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Dear Sonia

Offtake arrangements

We refer to the above document published by Ofgem. This document discusses various commercial and regulatory options to apply to the interface between the National Transmission System (NTS) and the Distribution Network (DN) should National Grid Transco (NGT) sell one or more of its gas distribution networks. Shell Gas Direct (SGD) is a licensed shipper and supplier to non-domestic consumers. As we have set out in responses to previous consultations, we do not object to the sale of the gas networks. We are concerned, however, that in order to optimise the potential for there to be net benefits to consumers, changes introduced to permit any sale should focus on minimising costs and complexity for shippers and consumers.

SGD supports Option 1 for the allocation of NTS exit capacity. SGD strongly supports Option A for diurnal storage and operational flows: we consider this the only appropriate way forward. We consider that this approach will minimise the changes to the industry, reduces complexity and should ensure that this transition can be made with minimum disruption to consumers. Although this document has been labelled a regulatory impact assessment (RIA), we do not consider that it fulfils the standards that the industry reasonably expects given Ofgem's obligations under the Sustainable Energy Act. We set out our views and the various options being consulted upon further below.

Key issues

We have reviewed the issues set out by Ofgem. Although we agree that the issues outlined are of importance, we do not consider the weighting given to each is appropriate. Ofgem's principal duty is to protect the interests of consumers, wherever appropriate through the promotion of effective competition between shippers, transporters and suppliers. The promotion of competition should be considered only where appropriate, where it can be effective and where it best serves the interests of consumers. While Ofgem has made reference to these objectives, it needs to set out more clearly how these objectives could be met when it makes its decision. Furthermore, as Ofgem has stated its commitment to the principles of better regulation it seems appropriate to consider its approach against these principles.

Allocation of exit capacity

The current regime appears to provide a sufficiently robust approach to ensuring security of supply through the provision of exit capacity to meet peak demands. As part of the GT's Safety Case (as required by the Gas Safety (Management) Regulations), it must demonstrate that it has adequate arrangements in place to minimise the risk of a supply emergency. Under the Gas Act, gas transporters must meet any reasonable requests to convey gas to any premises. We had understood that by satisfying the GT licence obligation to provide transportation for a 1 in 20 winter, a GT could demonstrate it was meeting its Act and GS(M)R requirements. We cannot see how removing this obligation from the licence could improve the safety of the system. This approach could delay this project's implementation as the HSE will need to be satisfied that such significant change to the gas transporters' Safety Cases are justified. Furthermore, given current concerns about security of supply in terms of sufficient supply of gas to meet peak demand (as opposed to sufficient transportation) it is surprising that Ofgem is willing to risk changes to the regime at this time which could negatively impact the market's ability to resolve these concerns.

We do not consider the *potential* for undue discrimination to be sufficient to warrant significant change to the industry. This is neither proportionate to the "problem" and, as the problem is only theoretical, unnecessary. Given the duties of gas transporters under the Gas Act and licences to ensure that they do not discriminate, it appears to us that there are sufficient arrangements in place to ensure non-discrimination. The issue that Ofgem seeks to address relates only to transporters but its solution is not targeted at them but instead would result in considerable costs being borne by shippers and their customers. We see no reason for extensive changes to be put in place; any issue which may arise in the future may be satisfactorily resolved *ex post*.

In Ofgem's document on roles and responsibilities, an outline of arrangements in other countries or in the electricity regime were examined. We would have welcomed this work being referred to while considering this specific issue. No evidence is provided that the current regime does not provide security of supply nor is there any evidence that this planning approach has caused difficulties in other countries. Ofgem's analysis of NGC's arrangements focuses on its thinking regarding future changes. In the absence of further analysis, we presume that the current arrangements have not caused any difficulties in ensuring that sufficient transportation access is provided.

We do not consider the comparisons to the entry regime to be convincing. Ofgem states for entry capacity "long term auctions, supplemented by subsequent trading of entry capacity rights in secondary markets [...] provide investment signals." This is the *intention* of the entry capacity regime but, to date, there is no evidence that Transco is receiving any signal to invest from the long term or shorter term auctions¹. Transco relies entirely on planning processes to plan the network; hence its need for access to upstream data and data as well as data it receives direct from customers. The only reported trading of entry capacity rights is in short term markets (eg within day or day ahead); these trades provide no market signal to Transco. On the entry side, gas production is a capital intensive industry where risk is managed through long term contracts. There is no equivalent at exit as customers change suppliers often and their main focus is unlikely to be related to the gas market. To encourage long term

¹ There may be more potential for "signals" at new entry points but this would not demonstrate that the approach that has been adopted is better than any other contractual arrangements that could have been introduced.

contracts between suppliers and customers, as Ofgem's proposals appear to be doing, would be likely to undermine liquidity of NBP trading. Ofgem's view that shippers can signal their requirements so far ahead is not justified and we do not understand how this can be done while retaining cost-reflective charges. Finally, experience with the introduction of entry capacity auctions demonstrates that this results in *increased* regulatory involvement, not decreased. This is demonstrated by the extensive, complex documentation and licence requirements introduced with the auctions, associated regular reviews, updates and approval of Transco's plans by the regulator itself. Ofgem's preferred approach for the offtake arrangements clearly fails this test. There is no reason to believe that the current complexity with the entry auctions will be reduced in future years.

During the workgroup discussions, shipper's views were presented and extensive discussion took place regarding the alternatives that Ofgem proposed. It is disappointing that the presentation material is not referred to in this document. Ofgem's response to the issues raised in the workgroups is absent. Amongst issues raised was how shippers would get to know enough about customers' future needs to provide reliable "signals" to the gas transporters: the customers themselves often do not have this information. Not only would shippers need to be able to predict gas market price changes but also likely changes in a variety of market segments likely to affect gas demand. There would need to be considerable investment to be able to even attempt this and it is clear that Ofgem has underestimated costs in this area.

The successful introduction of competition in shipping and supply has been based on having a predictable regulatory regime. The gas transportation network is an *enabler* for gas shippers and suppliers to allow them to carry out their businesses. The five-year price control regime provides predictability to all in order to drive investment whether in the networks themselves or in shippers' and suppliers' own systems and services. We consider it appropriate that the monopoly gas transporters take responsibility for ensuring that gas is transported in the best manner they consider meets their requirements to operate the systems efficiently and economically. We are not aware of any problem with the retention of the current RPI-X price control regime. The current regime is also premised on the assumption that customers will be able to switch suppliers easily. Ofgem's corporate plan includes its commitment to improving the customer transfer process. While SGD does not see any significant problem with the present transfer process for non-domestic gas customers, it appears to us that Ofgem's preferred approach (or interim arrangements) would undermine this objective as it is likely to be disruptive to the transfer arrangements. We would welcome further clarity regarding Ofgem's priorities.

If issues with the exit regime develop in future, then Ofgem should take action appropriate to the specific case encountered. One of the benefits that Ofgem has suggested could result from the sale of the distribution networks is the ability for different owners to come up with innovative approaches. However, Ofgem preferred approach (Option 4) for the allocation of exit rights is prescriptive and would undermine any potential for innovative approaches to be developed. As its development is not justified either now nor in the future, we see no reason for transitional approaches such as Option 3.

Diurnal storage and operational flow options

We support Transco's original proposal for an administered approach to diurnal storage and operational flows. As with our comments on the allocation of exit capacity, we see no reason for any further complexity to be introduced. Ofgem's view that commercial approaches could lead to a promotion of competition in the wholesale gas market

through the pricing of new services is not substantiated. This is not the first time that linepack services have been discussed by the industry. The most recent discussion was through the Modification 0513 “Review of Gas Balancing” process. During these discussions, the industry set out why it considered the development of linepack services to be impractical. Analysis has been produced which supports the view that a linepack service could undermine liquidity at the NBP and hence have a negative impact on competition. We see no reason to rehearse these arguments here. Ofgem has stated that it is committed to non-intervention in the market. Any proposal to move away from current arrangements appears to be an unnecessary intervention in the shipping activities, not driven by requirements of market participants nor targeted at any particular area where action is necessary. To show its accountability, Ofgem will need to review all material previously produced and ensure that it can address the issues raised by the industry.

Way Forward

We are concerned that this document, while labelled a regulatory impact assessment, does not fulfil the requirements of an RIA. Ofgem is required to have regard to the guidance available² to it but the issues discussed in this document are not well-enough developed to be able to carry out a proper assessment. In particular, although Ofgem suggests there is a potential for there to be undue discrimination, it makes no comment on its probability. We cannot see how Ofgem can make a judgement on the costs of implementation as it has not sought any information about this aspect of the DN Sale project from shippers and suppliers. We do not understand how the values that Ofgem has established for NPVs were derived nor can be justified in particular in relation to undue discrimination and efficiency by the network operator. As stated above, we are not convinced that Ofgem’s proposal will lead to less regulatory involvement; rather the opposite. The criteria that Ofgem has chosen to assess these options appear to lead to certain conclusions but we do not consider that these conclusions are sustained nor that the criteria fit well into Ofgem’s obligations under the Acts.

When considering the DN Sale, Ofgem should concentrate only on those issues which need to be addressed to allow the sale to go ahead. This document goes beyond this and introduces a new project areas which should be first raised through Ofgem’s planning process and only prioritised for activity if it is demonstrated that there is an issue to be resolved. Ofgem has stated its commitment to good regulatory practice: proposals should, therefore, be proportionate and only targeted at cases in which action is necessary. Ofgem needs to be accountable and transparent in its approach: where it reintroduces proposals previously discussed by the industry but not implemented, issues raised during earlier discussions should be addressed by Ofgem before further initiating further activity with the industry. As well as the direct costs of implementing projects, Ofgem needs to consider the significant indirect costs of crowding out shippers’ own investments in innovation and efficiency.

We supported the Gas Forum’s letter regarding the need for a project plan covering licence change notices, accession agreements, relevant code modifications, consultation timings and their order and interdependencies. We consider this to be a priority project.

We also reiterate our request for there to be two seminars in the new future: one to cover Ofgem’s exit RIA and another to cover the full RIA that we have been expecting

² For example, see the Cabinet Office’s Guide to Regulatory Impact Assessments

will be issued before the Authority makes its final decision. We consider it important that members of the Authority are in a position to hear shipper/suppliers' views before making their final decisions. We do not consider the workgroup process to be a sufficient substitute for broader, more focussed events.

Conclusion

We fully support Option A for diurnal storage and operational flows. We are supportive of Option 1 for exit capacity and consider that neither Options 3 or 4 should be pursued further. Unnecessary complexity should be avoided to ensure that continuing operation of the competition supply and shipping market. We recommend that wherever possible a minimum change approach is adopted and that the principles of best regulatory practice informs Ofgem's decisions in this area. There are significant interrelations between the exit arrangements discussed here and the issues raised in Ofgem's recent document on interruptions arrangements. As such, we consider it inappropriate for any decision to be made before Ofgem has fully considered the responses to the interruptions document.

Yours sincerely

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cc: Steve Chatfield, HSE