

Direct Dial: 020 7901 7433

08 November 2001

Transco, Shippers and Other Interested Parties

Your Ref:

Our Ref : Net/Cod/Mod/467

Dear Colleague,

### **Modification Proposal 467: Suspension of the Neutrality and Compensation Value Audit**

Ofgem has considered the issues raised in modification proposal 467: ' Suspension of the Neutrality and Compensation Value Audit'. Ofgem has decided to direct Transco to implement the modification, because we believe that the proposal will better facilitate the achievement of the relevant objectives of Transco's Network Code. The modification will be implemented with immediate effect.

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

#### **Background to the proposal**

Transco is required by the Network Code to appoint an auditor to review neutrality and compensation value charges in order to assess whether these charges have been allocated appropriately. Neutrality charges include incentive charges, reconciliation charges and transportation charge adjustments. Compensation charges relate to a liability package, which Transco pay if it does not meet its standards of service obligations. It is Transco's responsibility to tender for and appoint the auditor, on behalf of the shippers, which is overseen by the Neutrality and Compensation Value Audit Sub-Committee and the Network Code Committee. Since the audit is prepared on behalf of the shippers, Transco passes the cost of the audit to shippers through the neutrality charge. The cost of the audit is approximately £200,000 per year and is smeared to shippers according to throughput.

The contract for auditing neutrality and compensation value payments was initially issued to PriceWaterhouseCoopers for a three year period. Three full audits have been completed between March 1996 and March 1999 and two further extensions to the contract were issued. Firstly a six month extension to the PWC contract was issued for an audit between March 1999 to September 1999 which ensured that the review covered a full gas year. Finally, a further three month extension was granted for the period between October to December 1999 to review the Neutrality payments (following changes to the Energy Balancing regime) and the compensation value payments (following the introduction modification 204, Amendment to Standards of Service).

In order to continue auditing neutrality and compensation payments Transco would have to re-tender for the audit contract

### **The modification proposal**

Throughout the audit period the Neutrality and Compensation Value Audit Sub-Committee has noted that the auditors have not identified significant errors in neutrality and compensation value payments. The modification has been proposed to suspend future neutrality and compensation value audits based on the sub committee's view that the cost of the audit outweighs its benefit. The suspension allows for shippers to reinstate the audit in the future if they believe it to be necessary.

The audit may be reinstated either prospectively or retrospectively following consultation at the Network Code Committee and obtaining Condition 9(3) approval/disapproval from Ofgem. Whilst a shipper may approach the committee at any time to request that they vote on this issue, the committee will discuss the reinstatement of the audit at the start of every gas year. Shippers should note that if agreement is reached to reinstate the audit there will be a delay before it can be completed due to the time it will take Transco to tender for and appoint an auditor.

### **Respondents' views**

Four representations were received of which two supported the modification proposal; one had no objection to the proposal and one opposed implementation of the modification proposal.

The respondent who opposed implementation argued that the audit would be necessary to review changes to Transco's existing invoicing systems and processes following current proposals to amend the energy balancing regime. Also, the respondent believes that unanimous agreement amongst shippers would be difficult to obtain and suggests that the audit should be suspended only once a stable energy balancing regime is established.

One respondent stated that Transco demonstrated, at a Network Code Committee meeting, that its internal controls for compliance were sufficient.

Furthermore, Some of the respondents note that the audit has a limited scope and as such provides little value. One respondent suggests that instead of an external audit a dedicated workgroup could review the processes in areas of operation where shippers are most exposed to the charges and where self verification is not possible. The respondent suggests that information from Transco's own audit or from any audit on Transco which Ofgem initiates could be used to confirm whether the neutrality and compensation value charges are being allocated correctly. In response Transco proposes that these suggestions, including the idea of establishing a workgroup, should be discussed at a future Network Code Committee meeting.

### **Ofgem's view**

Ofgem sympathises with the concern regarding the need for an audit whilst changes to the energy balancing regime are being made. We believe that it is the responsibility of Transco to demonstrate to shippers that its internal procedures are sufficiently robust to comply with these changes as they occur. If shippers remain concerned that the charges are not being allocated appropriately then action should be taken by shippers to reinstate the audit or establish a workgroup as suggested by one respondent.

To the extent that the majority of shippers believe that the audit is no longer necessary or appropriate given its limited scope and cost to shippers, Ofgem agrees that it is appropriate to suspend the audit for the immediate future.

It should be noted that the reinstatement of the audit will require majority, rather than unanimous, agreement.

## **Ofgem's decision**

Recent neutrality and compensation value audits do not appear to have found material errors in Transco's procedures for calculating neutrality and compensation value payments. Consequently, Ofgem believes that the cost of the audit to the shippers outweighs the benefits shippers may accrue. The reduction in neutrality charges as a result of the suspension of the audit will contribute to a more efficient and economic operation of the pipeline system.

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,

**Lisa Hughes**  
**Head of Network Code**