Modification Report
Remedies for Transco's failure to honour its Entry Capacity Commitments
Modification Reference Number 0437
Version 2.0

This Modification Report is made pursuant to Rule 7.3 of the Modification Rules and follows the format required under Rule 8.9.3.

1. The Modification Proposal

This proposal provides remedies should Transco, as a consequence of an earlier error, choose to void transactions. A complimentary Modification Proposal "Correction of Transco errors on the RGTA Capacity System", is designed to clarify Transco's actions following such errors and should be considered concurrently.

The obligations outlined in Modification Proposal "Correction of Transco errors on the ROT A Capacity System" should make it absolutely clear to Transco what they should do should circumstances similar to those of the 5 July happen again. However, it does not prevent Transco acting in a fashion that is again contrary to the code. A remedy is required to protect shippers from the consequences of Transco failing to meet entry capacity contractual commitments. It is not enough for Transco to undertake to cover shippers "direct losses reasonably and demonstrably incurred". Such fine words are welcome but in practice shippers (and Transco know this) fmd it difficult to clearly demonstrate direct loss particularly if such losses involve substitute gas purchases at the NBP.

In all likelihood Transco will still make errors in their use or operation of the RGTA capacity system -in some cases these errors may not become apparent before it is too late. Hence, this proposal advocates the following remedies for shippers should they fail to meet Network Code obligations:

In the case of any transactions for the sale of capacity amended or voided by Transco:

(a) Shall be required to pay an amount under the capacity incentive (Section B2.11) equal to 1 00% of the value of the transactions voided or amended by Transco on that day.

Shippers shall for that Gas Day have the right to overrun at the relevant ASEP up to the quantity of capacity Transco has failed to honour. The failure to honour quantity shall be determined relative to the time at which Transco voids such a transaction as follows:

$$CV = CEOD \times (t + r) / 24$$

Where:

CV = the quantity of capacity against which a shipper would have a legitimate right to overrun against at the relevant ASEP.

CEOD = the end of day capacity that a shipper believes he has in good faith purchased on the RGT A capacity system.

t = the period of the gas day (in hours) which had elapsed at the time of Trans co voiding transactions.

r = a reasonable number of hours [say 2 hours] to enable affected shippers to renominate down deliveries at the relevant ASEP.

(b) Any overrun charge payable for overrun quantities, which are less than or equal to the value of Cv at the relevant ASEP shall be charged at a rate equivalent to the daily capacity reserve price. Any overruns in excess of this quantity shall be payable at the normal rate.

(c) Transco shall pay MSEC holders at the relevant ASEP amounts specified under Section B 2.11 based on the income from sales of daily capacity expected prior to any amendment or voiding of such trades by Transco. Such payments shall be considered as part of the Capacity Incentive Cost specified in Section B 2.11.

In the case of any transactions for the purchase of capacity amended or voided by Transco:

(a) compensation shall be payable to shippers for each unit of capacity not honoured by Transco at a rate equivalent to the original accepted offer price prior to voiding or amendment of such transactions by Transco. Such payments shall form part of the Capacity Incentive Costs under Transco's capacity incentive (Section B 2.11).

The above proposals apply prospectively, are designed to be cost reflective and seek to provide every incentive on Transco to honour contractual commitments with shippers. The remedies for breach of Network Code aim to cover both shippers financial exposure (but nothing more) and to penalise Transco for poor performance through the capacity incentive mechanism.

2. Transco's Opinion

Transco does not support the application of compensation payments similar to that proposed for instances of failures arising from software programming. The elimination of the probability of such failure is subject to diminishing returns as the costs of preventative measures rise. The complete elimination of such failures is not a condition that could ever be guaranteed. That principle is acknowledged in the Network Code (U 7.1) where Transco and UK Link Users agree and acknowledge that it would not be economical for UK Link to be designed, built or operated so as to reduce the probability of its failure below a certain level, and consequently that such failures may occur. Further to this the Network Code (U 7.3) specifies that Transco will not be liable to any User or other UK Link User for the consequences of any failure, error or defect in or in the operation or performance of UK Link or any other part of the UK Link System. Transco considers that the position established in the Network Code is not unduly favourable for Transco and reflects an appropriate balance of commercial risk having regard to assumptions made as to development costs and time scales.

Not withstanding Transco's ongoing endeavours to establish and operate robust systems it does accept that operator error can occur but maintains that such errors can be remedied by application of the present Network Code arrangements. Those arrangements involve buy-back or sales of Daily System Entry Capacity.

Transco does not support a Proposal that would enable Users to flow gas at overrun rates that are effectively offered at a substantial discount from the overrun rates that are determined by the present Network Code arrangements. In circumstances where Transco has amended or withdrawn a transaction the affected Users would be provided with an ability to overrun at discounted rates. That is despite the possibility that the reason for voiding a transaction may have been to avoid an excessive capacity release. That suggests that the sum of the existing capacity released and the discounted overrun quantity will be in excess of anticipated transportation capability. That implies that application of the Proposed rules would increase the probability of transportation constraints occurring. In such circumstances the Users who have been provided with a discounted overrun will not be able to take part in capacity management by way of offering buy-back capacity and the reduced pool of available capacity that can be offered for buy-back may tend to drive up constraint management costs. It can be expected that the outcome described would also increase standard overrun charges.

Transco does not believe that it is consistent to offer compensation for not honouring capacity transactions whilst simultaneously making available some of the requested capacity at discounted rates. It would appear that if a transportation right is offered, which is suggested by provision of discounted overrun charges, then that quantity should not be considered for further compensatory payment.

3. Extent to which the proposed modification would better facilitate the relevant objectives

Transco does not believe that the Proposal would further the relevant objectives. In particular, the Proposal implies that systems reliability should be increased beyond a level that might be considered economically efficient. Alternatively the proposal might lead Transco to become more risk averse in developing its systems leading to a reduction in the responsiveness of the UK LINK system to change. This could mitigate against rapid system changes being available to better facilitate economic and efficient operation of the system.

4. The implications for Transco of implementing the Modification Proposal, including

a) implications for the operation of the System:

On application of the proposed rules uncertainties may be expected to arise because the provision of discounted overruns in addition to the primary release of capacity is likely to be in excess of transportation capability. The probability of constraints will therefore be expected to rise.

b) development and capital cost and operating cost implications:

An additional form of overrun charge will need to be developed to enable this Proposal to proceed.

c) extent to which it is appropriate for Transco to recover the costs, and proposal for the most appropriate way for Transco to recover the costs:

It is anticipated that development costs would be part of allowed revenue.

d) analysis of the consequences (if any) this proposal would have on price regulation:

No consequences are anticipated.

5. The consequence of implementing the Modification Proposal on the level of contractual risk to Transco under the Network Code as modified by the Modification Proposal

The level of contractual risk for Transco is increased by this proposal to require Transco to fund compensation payments from its capacity incentive. The Proposal may also increase the probability of transportation constraints which could drive higher buy-back costs.

6. The development implications and other implications for computer systems of Transco and related computer systems of Users

Transco has designed and developed the RGT A systems in accordance with time lines that have as far as possible been formulated to fit the urgent status accredited to these developments by all parties including, Users, Of gem and Transco. If a greater burden of risk associated with systems development is now placed upon Transco then it is probable that more extensive validation processes will be manifested in longer lead times to build new or modify existing systems.

7. The implications of implementing the Modification Proposal for Users

If implemented, the Proposal will provide recompense for Users who may be affected by Transco's failure to honour its entry capacity commitments. Risks of buy-back and higher overrun charges will be increased if the Proposal is implemented.

8. The implications of implementing the Modification Proposal for Terminal Operators, Consumers, Connected System Operators, Suppliers, producers and, any Non-Network Code Party

No implications are anticipated.

9. Consequences on the legislative and regulatory obligations and contractual relationships of Transco and each User and Non-Network Code Party of implementing the Modification Proposal

The proposal is in conflict with existing Network Code provisions concerning the service levels to be attained in software development and operation.

10. Analysis of any advantages or disadvantages of implementation of the Modification Proposal

Advantages
The Proposal could encourage Transco to more thoroughly test new developments prior to implementation
The Proposal could incentivise Transco to put in place further procedures to mitigate the risk of errors.
The Proposal would provide recompense for Users affected by Transco's failure to honour its Entry Capacity commitments.

Disadvantages
Systems development costs would increase.
Systems development lead times would increase.
Transportation constraints would be more likely on occasions when the proposed rule is invoked.

11. Summary of the Representations (to the extent that the import of those representations are not reflected elsewhere in the Modification Report)

A total of eight respondents made representations to the Modification Proposal.

Of these, the following three express support for the proposal:

Powergen (PG)
Yorkshire Energy (YE)
TXU Europe Energy Trading (TXU)

The following five respondents do not express support for the proposal, although one of these (Aq) expresses support for the intention of the proposal:

Scottish and Southern Energy (SSE) Northern Electric and Gas (NEAGL) Alliance Gas (AGL)
British Gas Trading (BGT)

Aquila (Aq)

General Comments

PG and TXU express the view that it would seem prudent to compensate shippers directly for the costs involved with the removal of some or all of the capacity they were allocated. PG state further that Transco's performance should be judged against output measures and that it is irrelevant to shippers how an error (e.g. systems errors) occurs. It states that Transco should not be able to avoid responsibility because of failures of their systems.

Although TXU express support for the proposal~ it is unhappy with the proposal that the compensation would be passed through the capacity incentive as this then requires holders of ASEP to pay for a percentage of Transco's mistakes.

Of those respondents not expressing support for the proposal, AGL suggests that Transco should communicate any over allocation of capacity as soon as possible to the Industry and bear 100% of the costs. It further suggests that audit procedures are put in place to ensure Transco declares such an event and that other options are discussed in order for the Industry to agree a workable solution. SSE "has sympathy" with the intentions of the Modification Proposal but does not give the proposal full support at this stage. It suggests that a compensation mechanism should be more fully discussed following the outcome of the consultation on Modification Proposal 0436 and when there is further clarification over the circumstances under which Transco would be deemed to be in breach of the Network Code.

NEAGL believes that the present Network Code arrangements with respect to manifest errors are sufficient until there is further discussion on a mechanism to clearly define when a manifest error has occurred.

Aq states that it does not favour implementation of the modification proposal until the compensation procedures put forward in the proposal are given greater consideration.

Transco's Response

Further to Transco's views set out in Section 2 of this report, in considering any proposed compensation package to be introduced, Transco believes that it is important to take account of how such an error has arisen in order to understand the purpose of such a compensation mechanism. Although Transco recognises that the cause of such an error may be irrelevant to the shipper, it nevertheless needs to be considered whether specific liabilities are appropriate. Transco continues to be of the opinion that performance levels of computer systems cannot be set to 100% without a matching acceptance of the need for significantly increased investment in those systems to build out all possibility of error.

Transco agrees with shippers' concerns expressed on possible interactions with the capacity incentive mechanism. Transco also agrees that it is difficult to consider an appropriate compensation packages in advance of understanding the outcome of modification 0436 and therefore the circumstances in which Transco could be placing itself in breach of Network Code.

Transco is willing to discuss the principle of audit procedures in respect of declaring errors, although it is of the view prior to that the industry needs to agree a suitable definition of error in the context of capacity allocation for which Transco may be deemed to be liable to make compensatory payments.

Overrun Charges

PG states that modification proposal 437 does not advocate discounted overrun charges, but the protection from inappropriate overrun charges should Transco cancel sales of capacity within-day when shippers have already flowed gas against such capacity. It further argues that shippers need to be protected from the normal overrun charges and that it is incorrect to suggest that capacity sales would be in excess of transportation capability, nor that there would be any greater likelihood of a system constraint.

YE recommends a change to the formula to better reflect the principle that shippers should be permitted to overrun by a quantity of gas that was landed under the trade and during the period when the shipper believed that the trade was valid. It further argues that any overrun charge payable should be set a level equal to that which was bid and accepted under the trade.

Aq and BGT argue that where overrun charges have been waived, and shippers are charged just the reserve price for capacity, may create an incentive for shippers to try and flow more gas than they otherwise would for the 2 hours after the error declaration, and would increase the amount of capacity in the market and therefore the amount that would have to be bought back. Aq expresses the view that it would be better for shippers to pay the price they originally bid rather than the reserve price. BGT argue that this effect would lead to an increase in overall capacity costs.

Transco's Response

Transco considers that if additional capacity is released, it is most likely to constitute an 'error' if it increases total availability beyond the physical capability of the system. If that physical capability had not been exceeded then it becomes difficult to conceive of an error having occurred. Granting overrun capacity at favourable rates could then increase the probability that Transco will be driven to seek remedies through buy-back in addition to voiding all erroneous transactions as proposed. Buy-back under such circumstances could increase costs for other parties whilst the compensated Users are granted favourable rates of overrun charge.

Transco agrees with the respondents that have expressed some doubt about how the proposed formula is intended to operate. It is not clear whether the proposed formula suggests a period, t, which takes into account a period from the start of the gas day up until the time at which the error is declared or if it is intended to identify a time period for which the erroneous increment of capacity has be held by a User prior to declaration of the error.

Impact on economic efficiency and costs

BGT argues that the modification proposal will lead to an increased risk of the caps and collars being breached, particularly on a monthly basis. It further argues that by increasing the risk of this collar being breached by increasing buy-back requirements by permitting overruns, that the overall cost to shippers of capacity management will increase.

PG argues that Transco's view of economic efficiency is too narrowly focused. The cost-benefit, it further argues, should take account of the significant shipper costs or lost revenues that can result from Transco's errors.

Transco's Response

Transco agrees with BGT that the modification proposal, if implemented, could lead to greater risks of increased costs for both Users and Transco.

Transco is placed under a duty by its licence to establish transportation agreements that are calculated to achieve the efficient and economic operation by the licensee of its pipe-line system in a way that is consistent with its duties.

12. The extent to which the implementation is required to enable Transco to facilitate compliance with safety or other legislation

Not applicable

13. The extent to which the implementation is required having regard to any proposed change in the methodology established under Standard Condition 3(5) or the statement furnished by Transco under Standard Condition 3(1) of the Licence

Not applicable

14. Programme of works required as a consequence of implementing the Modification Proposal

A new form of (discounted) overrun charge would need to be developed.

15. Proposed implementation timetable (including timetable for any necessary information systems changes)

Transco does not recommend implementation of this proposal

16. Recommendation concerning the implementation of the Modification Proposal

Transco does not recommend implementation of this proposal

17. Restrictive Trade Practices Act

If implemented this proposal will constitute an amendment to the Network Code. Accordingly the proposal is subject to the Suspense Clause set out in the attached Annex.

18. Transco's Proposal

This modification Report contains Transco's proposal not to modify the Network Code and Transco now seeks agreement from the Director General in accordance with this report.

19. Text

As Transco is not in support of this proposal no legal text is provided

Signed for and on behalf of Transco.

Signature:

Tim Davis
Manager, Network Code

Date:

<u>Director General of Gas and Electricity Markets Response:</u>

In accordance with Condition 7 (10) (b) of the Standard Conditions of Public Gas Transporters' Licences dated 21st February 1996 I hereby direct Transco that the above proposal (as contained in Modification Report Reference **0437,** version **2.0** dated **26/01/2001**) be made as a modification to the Network Code.

Signed for and on Behalf of the Director General of Gas Supply.

Signature:

The Network Code is hereby modified with effect from, in accordance with the proposal as set out in this Modification Report, version **2.0**.

Signature:

Process Manager -Network Code

Transco

Date:

Annex

1. Any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which The Restrictive Trade Practices Act 1976 ("the RTP A"), had it not been repealed, would apply to this Agreement or such arrangement shall not come into effect:

(i) if a copy of the Agreement is not provided to the Director General of Gas Supply ("the Director") within 28 days of the date on which the Agreement is made; or

(ii) if, within 28 days of the provision of the copy, the Director gives notice in writing, to the party providing it, that he does not approve the Agreement because it does not satisfy the criterion specified in paragraphs 1(6) or 2(3) of the Schedule to The Restrictive Trade Practices (Gas Conveyance and Storage) Order 1996 ("the Order") as appropriate

provided that if the Director does not so approve the Agreement then Clause 3 shall apply.

2. If the Director does so approve this Agreement in accordance with the terms of the Order (whether such apgroval is actual or deemed by efflux ion of time) any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which the RTPA, had it not been repealed, would apply this Agreement or such arrangement shall come into full force and effect on the date of such approval.

3. If the Director does not approve this Agreement in accordance with the terms of the Order the parties agree to use their best endeavours to discuss with Ofgem any provision (or provisions) contained in this Agreement by virtue of which the RTP A, had it not been repealed. would apply to this Agreement or any arrangement of which this Agreement forms part with a view to modifying such provision (or provisions) as may be necessary to ensure that the Director would not exercise his right to give notice pursuant to paragraph 1 (5)(d)(ii) QL 2(2)(Q)(ii) of the Order in respect of the Agreement as amended. Such modification having been made, the parties shall provide a copy of the Agreement as modified to the Director pursuant to Clause 1 (i) above for approval in accordance with the terms of the Order.

4. For the purposes of this Clause, "Agreement" includes a variation of or an amendment to an agreement to which any provision of paragraphs 1(1) to (4) in the Schedule to the Order applies.