Shell Gas Direct Limited

National Grid Transco – Potential Sale of network distribution businesses Agency and governance arrangements: Regulatory Impact Assessment

Shell Gas Direct Response

This paper sets out the views of Shell Gas Direct (SGD) on the issues raised in the document published by Ofgem on the Agency Regulatory Impact Assessment (RIA).

The table below outlines our view of the relative costs and benefits of the options presented by Ofgem. We have, where appropriate, assigned different criteria than that used by Ofgem to better reflect the areas which will be affected. The reasoning for our assessment is outlined in the rest of this paper. We also refer to a report carried out by Oxera for the Gas Forum which we expect to be forwarded to you shortly.

Table: Assessment of costs & benefits

Agency Option	None	A	B1	B2	C	D	E	F
Competition								
▪ Retail	xxx	x	x	x	x	x	x	x
▪ Transfers	xxx	x	x	x	x	x	x	x
▪ Wholesale	xx	-	-	-	-	-	-	-
▪ Metering	-	-	-	-	-	-	-	-
▪ Connections	-	-	-	-	-	-	--	x
Governance								
▪ non-discrimination	-	-	-	-	-	-	-	-
▪ cost & complexity	xx	-	x	x	x	x	x	x
Cost mitigation								
▪ Credit & cash collection	-	x	x	✓	✓	✓	✓	✓
▪ operations systems	x	✓	✓	✓	✓	xxx	xx	✓
▪ SPA systems	xxx	✓	✓	✓	✓	✓	✓	✓

Note: We have compared the proposed change versus the 'do nothing' (ie no sale of the DNs) as a baseline for comparison. This is consistent with Cabinet Office guidelines on conducting regulatory impact assessments and provides a more robust basis for comparison. In addition to '✓' and 'x'. we have also used a '-' where we consider that there will be no significant impact.

While there are areas where we support Ofgem's views, we do not consider that there is sufficient information and analysis in this document to fulfil the requirements for an RIA. and we expect that further documentation will be produced by Ofgem to justify its views. SGD does not have the resources to read all of the materials arising from the workgroups and it is not clear how and why Ofgem chose the criteria it has for judging

PO Box 219
11 Adam Street
London WC2N 6QA

Registered in England: No. 2405635
Registered Office: Shell Centre
London SE1 7NA
VAT Reg. No. 235 7632 55

Tel: 020 7257 0100

the alternative proposals for an agency as they do not appear to have been discussed with the workgroups. Prior discussion may have led to better criteria being chosen. Some of the criteria seem inappropriate and there are new items that should be included.

In common with Ofgem, we have referred to experience in the electricity sector where appropriate to the area of discussion.

Impact on consumers: supply competition and transfers

Barriers to entry and impact on supply competition

Ofgem does not appear to have fully taken account of the risk that this project may negatively impact on supply competition. This is an area where experience from electricity should be considered although we acknowledge that any comparisons need to taken into account that there were different starting positions in the introduction of supply competition into these markets. To date, the gas supply market has benefited from a relatively simple structure with a dominant provider of gas transportation, ie Transco[1]. The main contractual document has been the Network Code instead of the multiplicity of arrangements in electricity and Transco has provided uniform LDZ charging structures.

Analysis of supply competition demonstrates that new entry into the electricity market has been limited compared to gas. For the non-domestic market, Ofgem's most recent analysis,[2] shows that no new entrant[3] has been able to establish a market share of greater than 10% in any electricity volume band or by meter point and none has been able achieve greater than 5% except for British Energy. There are 9 new entrants who each have market shares of less than 5%. In comparison, in gas 6 new entrants have been able to establish market shares of greater than 5% by volume and/or supply points. Furthermore there have been double (18) the number of new entrants. This would appear to show that the current gas structure has better facilitated market entry. Indeed, the DTI's recent analysis of competition in electricity and gas supply shows less concentration for domestic, business and the industrial markets in gas than in electricity. The top 9 suppliers in cover 97.5% of the market while in gas, the top 9 only have 72.2%.[4]

Continued re-structuring of the gas industry to further replicate arrangements in electricity would appear to have the potential to have a negative impact on supply competition with commensurate negative impacts on consumers.

Oxera's research carried out for the Gas Forum[5] suggests that the higher on-going costs associated with all of the agency options may also raise barriers to entry by raising the minimum commitment level required to enter the market. Although Oxera's research does not bring this out, we consider that the costs of the DN sale will fall disproportionately on smaller shipper/suppliers as there will be some economies as supply points served increases. This may encourage exit from the market furthering

[1] We have, for the purposes of this response, not included the experience with IGTs.
[2] Review of competition in the non-domestic gas and electricity supply sectors, Ofgem, July 2003
[3] The use of former monopolies as a point of comparison is consistent with the analysis carried out in Ofgem's recent review of domestic supply competition. New entrants therefore excludes former monopolies, ie British Gas and the previous PESs in both markets.
[4] UK energy sector indices, Department of Trade & Industry, May 2004
[5] Cost and benefit implications of alternative agency option for sale of DNs, Oxera, May 2004

concentration. We would welcome further comparison between the impact on smaller and larger shipper/suppliers in future Ofgem documents.

Customer transfers

Ofgem has encouraged the industry to look at issues with customer transfers through the Customer Transfer Programme. Analysis to date has shown that the level of complaints about customer transfers is higher in electricity than in gas. In fact, no evidence has been provided that there are any significant problems with non-domestic gas transfers as the regime currently stands. In looking at impacts of the DN sale project on customers and transfers, consideration should be given to the impact on multi-site customers who, to date, generally have found fewer problems in transfers in the gas market than in electricity.

Ofgem notes that a fragmented regime will increase shipper costs, discourage market entry and weaken retail competition. We agree and it is for this reason that SGD, amongst others, have raised concerns that the potential introduction of SPAA will have these negative impacts, especially if supply point administration is split off from related shipper/supplier processes. We consider governance issues can be satisfactorily resolved without a complex, fragmented regime being introduced.

Analysis

Ofgem states that the DN sales process presents risks to retail competition but says little further about the impact that it will have. It appears that Ofgem assumes that the Agency will entirely mitigate the negative effects but no evidence has been presented to justify this assumption. It is not clear how Ofgem has determined that the benefits of the DN sale are greater than the costs, but it appears that the benefits of benchmark competition are being assessed against direct costs to shippers. A more realistic comparison would be to consider the benefits of benchmark competition against the potential negative effects to market entry and possible exit on supply competition taking into account lessons to be learned from the electricity experience.

Our analysis of the impact on retail competition in terms of market effects (entry and concentration) and on customer transfers is reflected in the table above.   We do not contest that the agency will mitigate the significant negative costs that could occur through market fragmentation but cannot agree with the suggestion that it will fully mitigate the effect, particularly in the short term. We see no reason for Ofgem to suggest that creation of the agency will have positive impacts as it is only meant to replicate the regime already in place. Ofgem suggests that a key objective is reform the SPA arrangements but neither through this process nor through the CTP project has any evidence been produced to suggest that its reform is necessary.

Wholesale competition

We have also set out above analysis of the effects of the DN sale on wholesale competition. It is only in respect of full fragmentation (“no agency”) that we can see that there would be any effect whatsoever. We are not convinced that the reform of the governance arrangements Ofgem is proposing is necessary to this project nor would have the benefits that Ofgem suggests. The potential for negative impacts are at minimum equal and opposite. We discuss this further below. There could be negative impacts on wholesale competition in terms of costs to systems based on which model is chosen. This is particularly in the case of Option D, as discussed below.

Competition in metering

We have considered the analysis presented in this paper about the impact on metering competition of the sale of the DNs. We have also noted the Ofgem presentation on metering and the DN Sale given to the regulatory architecture working group (RAWG) in late March. Given competition in metering, it is very difficult to see that there will be any effect on metering liberalisation by the sale of the DNs, or it will be so minor as not be worth counting.

Competition in connections

We have also considered the effect of the DN sales on competition in connections. We cannot see that there are any benefits (or costs) in terms of competition in connections resulting from this project. There is no reason to believe that the DN sale will encourage new entry into this sector.

As a supplier to non-domestic consumers, we do not consider that there are significant benefits to channelling requests through an Agency given the relatively low rate of transactions. Instead there may be increased costs due to increased administrative complexity. We are aware that domestic suppliers may have different criteria but our assessment is based on the impact on our business.

Agency models

We have considered the various agency models being proposed. We consider that the broad agency approach would ensure that shipper/suppliers and consumers can retain as much of the benefits of the current arrangements as possible. However, we do not support the introduction of a governance entity. This is discussed further below.

Ofgem states that it has not included the costs of setting up the agency as it considers that these should be covered by NGT. However, whether or not the sale goes ahead, NGT has pushed forward with the development of the agency. Shipper/suppliers incur costs in implementing this change and these must be included somewhere.

We have studied the various options put forward by Ofgem in structuring the agency. As these have not yet been developed in detail. it is not clear what all of the impacts of the various options will be and our views on based on the information available to date.

There will be additional costs involved in having separate credit and cash collection if this is done by each DN, instead of the agency. These are not significant but does suggest lower costs through an agency approach.

SGD has expressed concerns about the development of Gemini by Transco. However, we have understood that this system would replace the current RGTA system and then AT-Link functionality. This approach increases perception of regulatory risk as the industry should be allowed to develop systems without the regulatory intervention that this option would imply. We see no strong argument to split these activities in this way. If Option E were to be considered further, the full cost to the industry (Transco and Shippers) of discussions and developments to date would need to be considered, requiring a further RIA.

We agree with Ofgem that systems fragmentation for Option D would be costly; we consider it likely that these costs would be significant. We are not convinced by the argument that this would increase accountability. The comparison with electricity is not that strong given the difference in settlement between the markets and the role of AQs in gas. In the absence of new information, we see no reason for this to be considered again at a future price controls.

Governance arrangements

SGD supports Total's modification proposal 0679 "Formally Include the Network Code Modification rules within the Network Code". This modification, if implemented, would allow shipper/suppliers to have more influence over the modification rules and allow the industry to be able to decide on the level and pace of reform to the current governance arrangements. Although there have been some concerns about Transco's management of processes, in general we consider that the secretariat role performed by Transco for the Network Code processes have been carried out well and in a cost-effective manner. There is no requirement for major reform.

Our review of minutes of the Agency workstream does not indicate that there has been strong support to introduce a "Governance Entity". It is not clear, therefore, why it has been included in all but one option. We do not consider that the *potential* for discriminatory approaches is significant enough to justify introducing an Elexon-type arrangement. Ofgem separately has suggested that its powers are sufficiently robust to ensure future changes take into account effects on market participants. In taking into account the experience in electricity, we note that there have been concerns with Elexon in terms of value for money, ie it is felt to be expensive for what it delivers. Furthermore, it is considered to be overly bureaucratic and lacking in understanding of parties' businesses and in representing their views.

We continue to advocate *incremental* reform of the governance of the Network Code (and, in turn, the Uniform Network Code). We do not consider that the potential for discrimination is sufficiently significant to outweigh the expected extra cost of introducing a separate governance entity. It may be that future developments will demonstrate that a separate entity is required but this does not necessitate such change at this time.

Finally, we note that this is an area that is still under discussion through the DISG and assume that this will be the subject of further consultation in June.

Conclusions

Shell Gas Direct supports a broad agency approach absent the introduction of a governance agency. On the basis of our own analysis and the work done by Oxera, we consider that this will minimise costs to shipper/suppliers and therefore should minimise the costs passed to consumers. We also consider that this approach, with appropriate governance, should ensure that on-going costs associated with the risk further divergence should also be ameliorated.

However, given the level of information in this document and the extent of further discussion in workgroups, we do not consider that the options are well enough defined to be able to make final conclusions. We note in particular that further discussion on the Uniform Network Code at the DISG appear to cut across the discussion in this document on governance arrangements. We advocate incremental reform to the governance arrangement driven by industry participants.

We consider that a robust regulatory impact assessment must compare the status quo versus a range of alternatives. Instead, Ofgem has chosen to compare a "worst case" scenario (no agency) which has not been seriously considered as an option against a range of alternatives. We note that this issue was raised in the workgroups but consider that the explanation only served to raise questions about the processes Ofgem is adopting in considering the impact of the sale.

While SGD does not object to the sale of the DNs by NGT, we remain concerned that the analysis of costs and benefits carried out so far does not fully address the risks that it could have a negative impact on supply competition.

Tanya Morrison
Regulatory Affairs Manager

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