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Dear Frances Warburton

Review of Transco's structure of distribution charges

I refer to the above consultation paper published by Ofgem in May 2004. This paper forms part of Ofgem's review of the structure of gas distribution charges for Transco's distribution networks (DNs), some of which may change ownership in the near future. In this document, Ofgem identifies a number of issues that it considers may deserve further consideration.

Shell Gas Direct is a licensed supplier to non-domestic consumers. SGD is also a licensed shipper. For the purposes of this response, these terms are used interchangeably. We supply a range of non-domestic customers including small and medium sized businesses (SMEs), multi-sites and intensive energy users. There are a number of issues which have been the subject of discussion within the industry and with Ofgem for a number of years which we hope this review will progress.

In considering whether to update the structure of the DN charges, it will be important to consider not just how taking forward these various issues will impact upon the DNs[1] but how they will impact on shippers and thence on consumers. The gas regime is currently subject to extensive restructuring, the costs of which and the risks inherent may be expected to be passed on to consumers. The impact of the separation of the DN price controls is only now being incorporated by shippers now that costs of implementation are better understood and increased risk can be included in customer offerings. In addition to this change, the impact of changes to wording in Transco's licence for the 2002-07 price control has led to increased changes of prices. While this may appear to be a sensible approach when focusing on the monopoly, its impact on the competitive market has not necessarily been positive and customers are right to be concerned about the cost of the increased risk being passed to them.

A trade-off must be made between making the DN charges more cost-reflective versus making the transportation charging regime so complex that it will make competition in gas supply difficult by constraining transfers or introducing barriers to entry. The

[1] Ofgem states that the DNs were formally known as Local Distribution Zones (LDZs). This is not correct: there continue to be 12 LDZs which singly or in pairs form the 8 DNs.

current regime was developed knowing that some compromises have been made to allow for supply competition. It will be essential in considering whether to take forward any proposal following this review to fully consider the impacts on supply competition in the RIA. A key to sufficient competition in the supply of gas going forward will be to allow for some stability in the regulatory regime. We would advocate that changes to the structure of DN charges are only taken forward once other key changes have been implemented (eg necessary change for the DN Sale).

We support the continuing use of a shallow connections policy as it should ensure that reasonable requests to extend the gas network can be met.

Ofgem refers in this paper to related changes that could affect the DN charging structure, most notably the reform of exit and interruptions regime. In this document, Ofgem states that it considers that the present arrangements "*may* be causing undue discrimination between some firm and interruptible customers and that the discounts provided to interruptible customers *do not necessarily* reflect the true *value* of interruptible services being provided." [Our emphasis.]. We had hoped that this document would provide some evidence to justify Ofgem's views. The interruptions regime has been subject to much discussion over the past few years and, to date, we are not aware of any evidence that there is undue discrimination. Furthermore, we do not understand how "value" can be established in a system where there is a monopoly provider (the DN) on one side and no, or limited, contestability on the other (customers). Any move towards a value based system will necessarily undermine the requirements on the DNs to have cost reflective charging. As you will be aware, the issue of how to deal with over- and under-recovery from entry capacity auctions has not yet been resolved and it will be important to ensure that new projects are consistent with legislative requirements.

We do advocate reform of the capacity / commodity split to make it more cost reflective although such change should be introduced gradually. However, again, this may not be in keeping with the approach advocated by Ofgem for reforming the interruptions regime. We would recommend that this area of work is taken forward, it is established what cross subsidies there are and how these are best resolved. We see no reason for reform of the interruptions regime to be associated with the DN Sale project and we again advocate doing sufficient analysis to clearly identify any cross-subsidies or discrimination before progressing with solutions. We will be repeating these views in our response to the upcoming RIA on exit.

In conclusion, SGD considers that any change to the DN charging structure should be taken forward; but, that implementation timescales need to be considered to ensure that there are no negative impacts on supply competition. We would like further analysis on the extent to which the DN charges are not cost-reflective before solutions such as changing the capacity/commodity split or reforming the interruptions regime are taken forward.

Yours sincerely

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