Modification Report
Correction of Transco Errors on the RGT A Capacity System
Modification Reference Number 0436
Version 1.0

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

1. The Modification Proposal

This Modification Proposal defines actions where Transco has made an error in the use or operation of the RGTA capacity system. The wording of the Modification Proposal was as follows:

"Should Transco in error commit to sell or buy capacity on the RGTA capacity system (whether due to system failures or human errors in placing or accepting bids/offers on that system) they will be obliged to correct such errors by means of counteracting transactions. In respect of the sale of too much capacity at an ASEP, Transco shall buy-back an equivalent amount of capacity within one hour of the error occurring and shall bear [20]%. Ideally this value should be 100% so that holders of MSEC do not have to pick-up 80% of the cost of a Transco mistake. In practice, however, there is no straightforward way to distinguish legitimate capacity sales from capacity sales made in error. Thus the rate has been set at the current sharing factor for the capacity incentive. Nevertheless it is important that the possibility of the principle of Trans co bearing all the costs should be enshrined in the Network Code -a method may be found to separate legitimate transactions from erroneous transactions in future. In respect of the buy-back of too much capacity at an ASEP, Transco shall sell an equivalent amount of capacity within one hour of the error occurring and shall only be entitled to receive [20]% Ideally this value would be set at 0%, but the value has been set at the current capacity incentive sharing factor."

2. Transco's Opinion

Transco does not support the application of compensation payments similar to that proposed, for instances of failures arising from its computer systems. 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 concept is acknowledged in the Network Code CO 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 CO 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 the position established in the Network Code is not unduly favourable and reflects an appropriate balance of commercial risk having regard to assumptions made as to development costs and time-scales.

Notwithstanding 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 agrees with the proposer that there is no straightforward way to distinguish legitimate capacity sales from capacity sales made in error. This is particularly the case for capacity that is offered within the confines of an incentive scheme. The incentive scheme is designed to encourage Transco to maximise the provision of entry capacity up to a point where incremental costs match incremental sales. If the Proposal were implemented costs would be generated by accepted shipper offers for buy-back capacity.

Under conditions where buy-back of entry capacity is required, for whatever reason, Transco does not believe that the least cost solution would be obtained by constraining Transco to complete all transactions within a limited time frame. Limits of this kind can be particularly detrimental under illiquid market conditions, which Transco argues is demonstrated by recent activity on the capacity buy-back mechanism. Such conditions would result in higher costs accredited to the capacity incentive and the setting of higher overrun charges at any affected Aggregate System Entry Point (ASEP).

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 implementation of the Proposal might lead to systems reliability needing to be increased beyond a level that might be considered economically efficient. Alternatively the Proposal may lead to Transco becoming more risk averse in developing its systems which may lead to a reduction in responsiveness to change.

The proposer may have intended to encourage a reduction in the frequency of events when Transco fails to honour its entry capacity commitments and in that respect the intent of the Proposal was to tend towards a more efficient system. However, in addition to the potential systems costs identified above, the Proposal would potentially generate additional costs (through the capacity incentive and overrun charges) for both Transco and Users. Transco believes that those costs would be higher than could be obtained if the present Network Code arrangements are applied. The potential for additional costs and uncertainties regarding their occurrence could tend to reduce efficiency.

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

a) implications for the operation of the System:

Transco might be required to develop operational guidelines to determine what constitutes an error in the primary capacity allocation processes. No additional uncertainties are expected regarding the physical operation of the system.

b) development and capital cost and operating cost implications:

No implications are anticipated in this subject area.

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:

Not applicable

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

No such consequences have been identified

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 would increased by this Proposal as it would require Transco to fund part (or all) of the costs arising from any higher than planned primary release of entry capacity. The proposed buy-back obligation would be invoked without regard to the probability of transportation constraints occurring, which is taken as the present indicator of need for buy-back.

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

Transco has designed and developed the RGTA 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 were now placed upon Transco then it is probable that more extensive validation processes would be required before future developments can "go live". The probable outcome of such a development would 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 would provide recompense for Users that were affected by Transco's failure to honour its entry capacity commitments. The Proposal would increase costs to be counted against the capacity incentive scheme. Users that hold Monthly System Entry Capacity (MSEC) are liable for 80% of capacity incentive costs. Users that overrun at ASEPs at which, and on the day when, a mandatory buy-back as required by this proposal has been invoked, would face increased overrun charges.

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

A requirement to buy-back capacity regardless of the presence of transportation constraints could increase uncertainty and the perception of risk for all parties associated with the gas supply chain.

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 might encourage Transco to more thoroughly test new developments prior to implementation.
The proposal might 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.
The circumstances when the proposed rules should be invoked are unclear Capacity incentive costs could increase
Overrun charges could increase whenever the proposed rules are invoked.

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

Eight representations were received of which three supported the Proposal.

These representations were from Aquila Energy (Aquila), TXU Europe Energy Trading (TXU), Scottish and Southern Energy (SSE), Northern Electric and Gas (NEAGL), Yorkshire Energy (YE), Alliance Gas (AGL), British Gas Trading (BGT) and Powergen.

General Comments

Powergen is of the opinion that any errors should be corrected through the market mechanism, therefore ensuring that contracts are honoured. Powergen believes that this is a fundamental basis for successful trading and notes that similar principles will apply to the National Grid Company in the electricity regime. Powergen also argues that Transco's cost-benefit analysis should take into account the costs or lost revenues for Shippers which result from Transco failures, as ultimately these costs will be passed through to customers.

Aquila is in support of Modification Proposal 0436 and the introduction of measures which would ensure that Transco follows a clear set of procedures when a manifest error occurs and is of the opinion that the voiding of capacity trades which was carried out by Transco on 5 July 2000 was "unacceptable".

AGL does not support the proposal although agrees with the principal that there should be a mechanism in place to address UK-Link failures which result in an over allocation of capacity. AGL suggests that the industry should discuss the issues further in order to achieve a "workable solution". SSE expresses a preference for Transco to develop its own "manifest error" procedures and included these in the Operational Guidelines if possible. NEAGL believes that the current provisions within the Network Code are sufficient until such time that a "robust and transparent" system can be introduced to identify when genuine manifest errors have occurred.

Transco's Response

Transco believes that the present capacity incentive arrangements offer sufficient means to remedy Transco operator error. However, a finite level of reliability must be associated with operation of computer systems. This principle, it believes is widely accepted and indeed is recognised elsewhere in the Network Code (07.1)
Instances of systems error could be reduced across UK LINK systems by a programme of further investment aimed at increasing performance levels. However, Transco does not believe that a cost-benefit analysis would support such an initiative.

Treatment of System failures.

Powergen argues that the manner in which a manifest error has occurred is irrelevant for Transco's customers and that Transco should not be able to avoid responsibility for errors which occur as a result of the failure of Transco' s IT systems. Powergen stresses that Transco should be treated in the same way as Shippers, which have to bear full financial responsibility for any type of error which they make.

Aquila also stresses that there should not be any distinction made between errors which occur as a result of system failures and human errors and suggests that the legal drafting for Modification 0436 should clarify that the proposals take precedent over the terms of Section U, which state that Transco would not be liable for costs arising out of the failure of UK-Link systems. YE also acknowledges the concepts with Section U7 of the Network Code.

Transco's Response

Transco recognises that Users may have concerns regarding IT systems reliability. It should be recognised, however, that a balance has to be struck for IT systems such as UK

LINK between cost and reliability. This underlines the concepts detailed in Section U7 of the Network Code, which gives Users considerable assurance on performance levels but recognises that an element of risk applies to all Users. Transco believes that any review of changing performance levels should include an assessment of the economic consequences and should take into account performance across the full range of UK LINK systems.

Transco does not consider it appropriate to adopt a "pick and mix" approach to the applicability of Section U. The UK LINK system supports processes set out in the Network Code and Section U should therefore apply wherever the UK LINK system is involved.

Time Period for Buy Back Actions

Aquila, TXU, SSE, NEAGL and BGT raise concerns over the proposal that Transco should take any necessary buy-back actions within one hour of the manifest error occurring. Aquila notes that this may not always be possible as on some occasions there may be some time before Transco realises that an error has occurred.

NEAGL raises concerns that the proposals for Transco to buy back within one hour of the error occurring would not result in the "least cost solution". NEAGL also advocates that Transco should have discretion in deciding the quantity of capacity to be bought back and not necessarily be required to take an action of the same magnitude in the reverse direction. TXU also believes it could result in Transco taking actions at some extreme prices, substantially increasing costs to Monthly System Entry Capacity holders. BGT argues that the proposal could lead to an escalation of overall capacity costs and as Shippers would bear 80% of these costs Shippers would bear significantly more of the costs associated with a manifest error.

Transco's Response

The representations rightly address some of the difficulties encountered in transactions where one party has restrictions to the time period during which a deal might be struck. It therefore agrees that the restriction on buy-back actions is one of the undesirable features of the Proposal.

Distribution of Buy Back Costs

TXU, NEAGL and BGT express the opinion that Transco should correct errors through the buy back mechanism and incur 100% of the costs of these actions. BGT adds that this Modification Proposal would offer "no incremental incentive on Transco other than the existing incentive regime".

YE proposes that the 80:20 split of buy back costs under circumstances when a manifest error has been made should be reviewed.

SSE and AGL also express support for the principle that Transco should bear 100% of the buy back costs arising from a manifest error. However, concerns are raised by both respondents that this may give Transco a "perverse incentive" to disguise manifest errors so it would only be liable for the nonnal 20% of buy back costs. SSE suggests that the circumstances under which the proposal would apply are not clear and, for example, questions

whether the onus would be on Transco to identify when a manifest error had been made. Both SSE and AGL suggest that audit procedures would also need to be established to monitor these queries where the manifest error claims would be audited.

SSE notes that if the sharing of costs associated with manifest errors is carried out on the same basis as the current capacity incentive then the companies which hold Monthly System Entry Capacity would incur more of the costs than Transco. SSE also argues that the proposal could have an adverse influence on the market price for capacity due to the fact that daily capacity transactions are incorporated into the calculation of overrun charges and therefore mitigating buy-back actions would have an impact on overrun charges.

Transco's Response

Transco agrees that there is no straightforward way of distinguishing legitimate capacity sales from capacity sales made in error. The Proposal acknowledges this problem and therefore argues that it would be difficult to effectively operate any error specific provisions that require a different set of cost sharing factors. In general the representations emphasise some of the adverse implications of the Proposal which indicate that another approach might be more suitable.

Impact on Capacity Incentive

SSE comments that it is not clear what the impact on the capacity incentive would be. BGT also considers that as the proposal envisages the costs being borne within the current incentive mechanism it could lead to an increased possibility of the caps and collars being breached on a monthly basis. BGT reminds that the risks of this have been detailed under Modification Proposal 0430 -Removal of Monthly Capacity Incentive Limit Amount and it raises concerns that "the overall cost to Shippers of capacity management will increase".

Transco Response

Transco agrees that this proposal does affect the risk profile for both Users and Transco.

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

No direct programme of works is necessary to implement the Modification Proposal.

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 **0436,** version **1.0** 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 **1.0**.

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 RTPA"), 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.