Transco, Shippers and other Interested parties

Our Ref: net/cod/mod/0437
Direct Dial: 020 7901 7437
Email: mark.feather@ofgem.gov.uk

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Dear Colleague,

Modification Proposal 0437 '*Remedies for Transco's failure to honour its entry capacity commitment*'

Ofgem has considered the issues raised in Modification proposal 0437 '*Remedies for Transco's failure to honour its entry capacity commitments'*. 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 may 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 0437 jointly with its decision on modification proposal 0436.

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 including 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

This proposal which has been raised by Powergen aims to provide protection to shippers from the consequences of Transco's actions should it in future void or amend capacity contracts as a consequence of an earlier Transco error.

This proposal advocates that should any transactions for the sale of capacity be amended or voided by Transco, it must adhere to the following:

a) Transco shall be required to pay an amount under the capacity incentive (Section B2.11) equal to 100% 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 Aggregate System Entry Point (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 it has purchased in good faith on the RGTA capacity system.

t = the period of the gas day (in hours) which had elapsed at the time of Transco 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 charges 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 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).

Powergen indicates that the proposals are intended to be cost reflective and are intended to provide Transco with the incentive to honour contractual commitments with shippers. In particular, the proposal is intended to covers shippers' financial exposure and to penalise Transco for poor performance through the capacity incentive mechanism.

The proposal was raised in conjunction with Modification proposal 0436, *'Correction of Transco errors on the RGTA Capacity System'*. This proposal forms the subject of a separate decision letter.

Respondents' views

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

Views against the proposal

A number of participants raised concerns at allowing shippers to overrun against any voided capacity rights for a [2] hour period following the declaration of an error.

One respondent commented that whilst providing a degree of protection for those shippers with transacted trades, the proposal would increase the amount of capacity in the market and therefore the amount that would have to be bought back in the event of a constraint. The respondent indicated that the proposal was therefore likely to lead to increases in overall capacity costs as Transco would only void transactions in circumstances where it believed that constraints were likely.

Another respondent, whilst supporting the intent of the proposal, suggested that by requiring shippers to pay only the reserve price for capacity in respect of any capacity overruns the proposal may create an incentive for shippers to flow gas more than they otherwise would within the [2] hour period. This respondent considered that it would be better for shippers to pay the price they originally paid for the capacity rather than the reserve price.

This respondent also indicated that the compensation procedures invoked in the event of Transco voiding capacity transactions require further consideration.

One respondent indicated that whilst mechanisms should be developed to address capacity system failures both modifications 0436 and 0437 were not workable. The respondent indicated that if Transco overallocate capacity it should communicate this as soon as possible to the industry and bear 100% of the costs.

Another respondent indicated that it believes that the present Network Code arrangements with respect to such errors are sufficient until such time as a mechanism can be developed to identify manifest errors. This respondent also considered that as a principle Transco should bear 100% of the costs of its errors, and resources would be better deployed in developing a robust and transparent system for identifying such errors.

One respondent whilst expressing sympathy with the proposal, indicated that it was difficult to comment constructively on the modification until a decision had been made on modification 0436, and until Ofgem clarified in a letter to the community whether Transco was indeed in breach of the Network Code on 5th July 2000. This respondent suggested that a decision on this proposal be implemented pending the outcome of Modification 0436 and that a further consultation be initiated following this decision.

Views supporting the proposal

One respondent indicated that it is prudent to compensate shippers directly for the costs involved with the removal of some or all of their entry capacity they were originally allocated. In addition, the respondent indicates that allowing shippers to overrun for the capacity they have already flown against and allowing them time to turn down without incurring penal overrun charges will avoid punishing shippers unnecessarily. However the respondent express concerns regarding any compensation being passed through the capacity incentive as this then requires holders of monthly system entry capacity to pay for a percentage of Transco's mistakes.

Another respondent indicated its support in principle but suggested some changes to particular elements of proposal. First, whilst supporting the principle that shippers should be permitted to overrun a quantity of gas that was landed under a trade and during the period when the shipper believed that the trade was valid, the respondent suggested that the formula proposed did not reflect this principle. The respondent therefore outlined an amendment to the formula.

This respondent also suggested that any overrun charge that is payable by the shipper with respect to the use of capacity that was the subject of a voided trade should be set at a level equal to that which was bid and accepted under the trade.

Powergen also submitted a response to its own proposal which was intended to clarify various aspects of the compensation mechanism and the arrangements for determining appropriate levels of overrun charges to be payable by shippers that flow against capacity that has been the subject of a voided trade.

In this response Powergen indicates that the proposal was not intended to advocate discounted overrun charges, merely protection afforded to shippers from overrun charges that would apply should Transco cancel sales of capacity within-day when shippers have already flowed against capacity rights. Powergen indicates that shippers cannot unflow the gas they have already flowed and that it is incorrect to suggest that capacity sales would be in excess of transportation capability thus creating a greater likelihood of constraints.

Powergen also indicate that the cost of overrunning was set at the reserve price as a matter of simplicity. However, Powergen indicate that the cost of overrunning could equally be set at the original accepted bid prices.

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 also 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 indicates that it does not support a proposal that enables users to flow gas at overrun charges that are effectively offered at a substantial discount to the present overrun rates. Transco is concerned that the proposal would enable shippers to overrun at discounted rates potentially increasing the probability of transportation constraints and potentially increasing the cost of constraint management.

Transco argue if a transportation right is offered, which is suggested by the provision of discounted overrun charges, then that quantity should not be considered for further compensatory payment.

Transco believes if this modification is implemented, this could lead to greater risks of increased costs for both Users and Transco.

Ofgem's view

Ofgem welcomes the discussion that has surrounded both Modification 0436 and 0437 and agrees that Transco should be exposed to a proportion of the costs associated with system software or human errors. However, Ofgem has a number of concerns regarding this proposal and believes that any manifest error arrangements that apply to Transco should form the subject of a more comprehensive process that addresses both Transco and shipper manifest errors in the capacity market.

At the outset, Ofgem considers that any approval it gives to Modification 0437 may potentially legitimise any future actions that Transco may take to void any capacity transactions that occur as a result of a systems or human error with respect to Transco's capacity allocation or buy-back processes. As outlined above, Ofgem has made clear on several occasions that Transco's actions on 4 July 2000 represented a breach of the Network Code and that in our view, Transco is obliged under the Network Code to use the capacity buy-back mechanism to address any erroneous capacity increases. Ofgem notes in this regard Transco's acknowledgement in its Final Modification Report that errors be remedied through the application of the present Network Code arrangements which involve buy-back or sales of Daily System Entry Capacity.

Ofgem does not therefore believe that Transco would be acting within the scope of the Network Code by voiding capacity trades in similar circumstances to those that arose on 4 July 2000. Accordingly therefore Ofgem believes that this modification is somewhat flawed by virtue of its underlying assumptions. Instead, Ofgem believes that industry resources would be better focussed upon developing arrangements that formally address the occurrence of Transco manifest errors and which efficiently allocate the costs associated with these errors. A number of the issues that the industry needs to consider in developing these arrangements are outlined in Ofgem's decision with respect to Modification 0436.

Notwithstanding this, Ofgem has a number of concerns regarding particular aspects of the proposal which are outlined below.

First, Ofgem is concerned by the proposal to allow shippers to overrun against voided capacity rights subject to the payment of a discounted overrun charge. In the first instance Ofgem agrees with respondents that allowing shippers to flow gas under these arrangements may in some circumstances encourage shippers to bring gas onto the system within the fixed [2] hour time period thereby potentially creating constraints on the transportation system.

Clearly this would lead to additional costs associated with the management of these constraints.

Ofgem acknowledges the views expressed by Powergen that shippers cannot remove the gas that has already been entered onto the system. However, as one respondent indicates, the creation of a right to flow against a discounted overrun charge may nevertheless create perverse incentives on shippers to flow gas that may not have otherwise flowed should the normal overrun arrangements apply during the [2] hour period. Further, Ofgem considers that the existing capacity buy-back mechanism would effectively ensure that any additional capacity entitlements granted to shippers as a result of an error can be honoured. In particular, if Transco buys back capacity to address an erroneous capacity release then a shipper's additional capacity entitlement is ensured and at least one shipper at the relevant terminal will reduce its flows over the remainder of the day.

Ofgem therefore believes that the application of any form of discounted overrun charge has the potential to create additional costs and prejudice the efficient operation of the system. Ofgem notes in this regard that shippers are under a licence obligation not to prejudice the safe and efficient operation or the efficient balancing of the National Transmission System. To consent to this modification would potentially condone a form of conduct that is inconsistent with these obligations.

Ofgem also believes that the proposals to require Transco to pay an amount under the capacity incentive equal to 100% of the value of the transactions voided are somewhat arbitrary given that the opportunity cost associated with having that capacity withdrawn from the market will vary depending on whether individual participants have traded gas on the basis of the capacity rights that were allocated to them.

Ofgem's decision

Ofgem does not support this modification as we believe that allowing discounted overruns for the voided transactions, while providing some protection for those shippers with transacted trades, would potentially increase the costs of managing system constraints and may prejudice the safe and efficient operation of the National Transmission system. In this context, Ofgem does not believe that the proposal would better facilitate the efficient and economic operation of the NTS.

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