Final Modification Report
Modification Reference Number 0353
Liability mechanism for incorrect EUC apportionment (97/8, 98/9)

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:

The Proposal states that: "Transco update the Annual Quantity and other specified data each 1st October for non-daily metered sites. For gas years 1997/8 and 1998/9, Transco have made gross errors in the calculation and provision of this data to shippers. This has had the effect of Transco making excessive capacity charges for those impacted NDM supply points (around 40,000 per annum), which have subsequently been rebated. More seriously, shippers faced an undue increase in SOQ and deemed demand, which directly translated into increased purchase of deliverability assets, gas and increased commercial exposure.

This modification proposal places a transparent, market related liability on Transco to reflect some of the costs to the industry, both realised and carried through exposure to Transco's errors in calculating EUCs. This liability is proposed to be a bottom line hit to Transco and would not be recoverable through Neutrality or "k" factor. This Modification proposal only applies for Registered Users whose capacity for any affected sites is overstated by a net positive amount."

2.Transco's opinion:

This Modification seeks to recover liability payments from Transco for Shipper behaviour as a result of errors potentially affecting the EUC's of some larger Non Daily Metered, Industrial and Commercial supply points. Whilst the problem was first identified following the AQ98 Review, it also occurred during the earlier AQ97 Review. Having identified the issue, Transco took immediate steps to alleviate the potential effects on Shippers including:

Agreeing Capacity Withholds
Agreeing a resolution process
Reporting of affected meter points for reconciliation purposes.

As Transco was unable to automatically amend the affected meter points, due to data quality system risks, the resolution process allowed for those Shippers that appealed sites to be reimbursed for the associated administration costs.

In addition to issues associated with the resolution process, some Shippers expressed concern that inflated SOQ's gave rise to further 1 in 20 peak day exposure. During discussions with the EUC sub group, it was acknowledged that Shippers would employ a variety of strategies with regard to this risk, from purchasing additional storage to deferring any action. Depending on a Shipper's risk management policy and commercial circumstances, potential additional costs could vary significantly, with some Shippers incurring no costs at all.

Although sympathetic to Shipper concerns, Transco maintains that whilst the EUC misallocations may have increased risk, it does not follow that this translates directly into additional costs to Shippers. The methodology envisaged by the Modification Proposal seeks to reimburse affected Shippers for actions they may not have taken and costs they may not have incurred. Throughout this process Transco has consistently asked Shippers to provide evidence of additional costs: to date none has been submitted.

The Proposal indicates that a retrospective amendment to Sections H and V of the Network Code may be required. Transco remains of the opinion that retrospective amendments to Network Code, in general, do not further the terms of the relevant objectives. In this case, the Proposal seeks to apportion costs to Transco and does nothing to improve the commercial and contractual framework, as any errors have already been identified and addressed.

Section V. 8.1. of the Network Code provides that, “No Party shall be liable to any other Party for loss arising from any breach of the Code.” This includes, loss of profit, increased costs and any indirect or consequential loss. This is a standard feature of contracts and protects all parties against claims for consequential losses. Retrospective amendment to such terms would raise substantially the level of risk for all Parties and therefore potentially increase costs for the industry. Where appropriate, Transco has agreed liability mechanisms for specific processes and these are recognised and understood by all parties on a prospective basis.

Throughout discussions with Shippers, Transco has suggested that this Proposed Modification to the Network Code is unnecessary and inappropriate. Whilst acknowledging the difficulties of providing evidence of costs incurred, Transco believes that payment of liabilities without adequate proof of loss is difficult to reconcile with standard commercial practice. On this basis Transco reiterates its offer of 11 May 1999, that it is prepared to enter into confidential discussions with any Shipper that is prepared to furnish hard evidence of additional costs incurred.

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

This Proposal does not better facilitate the relevant objectives in that a Modification which seeks retrospectively to recover costs allegedly incurred due to past errors, which have been recognised and addressed, does not improve the contractual framework, under Licence Condition 7(1).

Instead the Modification is primarily a vehicle for certain Shippers to claim liability payments from Transco for unquantified loss.

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

a) implications for the operation of the System:

There are no implications for operation of Transco systems.

b) development and capital cost and operating cost implications:

There are no capital and operating cost implications for Transco.

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:

The Modification Proposal states that any liability payment should not be recovered by Transco. However Transco would expect that any liabilities contemplated would be considered within the discussions surrounding the regime introduced by Modification 204.

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

This Proposal will have no consequences on price regulation.

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 Proposal carries a significant level of contractual risk to Transco in that it retrospectively seeks to vary the terms of Network Code with regard to limitation of liability. Any decision which allowed for liability payment without hard evidence of loss could fundamentally alter the contractual balance. The precedent could leave Transco exposed to future claims.

The Network Code contemplates a level of risk accepted at the time by all parties and includes specific liabilities where agreed. Application of retrospective liabilities undermines the contract and could discourage development of the Code and future commercial initiatives.

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

There are no known development implications for computer systems of Transco or Users.

7. The implications of implementing the Modification Proposal for Users:

There are no known development implications for computer systems of Transco or Users.

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

There are no implications for these parties.

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:

Other than those affecting the Network Code as detailed in Section 5 of this report, there are no legislative, regulatory or contractual consequences of implementing this Proposal.

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

Advantages: Shippers affected by misallocated EUC's arising from the AQ '97 and AQ '98 reviews will receive liability payments..

Disadvantages: Retrospective amendment to Network Code increases level of risk to all Users and Transco, without improving the regime.

The Proposal does not require proof of loss and therefore allows for payment which may be substantially more than any actual loss incurred.

The principle of liability payment with no requirement to prove loss could set a precedent for future claims, undermining the contractual framework.

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

Representations on the draft Modification Report were received from British Gas Trading, Eastern Power and Energy Trading, Aquila Energy, Scottish Power, Quantum Energy Distribution and Yorkshire Energy, two of which were received after the closure for representations.

All respondents expressed support for the Proposal and four provided further comments as follows.

Aquila Energy argued that Transco should be liable for the costs it believed shippers incurred from the requirement to purchase additional peak gas supplies due to Transco's incorrect information on SOQs. "Such liabilities should be at least equivalent to the additional cost that the industry has incurred".

Aquila also expresses support for the Proposal to use BG Storage published prices to calculate shipper costs. Although accepting that shippers would have used a variety of methods to provide the additional gas supplies, it is felt that BG Storage prices are the most suitable indicator of the costs incurred.

Aquila stresses that shippers are dependent on Transco to provide correct information on site SOQs and hold the opinion that if errors are made in this process then the entire concept of a daily balancing regime is undermined. Aquila states that it is "incumbent on Transco to demonstrate that it is committed to maintaining the principles and concepts of the Network Code".

Scottish Power sets out the information sources it uses in order to assess its peak day requirements and the methods it used to source the additional requirement which arose from Transco's overstatement of I&C EUCs. Scottish Power also notes that there were consequential effects on gas profiles which manifested themselves in gas pricing distortions. These were difficult to quantify but had the result that shippers were exposed to gas supply costs which were different to those originally contracted for.

Scottish Power argues that the only option shippers currently have to gain compensation is through a legal route but the cost of pursuing this would be disproportionate to the monies involved. Scottish Power believes that Transco has failed in its PGT licence obligation to "manage it's business in an efficient and economic manner"

Scottish Power states that it is inappropriate for specific details of gas purchasing strategies to be divulged to Transco, although it would consider releasing information to Ofgem if it were prepared to act as an independent arbitrator. It therefore supports this Modification which it considers is a "pragmatic way forward".

Note: Scottish Power has requested that their response is not issued with the report due to the sensitive nature of the information provided.

Quantum Energy Distribution (QED) summarises the history of the EUC problem and stress that QED brought to Transco's attention the impact of the incorrect EUCs in February or March 1998, and expressed surprise at an earlier report by Transco on Modification 0234 which stated that EUCs did not affect demand attribution. QED therefore expresses support for the Modification, stating that Transco has been in full knowledge of the impact of the incorrect EUCs for most of the period in question.

Yorkshire Energy support the Modification as an appropriate, transparent solution to a situation that Transco has not taken reasonable steps to resolve, seeking to compensate shippers in a non discriminatory manner for the costs and risks incurred.

The change to shipper's gas profiles has resulted in shippers putting more gas in during the winter period. At an aggregate level this is compensated for by reductions in other NDM sectors, however this does not provide relief at individual shipper level.

Yorkshire Energy contend that linkage to Storage Prices is appropriate because:

Storage provides a lower cost market solution than beach swing or NBP prices.

Price transparency

Weighting to aggregate industry storage bookings

Equal treatment of the issue for affected shippers

Furthermore that section V8.1. of the Network Code does not apply as the costs are direct costs as a result of gross errors by Transco.

Yorkshire Energy also believe that if the Modification is not approved and Ofgem encourage Transco to make negotiated ex gratia payments some shipper claims may exceed the formula proposed.

Transco Response:

Whilst acknowledging its responsibility for the misallocation of EUC's, Transco does not believe a Modification Proposal is the most appropriate method for addressing this issue since it takes no account of shippers particular circumstances. Transco has offered to consider claims from those Shippers that can provide adequate proof of loss and would welcome any such approaches.

In particular the Proposal raises a number of issues and precedents which potentially undermine the contractual framework and are therefore strongly opposed by Transco:

1.Assigning liability payments without any requirement to prove loss.

Transco has consistently asked Shippers to provide proof of loss yet, despite the claims of some Shippers, none has been forthcoming. The principle of paying compensation in such circumstances is commercially unsustainable.

2. Retrospective amendment to the Network Code

Transco has consistently opposed retrospective Modifications which do not improve the current regime. A Proposal which seeks to impose a retrospective liability does nothing to further the relevant objectives.

3. Amendment to the consequential loss provisions of the contract

This clause of the Network Code is of a type commonly contained within many commercial agreements and protects all parties from consequential loss arising from each others actions. Retrospective removal of these provisions could fundamentally alter the balance of risk and reward for all concerned.

4. Precedent for future claims

Acceptance of the Proposal could give rise to the prospect of future claims where no requirement for proof of loss is needed.

Transco notes that whilst certain Shippers have claimed significant but unquantified commercial loss, this has not been reflected in the attention given to this Modification Proposal. Whilst all shippers were potentially affected by any EUC misallocations, only six have submitted representations, two of which were received significantly beyond the standard period for submitting representations. This may give some indication of Shippers own view of the importance and priority of this Proposal.

12. <u>The extent to which the implementation is required to enable Transco to facilitate compliance with safety or other legislation:</u>

The Proposal does not affect compliance with safety or other legislation.

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

Transco is not aware of any changes of methodology established under Standard Condition 3(5).

14. <u>Programme of works required as a consequence of implementing the Modification Proposal:</u>

No programme of works will be required.

15. <u>Proposed implementation timetable (inc timetable for any necessary information systems changes):</u>

Transco does not support the Proposal and therefore no timetable is provided.

16. Recommendation concerning the implementation of the Modification Proposal:

Transco recommends rejection of the Modification 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 to modify the Network Code and Transco now seeks direction from the Director General in accordance with this report.

19. Text;

Transco does not support the Modification and accordingly no text is provided. The Proposer has suggested unspecified amendments to Sections H and V of the Network Code.

Signed for and on behalf of Transco.

Signature:

Tim Davis
Manager, Network Code

Date:

Director General of Gas Supply and Electricity Response:

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 **0353**, version **1.0** dated **25/10/99**) be made as a modification to the Network Code.

Signed for and on behalf of the Director General of Gas Supply and Electricity

Signature:

Director of Transportation Regulation

Date:

The Network Code is hereby modified, with effect from , in accordance with the proposal as set out in this Modification Report, version **1.0**.

Signature:
Process Manager - Network Code
Transco

Date:

ANNEX

Restrictive Trade Practices Act - Suspense Clause

For the purposes of the Restrictive Trade Practices Act 1976, this document forms part of the Agreement relating to the Network Code which has been exempted from the Act pursuant to the provisions of the Restrictive Trade Practices (Gas Conveyance and Storage) Order 1996. Additional information inserted into the document since the previous version constitutes a variation of the Agreement and as such, this document must contain the following suspense clause.

1.Suspense Clause

1.1 Any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which this Agreement or such arrangement is subject to registration under the Restrictive Trade Practices Act 1976 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 paragraph 2(3) of the Schedule to The Restrictive Trade Practices (Gas Conveyance and Storage) Order 1996.

provided that if the Director does not so approve the Agreement then Clause 1.2 shall apply.

1.2 Any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which this Agreement or such arrangement is subject to registration under the Restrictive Trade Practices Act 1976 shall not come into effect until the day following the date on which particulars of this Agreement and of any such arrangement have been furnished to the Office of Fair Trading under Section 24 of the Act (or on such later date as may be provided for in relation to any such provision) and the parties hereto agree to furnish such particulars within three months of the date of this Agreement.

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