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Dear Colleague,

Modification proposal 636: 'Clarification of Gas Supply Emergency Claims Review Criteria'

Ofgem¹ has considered carefully the issues raised in modification proposal 0636 to Transco's network code, "Clarification of Gas Supply Emergency Claims Review Criteria"

Having had regard to the principal objective and statutory duties of the Authority, Ofgem has decided not to direct Transco to implement modification proposal 0636 because Ofgem does not consider that the proposal will better facilitate the relevant objectives of Transco's network code under standard condition 9 of Transco's Gas Transporters (GT) licence.

In this letter, Ofgem explains the background to the modification proposal and gives reasons for making its decision.

Background to the proposal

In the event of a network gas supply emergency (NGSE) such as a major supply loss, there are a series of principles in place which guide the process by which parties can claim for financial loss as a result of actions taken by Transco to resolve that NGSE.

Under the current arrangements, in the event of a NGSE, any user delivering more gas to the system than they take off will receive their daily imbalance multiplied by average SAP (System Average Price) over the past 30 days. Under delivery would involve payment to Transco at the average SAP of the past 30 days.

¹ Ofgem is the office of the Gas and Electricity Markets Authority. The terms 'Ofgem' and the 'Authority' are used interchangeably in this letter.

Any user who considers they have faced financial loss as a result of only being paid the relevant price may submit a claim for a higher price. Transco appoints an independent claims reviewer to review claims and advise on the justification of the loss.

Any fees and costs of the reviewer are paid for by Transco and then smeared back through neutrality charges.

Discussions took place within the CMIWG (Commercial Market implications Working Group) of the GEIEC (Gas & Electricity Industry Emergency Committee²) to consider these principles. As a result of working group discussions, Transco proposed a modification to refine or clarify some of these principles.

Comparison to the electricity industry

In the electricity industry, there are, to some extent, similar arrangements. Section G of the Balancing and Settlement Code (BSC) outlines the balancing and settlement arrangements that can be invoked in emergency situations. In these circumstances (after consultation with Ofgem), the Secretary of State may activate changes to the balancing and settlement arrangements including:

- ◆ specifying that a single cash out price be determined to reflect the price of bulk electricity in the relevant settlement period. This price can refer to reported prices and price indices (i.e. the price is intended to reflect the “market price for bulk electricity”); and/or
- ◆ limiting the prices for bids and offers to historic values.

Alongside Section G of the BSC, the Fuel Security Code (FSC) allows for the provision of compensation to generators. Compensation will be given if the Secretary of State determines that a generator has suffered exceptional loss in carrying out instructions issued via direction(s) given by the Secretary of State under Section 34 or 35 of the Electricity Act 1989 in relation to fuel security event, and the Secretary of State determines that it is acceptable for the generator to receive compensation.

The modification proposal

Modification proposal 0636 was proposed by Transco on 13 June 2003. This modification seeks to amend the arrangements relating to a NGSE as follows:

Principles for validating claims

It is proposed that in the event of a NGSE, claims by Users for financial loss would be subject to the following principles:

- allowed costs should be based on an appellant’s total costs and not the cost of an individual source;

² GEIEC is a DTI led committee comprising representatives from Ofgem and industry, and was established to consider emergency planning arrangements.

- intra-group transfers, those transfers that take place between subsidiaries within a body corporate, should be deemed to be made at market price;
- “windfall gains” should be netted off wherever possible;
- reasonable administrative/legal costs of making a claim should be allowed, but subsequent costs of pursuing a claim should not be;
- the above administrative/legal costs should be limited to 5% of the net claim; and
- net income from the value of electricity sold less cost of gas shall be taken into account in the case of a power station “directed on” under PGCA (Priority Gas Customer Arrangements) rules.

Discussion within the NT&T Workstream clarified and amended the original Proposal. This led to the:

1. withdrawal of the final bullet relating to PGCA rules;
2. changes to the definition of "intra-group transfers" and "market price"; and
3. recognition of treatment of "windfall gains".

Market Price

The Workstream suggested that there should be a three stage determination of market price:

1. if the market had not been suspended at the commencement of the Day, the SAP calculated from all the OCM trades that had taken place would set the market price for intra-group transfers;
2. if the market had been suspended at the commencement of the Day or Transco reasonably believed that this SAP was not market reflective it would propose a price to Ofgem for approval; and
3. if Ofgem did not approve Transco's proposed market price an expert would be appointed generally in accordance with Section T2 of the Network Code and that expert would determine the applicable market price.

Windfall Gains

The Workstream suggested that this issue would be solved by the satisfactory treatment of allowed costs based on an appellant's total costs. The principle accepted was that claims should be submitted on the basis of the net cost derived from all sources of gas delivered or procured by the User on that Day. This relied upon the assumption that the User would derive a benefit if its average purchase price of gas were lower than the cash-out price for that Day but would face a cost if its average purchase price were higher than the cash-out price.

Respondents' views

Transco received five responses to its consultation on this proposal. Three respondents were in favour of the proposal, with another offering qualified support, though all suggested that the proposal may benefit from further discussion and/or enhancements.

Three respondents stated that the present claims process lacks clarity and could lead to less support in the event of a NGSE. One of those respondents also thought that where users take

gas from a number of sources the modification will give clarity and avoid excessive legal and associated costs flowing through to balancing neutrality.

One respondent was uncomfortable with Transco being solely responsible for determining whether SAP was market reflective and that in the case where the market has been suspended, Transco should appeal to Ofgem for a decision on the relevant price. Another respondent felt that where the market has been suspended at the commencement of the day, SAP should be set to the previous day's SAP.

The same respondent agreed that 5% was an appropriate level for administration and professional costs, but sought guarantees that extra administration costs could not be pushed back onto users. However, one respondent felt that a 5% limit on legal costs does not accurately reflect the expense of making a small claim, suggesting instead that a sliding scale should be introduced with claims of up to 10% up to £250,000 and 5% on amounts thereafter.

One of the respondents sought greater clarification of legal text and defined terms in relation to all aspects of the windfall provision. Another respondent felt that windfall gains should be removed altogether, with costs being more reflective if they were based on the actions taken by a user for bringing additional gas to the market, in the event of a NGSE.

One respondent felt there may be difficulty in assessing appellants' total costs and there would be some benefit in discussing this further.

The one respondent not supporting the modification felt that it was underdeveloped and required further definition. The respondent drew particular attention to the potential losses on the electricity side emanating from imbalance costs. They also stated that the FSC should be taken into consideration and aligned with any potential changes.

Transco's view

Transco considers that the existing lack of clarity underlying the present claims process - where discretion exists - could be detrimental to the provision of support available from Users in the event of a NGSE. However, it considers that some discretionary element in the claims process is to an extent unavoidable as the claims reviewer needs to handle a wide span of consequences that might result from a NGSE.

The GEIEC workstream development process carefully considered the market price determination issue, and the principles were incorporated within the legal text that accompanied the Draft Modification Report, which were intended to reflect these discussions. It was noted, however, that whilst there had been development of alternative methodologies within the NT&T Workstream, there was no clear consensus that a satisfactory process had been developed for determining the market price. It was therefore appropriate to consider whether the approach advocated in the Draft Modification Report, or an alternative approach, would be considered preferable to the current position whereby the current Network Code leaves such discretion with the claims reviewer.

Transco, particularly in the light of the conflicting responses to this consultation, has considerable doubts as to whether a greater level of detail with respect to the determination of

market price within the Network Code would be helpful. Transco therefore does not recommend implementation of this Proposal.

Transco also noted that issues such as the applicability of a single legal cost cap and the derivation of appellants' total costs were, according to some representations, still unresolved. Transco therefore concludes that this Modification Proposal should not be implemented. Transco considers that this need not prevent any further discussion at the CMIWG of the GEIEC which might take into account changes in the Fuel Security Code. Additionally, should Users believe there might be scope for improvements to the Network Code in this area, it might be helpful to raise this issue as a topic in the NT&T Workstream which might provide a vehicle for the development of a new proposal.

Ofgem's view

Ofgem has carefully considered the views of all respondents and Transco on modification proposal 0636. Having had regard to its principal objective, Ofgem considers that this modification proposal does not better facilitate achievement of the relevant objectives of Transco's network code.

Ofgem supports in principle any modification that endeavours to clarify the current arrangements for claims in the event of an NGSE.

However, whilst there is some support for the modification from respondents, many have also raised concerns over areas of the modification that require further discussion. Transco as, the proposer, has in the light of these responses withdrawn their support and suggested the modification be rejected. On this basis, Ofgem is not satisfied that it has been demonstrated that the proposal would better facilitate any of the relevant objectives.

Ofgem's decision

For the reasons outlined above, Ofgem has decided not to direct Transco to implement this modification, as we do not consider that it better facilitates the achievement of the relevant objectives as outlined under Amended Standard Condition 9 of Transco's GT licence.

Way Forward

Ofgem notes that the proposal and discussions that led to the final proposal, do not appear to have considered in detail the potential interactions with the electricity system. The current electricity arrangements work in conjunction with the FSC. The arrangements in both gas and electricity could give conflicting signals. Any consideration of the current arrangements in gas needs to take into account carefully the interactions with the arrangements in electricity. Ofgem acknowledges that the GEIEC has been considering the appropriateness of the emergency arrangements over recent years. However, Ofgem does not consider this work has developed sufficiently in line with the concerns set out above. Hence a further review of the emergency claims review arrangements seems necessary.

In this context Ofgem notes that consideration of the emergency cash out arrangements can be undertaken by the cash out review working group³. Ofgem considers that this working group could further consider the issues associated with emergency cash out arrangements including those raised during the modification proposal 0636, recognising Ofgem's concerns regarding the interactions between gas and electricity arrangements and the potential for unintended consequences resulting from proposed modifications as highlighted in this letter.

Yours sincerely,

Steve Smith
Managing Director, Markets

³ Cash out review working group – following the Ofgem May 2004 consultation relating to cash out arrangements, Ofgem initiated a cash out review working group. This group is due to meet for the first time on 2 December 2004.