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Dear Kyran

National Grid Transco - Potential Sale of network distribution businesses

I refer to the above consultation documents published by Ofgem in July. In it, Ofgem outlines the regulatory approach it plans to take in the event that National Grid Transco (NGT) sells one or more of its network distribution businesses ("DNs").

Shell Gas Direct (SGD) is not concerned with whether NGT chooses to sell some of its assets to enhance shareholder value. This is a decision for it to take. However, we are concerned about many aspects that result from the potential sale. In summary, these are:

- **Timescales.** We are concerned that aiming to achieve a new framework that would allow for independently owned DN's by September 2003 is too hurried given the extent of work that needs to be done. The timescales must be driven by the project itself, not the other way around.
- **Resources.** Ofgem does set out how they plan to resource this project but it is clear that they will need to devote a considerable project team to this. Industry participants such as shippers and suppliers must be given the opportunity to provide input to any proposals but the substantial work must be undertaken by NGT and Ofgem. This is particularly the case given the extent of other Ofgem initiated projects and regular workstreams already underway.
- **Regulatory Impact Assessment (RIA).** The initial RIA is welcome but this document is not detailed enough to be able to base any firm conclusion upon it. A more detailed RIA must be produced and consulted upon by Ofgem before the Authority will be in a position to make a final decision on whether to allow the sale of a DN. The next RIA must take the "as is" position as given and use this as comparison. Projects which are likely to be taken forward in any case should be excluded from consideration.
- **Complexity.** For any sale to go ahead, there must be minimal impact on shippers and suppliers. Any other projects which Ofgem assumes to be beneficial for consumers and/or market processes, must be divorced from the sale off process. In particular, we are not supportive of using these circumstances as a way of pushing forward radical changes to the governance of the gas market, eg the introduction of SPAA.

Below, I outline in more detail SGD's views on many of the issues raised by Ofgem in its document and at the seminar earlier this month.

Regulatory architecture

The “gateway” concept adopted by Ofgem is a good way of approaching the decision making process in respect of this project. However, we do have concerns about the gateways being adopted and whether they are the right ones. We comment in more detail below about exit and supply point administration but note that we are not convinced that these are the correct gateways to choose. Ofgem should look at what is needed to carry out this project and only seek to include other areas of work where it can be demonstrated that they are a necessary part.

It would seem preferable for there to be separate licences for distribution and transportation. However, given the potential issues with the Gas Act etc, it appears to be a practical way forward for there to be transmission and distribution functions within the GT licence. We assume that this will not preclude further development of the licences, if this is felt necessary.

We consider that a uniform network code is the best way forward, at least initially. We are not convinced that there is great value in the networks developing separate arrangements, as this is likely to undermine effective competition between shippers and suppliers. Where there *may* be value in innovation etc is in having different management innovate on how well optimise opex, management skills etc (although we have reservations about the extent of this as set out under RIA). It is essential that the arrangements for shipping gas remain consistent wherever possible which a uniform network code should facilitate.

We would welcome the development of an offtake agreement. It is essential that this agreement is *published* and consulted upon before any sale goes ahead.

Exit and interruptions

As set out in the next section, we consider that there should be only a single SO with a single balancing point.

SGD is unaware of any reluctance by parties involved in discussing evolution of the interruptions regime to consider change. We are concerned, however, that any new arrangements should be developed to issues which have been clearly identified, instead of trying to fit prescribed solutions on to the present arrangements.

Ofgem has restated its previous policy on interruptions without acknowledging the extent of discussions to date nor the reasons for alternative viewpoints. We cannot understand how Ofgem can assert that specific problems exist without first doing the analysis which it commits to in further paragraphs. For example, it is possible that some interruptible consumers are being cross-subsidised by firm consumers, but it is also likely that cross-subsidies are working in the opposite direction. Transco pricing was originally developed to be cost-reflective but now there is a drive for the ‘value’ of interruption to be established. We would welcome a clear exposition from Ofgem regarding the circumstances it considers that a natural monopoly should have its assets priced in relation to ‘value’, perhaps with reference to the economic literature. We are not convinced that Ofgem has fully considered the potential to distort the competitive supply market when it seeks to base natural monopoly regulation on “market” prices.

We do not consider that full reform of the exit regime is necessary for NGT to be able to sell a DN. Some work in this area could be taken forward regardless of whether a sale goes ahead. Ofgem, as project manager, will need to ensure that the two streams of work are consistent. We do not think that interruptions reform should be squeezed into the timetable suggested for the DN sale. For example, we do not see that it is necessary to resolve having Transco or the DNs contract directly with customers for the DN sale project to go ahead. SGD was party to discussions amongst suppliers and consumers regarding the interruptions regime, "The Alternative Proposal".

While we can see that there could be value in allowing consumers to negotiate more bespoke arrangements with Transco, for the purposes of this project, we see no reason not to continue with administered prices. What we would welcome is a clear statement from the Authority regarding its interpretation of the Gas Act in respect of Transco contracting direct with consumers. In our view, it is this issue which is creating continuing delay to reform.

Gas balancing

The establishment of NBP trading is a key success of the development of liberalisation of the gas market in the UK and should not be undermined. Multiple SOs would fragment NBP trading and it is difficult to establish how multiple balancing points would provide 'locational signals' nor see that they have any value. Some have argued for few balancing points throughout Europe to ensure a liquid market and Ofgem should ensure that its approach does not undermine this.

We support the establishment of offtake agreements which must be published to ensure market transparency.

Ofgem's approach to the use of gas in the networks is not clear. We are not clear on whether the discussion on balancing accounts, linepack, balancing incentives, shrinkage and profiling are intended to be separately considered or could be taken forward as a package. We oppose any proposal which leads to gas being traded between the DN and SO, or DN and shippers. The DNs should be incentivised to concentrate on operating their systems efficiently, not competing with their consumers. We cannot see any value in having DNs provide different gas quality standards in their networks.

We note that Ofgem makes reference to the positions it has previously set out in respect of end-of-day linepack service, we must note that this has already been discussed extensively. Presumably, if a shipper felt that the introduction of such a service would be of value, a modification proposal to this effect would have already been raised. We are disappointed that Ofgem has not acknowledged, let alone addressed, issues raised by industry participants regarding how a linepack service could work, for example through M513 discussions. This raises questions about how Ofgem will approach developments should this project go ahead. SGD does not consider that a linepack service would provide any value to shippers to help balance inputs and offtakes over the day. We assume that if a shipper did see this development as necessary to the market, a modification proposal would have been raised by now. We recommend that nothing further is done in respect of a linepack service for shippers given the absence of a more comprehensive explanation of Ofgem's thinking in this area, including fully addressing issues raised during previous workstream discussions.

Supply Point Administration

An important gateway is to ensure that the sale of a DN does not lead to market fragmentation such that supplier/shippers had to deal with multiple systems. We consider it to be highly unlikely that variety in supply point administration (SPA) systems would create sufficient value in terms of innovation and efficiency gains to outweigh the costs on shippers and the negative effects on competition.

We do not concur with Ofgem's analysis on barriers to change with Transco's SPA systems and suggested solutions. Transco has licence obligations to a SPA system the costs of which are covered in its price control; it may be that future price controls should be more specific about what it is expected that Transco will deliver. The licence obligations themselves should provide sufficient incentive to ensure that it does not intervene with market developments. We cannot understand how new governance arrangements, such as those developed for the proposed Supply Point Administration Agreement (SPAA) would resolve problems which arise due to the integration of Transco's SPA systems.

We are perplexed by Ofgem's references to Elexon in relation to SPA. Although some parallels can be made between Elexon's settlement processes and those undertaken by Transco in gas, there are also a number of processes undertaken by MRASCo (Gemserv) which also parallel Transco's activities in relation to SPA, which should have been drawn out in the discussion. While there may be benefits in considering electricity arrangements when developing the gas market, we do not consider that this should necessarily lead to the assumption that the gas market should adopt the electricity model. We would note that the electricity model is not without problems. For example, there appears to be more problems with supply point transfers and billing in electricity than in gas which would suggest that making the electricity model mimic that in gas may be a better way forward. In any case, we have not been presented with information which makes the Elexon model attractive. SGD is aware of concerns being expressed regarding Elexon being value for money and overly bureaucratic. We are not convinced that this model would necessarily lead to improvements.

Transco's proposal for an agency appears sensible. We do not consider that any further, more radical change, should be included as part of this proposal. Ofgem has not yet responded to points raised in response to its recent consultation on SPAA. We are concerned that it is pressing ahead with the SPAA project without fully addressing issues raised to date, particularly by suppliers who only serve the industrial and commercial market. In referring to suppliers having control over managing the CoS process, Ofgem appears not to have considered the role of the shipper. We assume that Ofgem has not concluded (paragraph 7.13)

Furthermore, Ofgem has required the industry to consider issues with customer transfers. It is unlikely that this project will have identified solutions (it has yet to properly identify the issues) in time for proposals to be made regarding any DN sell-off. The agency may provide the best solution for the timetable proposed. It will be important to ensure that further evolution of the market, including potential new ownership arrangements are not prevented by the creation of an agency. However, we consider it to be very unlikely that alternative, robust arrangements can be put in place in the timescales suggested.

Regulatory Impact Assessment

We welcome Ofgem's commitment to using Regulatory Impact Assessments (RIAs) and recognise that the RIA contained in this document is necessarily preliminary. However, we do not consider that it is sufficiently complete to allow for proper consultation on the costs and benefits of any disposal to be made. It is therefore difficult to understand how the Authority will be able to use the RIA when deciding on the way forward in November.

As with other industry participants, we are concerned that there is an element of "double-counting" with this proposal. Benefits have already been claimed for the separate price controls for LDZs and it is not clear whether new benefits have been found or just the same ones are being counted. It may be that there are additional benefits to bench-mark regulation that cannot be captured through separate price controls but it is not clear that this is what has been included. We would welcome further clarity on this point. We have some reservations about the extent to which benchmarking can deliver value for consumers and the conflict between innovation and ensuring a simple system to allow for supply competition. The introduction of independent gas transporters also promised new approaches but this appears to have undermined competition for consumers on these networks. Ofgem has duties to protect consumers' interests by promoting competition in supply and we would recommend that caution is used in attempting to introduce "competitive" pressures for natural monopolies lest market competition is undermined.

We strongly recommend that the RIA is done comparing that status quo with the changes that would be introduced with any sale. We have made comments already on the reform of the interruptions regime above. We do not consider that it is necessary nor welcome to require significant change to the exit regime to be part of this project. Similarly, we do not support any proposal to make use of the potential sale to push forward on the introduction of radical change to the supply point administration regime and potential parallel introduction of SPAA. We do not consider that this approach has been adequately consulted upon nor developed by Ofgem to allow for its swift introduction.

Our most significant concern is that the RIA has not taken into account the impact of this project on other initiatives already underway in the industry. We do not agree with Ofgem's view that Transco's costs can be counted as neutral just because it will only press ahead if there is a positive benefit to its shareholders. What is important is the benefit for *consumers*. Already, Ofgem has established industry input into the customer transfer project, has established groups looking at credit, there are plans for end-to-end testing for RGMA in spring 2004, etc. Ofgem must take a view of which of these projects it considers to warrant the most industry focus. Some of these projects may affect Transco's systems and it cannot be guaranteed that they would not be delayed due to the work being done for separation. It should also be noted that given the size of the industry, it can be easy for small savings per consumer over several years to aggregate to a large sum. However, the saving per customer per year that Ofgem appears to expect is less than one would hope for with normal efficiency savings through supplier competition.

We would expect that any project to take this forward would have a steering group with shipper/supplier representation. However, detailed proposals will need to be worked up by Transco and by Ofgem. We are concerned that this document only gives bare outline to many ideas without any analysis of how they will work. Ofgem will need to be in a position to develop detailed analysis of Transco's approach as well as being able to detail its own alternatives. The industry should not be expected to do much more

than comment on these. Even with this, there is the danger that industry players will find it difficult to resource this project. In addition to the projects outlined above, there are already planned workstream discussions on reconciliation and ratchet charges.

We plan to raise these concerns in more detail in response to the consultation on Ofgem's plan. However, in Ofgem's November document, assuming the project goes ahead, it will be necessary for Ofgem to indicate how much resource it intends to devote to this project (including any consultants).

The way forward

We would welcome further consultation on the RIA once Ofgem has narrowed the range of options that it is looking at. It is only at this stage that industry participants will be able to meaningfully input comments on the costs that they will face to implement this project. The updated RIA should concentrate on the costs and benefits of this project absent other initiatives. The RIA must also take into account the potential for this project to affect the timescales of other projects and take this into account.

We recommend that, if this project is to go ahead, that Ofgem makes clear its resource commitment. It will be important that Ofgem will be able to fully participate in any workstream discussions, including presenting draft licence conditions etc.

Conclusion

SGD has no view on whether NGT should be allowed to sell one or more of its distribution networks (DNs). However, we have concerns about the impact of any sale on shippers and suppliers and have yet to be convinced that the full scope of work could be achieved by September 2004. We welcome the publication of an initial regulatory impact assessment, but consider that a more detailed one needs to be published before a final decision on this project can be made. Finally, we consider it important that the project to allow the sale of one or more DNs is focussed on this issue alone. Other projects, while they may be considered in parallel and may have an impact, should not be included within the scope of this project nor made essential to it.

Yours sincerely

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