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Dear Joanna

Gas Distribution Charges From October 2005

I refer to your letter of 4 May 2005 where you set out the background to the indicative charges for gas distribution charges published by Transco. As a supplier to non-domestic customers, from small commercial businesses to large industrial sites, Shell Gas Direct (SGD) has a number of concerns regarding these proposals which we set out below.

We welcomed Transco's agreement to delay implementation of different LDZ charges through PC80. However, we are not convinced that the six month delay in itself explains the extent of the changes. We would welcome a view on how much the price rise would have been if the implementation had been in April 2005. We remain unclear as to why two years of under-/over-recoveries have been allowed to accumulate. Implementing this change in October rather than April should only have made a difference relating to six months' worth of charges. Transco will be aware of concerns that shipper/suppliers have expressed over the past few years about unexpected price increases. While we were aware that rate changes would affect transportation charges, we consider that Transco could have made earlier effort to alert the industry to the potential impact.

Extent and speed of price differentiation between the DNs

When Ofgem published its final proposals on the separation of Transco's distribution price control in June 2003, it stated that it would be "important to minimise any unnecessary disturbance to charging levels" and Ofgem's intention that "[d]isruption to consumers would be minimised as any regional variations should gradually emerge over a relatively long period of time". This was to "ensure that domestic and I&C consumers do not face step changes in charge levels." With the sale by National Grid Transco of four of its distribution networks, this approach is no longer possible. We note here that the costs of this effect was not properly included within the impact assessment for the DN Sale and that Ofgem's original concern about disruption is now becoming reality. However, we understand that there is now no potential for the "smoothing" between the distribution networks (DNs) to be considered as had been possible with the LDZs when the separate controls were introduced.

Volatility between gas years

An area that Ofgem and the DNs should consider is smoothing of between Gas Years. As set out in Table 1, transportation prices between years will be very volatile, at the extreme, we could face a reduction of –4.8% one year followed by an increase of 11% the next. This is not in the interests of consumers nor the suppliers who serve them. Those consumers who have transportation pass through arrangements will need to endure the volatility themselves. For the rest, the effect of this approach will be to make it more difficult for suppliers to price their offers: the additional costs of risk and administration will be passed on to these consumers. The “choppy” annual changes in transportation prices could also lead to suppliers preferring customer contracts to start in line with these changes to reduce risk. This would be unfortunate given concerns regarding the effects on gas prices from I&C customers “bunching” their contracting rounds. (See for example Global Insight’s report to the Department of Trade and Industry, “Ensuring Effective and Efficient Forward Gas Markets”, published in May 2005. It discusses potential distortions to the demand side of the gas market with the concentration of gas contract renewals in October and recommends that buying decisions should avoid any “buying concentration” period.)

We would recommend, therefore, that Ofgem and the DNs discuss ways to smooth the changes between the gas years. We consider the positive effect on consumers and on the gas market itself would significantly outweigh negative effects (if any) with respect to cost targeting.

We recognise that REPEX is not the key driver to these changes. However, we remain concerned that annual incentives prescribed by Ofgem for the DN operators to closely incentivise their behaviour does not align the interests of the DNs with consumers and suppliers, but instead has negative consequences through unnecessary volatility in transportation prices. We encourage Ofgem to consider longer term incentives, such as the 5 year RPI-X incentive formula, rather than annual targeting.

Conclusion

SGD considers that the extent of the proposed changes in transportation charges between DNs will have impacts on us as a supplier to I&C consumers, and therefore on the consumers themselves. We recommend that to mitigate the effects, smoothing between Gas Years (or formula years) is undertaken.

If you would like to discuss this response, please feel free to contact me as above.

Yours sincerely

Tanya Morrison
Regulatory Affairs Manager