in the resetting of capacity allocations.

One shipper indicated that the overrun charge element of the compensation mechanism should be calculated on the basis of the existing overrun regime which retains an energy link in the overrun calculation rather than the new overrun regime which is scheduled to commence from 1 October 2000 following Ofgem's acceptance of the revised Modification 408 '*Review of Entry Overrun Charges*'. This shipper suggested that the retention of the energy link should be retained in circumstances where shippers have chosen to purchase gas from the NPB because of the perceived need to renominate beach contracts, to within reduced capacity limits (i.e. the overrun regime in place prior to the implementation of Modification

Some shippers commented upon how any compensation payments are to be funded, suggesting that BG Transco should meet the full costs of any compensation.

Several respondents commented on the need for a mechanism for dealing with both Transco and shippers manifest errors in the future. In this context, some shippers suggested that a mechanism be put in place that allows a party to a trade to declare an error and withdraw from the transaction within a short period of its acceptance. This would occur subject to agreed rules and permission being granted by a designated arbiter and subject to the payment of a fee.

Ofgem's View

Ofgem has not in general been supportive of modifications to BG Transco's network code that contain retrospective elements. We do not believe that in this case there is sufficient justification particularly in view of some of the concerns that have been expressed by

participants regarding certain elements of this proposal. In particular, Ofgem accepts the view that has been put forward during the consultation that the compensation mechanism proposed is not necessarily related to the losses suffered by individual participants. Indeed, Ofgem considers that the compensation mechanism is arbitrary and could result in some participants receiving excessive compensation whilst others may be under compensated. In these circumstances Ofgem does not believe that this modification should be implemented either retrospectively, or prospectively.

Notwithstanding this, Ofgem does not believe its decision on this modification proposal should preclude future modifications being raised that suggest alternative compensation mechanisms to address errors that have been made by BG Transco. However, Ofgem also believes that before any compensation mechanisms are put in place it would be beneficial for a procedure to be agreed regarding the actions that BG Transco should undertake in respect of future system errors. In particular, Ofgem believes that it is more appropriate for the error to be addressed through an agreed form of remedial action to minimise the potential commercial costs that may be imposed on shippers and the distortions that may be imposed upon the gas market.

In this regard we share the industry's concerns about the lack of provisions for dealing with manifest or system errors either by BG Transco or shippers. In our decision letter for Modification Proposal 0402 *'Referral of Entry Capacity Disputes to the Energy Balancing Credit Committee'* we made it clear that it was important that a mechanism should be put in place to prevent the occurrence of manifest errors. In this regard we welcome BG Transco's plans to implement validation systems for shippers entering data onto the RGTA capacity system from 1 December 2000 for dealing with shipper manifest errors. We also note that Powergen have put forward Modification Proposal 419, *'Avoidance or correction of shipper errors in purchasing and selling entry capacity'* that also proposes the development of bid validation procedures as well as a manifest error correction mechanism similar to that operated by EnMO on the OCM and the mechanisms suggested above. Ofgem however are, as indicated above, also concerned that procedures and mechanisms should be put in place to deal system errors caused by BG Transco such as the error that occurred on 4 July 2000. We would therefore, encourage BG Transco to develop such provisions.

Ofgem share shipper's concerns about BG Transco actions on the 5 July 2000. Likewise, Ofgem believe that BG Transco's decision not to honour its obligations and annul the trades is questionable. BG Transco as well as all other parties have an obligation under BG Transco's network code to honour all capacity trade contracts registered on the system. Arguably this particular error should have been dealt with through the invoking of the buy-back mechanism with BG Transco agreeing to bear the full costs (or a proportion of the costs) should it have been deemed necessary in view of the amount of capacity that was released. It is worth pointing out that if a shipper makes such an error, it suffers the consequences of such action. It does not appear fair that one party should have the liberty to render its own mistakes 'null and void'.

Ofgem believes that BG Transco and shippers should, as a matter of urgency, seek to put in place suitable operational and contractual arrangements to deal with this situation going forward. As stated above, Ofgem's preference would be that BG Transco should use the buy back mechanism to deal with any erroneous capacity releases. It will then be necessary to determine what BG Transco's exposure to the costs of any buy-backs should be. Clearly, BG Transco is best placed to mitigate the risks associated with the systems and software it develops and operates. If BG Transco is exposed to the costs associated with system or software errors this will provide it with appropriate incentives to develop robust systems. However, as any system, no matter how carefully designed and tested may lead to the occasional error, it may be appropriate to cap Transco's exposure or only expose it to a proportion of the costs incurred under certain circumstances.

Whilst, not condoning BG Transco's behaviour on 4 July 2000, Ofgem welcomes BG Transco's without prejudice offer to consider providing appropriate compensation in relation to direct losses reasonably and demonstrably incurred as a result of the systems error.

Ofgem's Decision

Taking all the considerations above in to account, we have decided not to consent to this modification, as we believe that it does not conform to the relevant objectives as outlined under Standard Condition 7 of BG Transco's Public Gas Transporters' licence.

If you have any queries in relation to the issues raised in this letter, please feel free to contact me on the above number.

Yours sincerely,

Stephen Smith
Director, Trading Arrangements