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Dear Robert Hull,

Transmission price control review

I refer to the initial consultation document published by Ofgem in July 2005 regarding the transmission price control review (TPCR4). This document outlines the process which will be adopted in carrying out TPCR4 and the seeks views on various issues which arise for the review.

Shell Gas Direct (SGD) is a licensed supplier to non-domestic gas consumers and a licensed gas shipper. Our comments focus on issues relating to the price control for National Grid plc's Transco NTS price control as we are most active in that market but we also make some comments on the electricity grid price control where appropriate.

Issues with the current gas transmission price control

We welcome this review and consider this an opportunity to consider the extent to which the approach taken for the 2002-07 Transco NTS price control has been successful and whether a different approach should be adopted going forward. We consider that while the RPI-X control work well, the associated sharing incentives to be exceptionally, and unnecessarily, complex. It is difficult as a User of Transco NTS to have a clear idea of the impact on us of 170 pages of legal drafting. We note that the 1997-2002 gas transportation price control was only 17 pages which included drafting for what are now independently price controlled distribution networks (DNs).

Consistency between electricity and gas price controls should not be pursued for the sake of it. Only if there is a demonstrable benefit or improvement in one approach over the other should commonality be pursued. Differences between gas and electricity can reflect the differences in physical set up and operation of the networks. If differences negatively affect the gas or electricity traded markets, or interactions between them, this could suggest that the arrangements are made more similar. However, we must emphasise that we know of no reason to suggest that there are negative impacts on the markets due to the differences between the gas and electricity transmission price controls. Even if there were problems, the solution would not necessarily be to make the controls consistent. In the absence of any issue, we recommend that no further action in this area is pursued.

We note that Ofgem considers that the 2002-07 Transco NTS price control was “designed to be flexible”. We are not convinced it has succeeded in this aim. Our reasoning is set out below.

Framework, context and objectives

RPI-X Incentive Framework

Ofgem restates its conclusion that incentive regulation is the most appropriate means to protect the interests of consumers where competition is not feasible. We concur with this principle and note that as a natural monopoly, competition is not feasible on gas pipeline systems. The focus must remain on appropriate regulation. We further note that the RPI-X price control is a tried and tested incentive based approach to regulating the pipeline’s revenue. The RPI-X approach incentivises the regulated company to outperform the target, X. We emphasise this as it has been suggested that sliding scale arrangements are required for there to be incentives; this is not the case.

We also note that the RPI-X approach has been subject to several reviews since its introduction¹ and generally found support from industry and customer groups. While some problems had been identified with RPI-X regulation, ie that it could result in poor service, these should be resolved by now by the introduction of competition in supply and subsequent removal of supply price controls.

We do not consider that there is any further scope for “de-regulation”. If Ofgem considers this further, its analysis must focus on why this is practicable and would benefit consumers. It should not be assumed that making a service “contestable” will necessarily provide consumer benefits. Furthermore, it should not be assumed that moving services outside of the price control is consistent with de-regulation as experience shows that this can result in a higher overall level of regulatory and industry resource to manage new regimes.

We have no firm view at this time on whether the current 5 year framework should be adopted or whether there is value in extending the price controls to be 7 or 10 year controls. We consider this worthy of further investigation to see whether the trade-off of regulatory certainty for the entire industry outweighs any negative effects of a longer control.

External factors

The link between gas and electricity networks as a result of the increased use of gas for electricity generation is not new and we do not see that it needs to be catered for differently in the new price control. It was referred to in the two previous price controls and considered, for example, in the Green Paper referred to in footnote 1. It is important that the framework is flexible enough to cope with any further increase in gas fired electricity generation. From the experience with the two price controls (1997-2002 and 2002-07), we consider that the volume driver deserve reconsideration as it provided a transparent and flexible approach. It was successful in delivering sufficient

¹ See for example, “A Fair Deal for Consumer: Modernising the Framework for Utility Regulation”, Response from Government. DTI 1998. “*On mechanisms, the Government confirms that RPI-X should be retained as the fundamental system of price regulation, so long as regulators continue to judge this is best for consumers.*” Conclusion 35

transportation capacity at a time when there was an increase in demand on the system from generators and the Interconnector UK was introduced.

Great Britain (GB) is now part of a global gas market with its increased dependency on imported pipeline gas and LNG. It must be flexible enough to deal with this and yet not so complex as to undermine the primary objectives of allowing trading and competition gas supply market. The future pattern of flows on to, and off of, the gas transmission system are difficult to predict by any party, particularly those involved in competitive activities. We consider that a planning approach, using scenarios, is best placed to ensure that a robust transmission system is developed and maintained.

We had understood that the separation of the DN price controls and subsequent work on the DN Sales were sufficient to deal with the new arrangements for the gas transporters. We are not clear what further consideration is required in this area and expect that at the upcoming Ofgem seminar, responses that suggest that further work is required will be discussed and then be subject to further consultation.

Rolling incentives

We have some concerns with the current rolling incentive arrangements associated with entry capacity auctions and other arrangements. It is not clear how these interact with the price controls and how the dependencies work. We would welcome more explanation in this respect.

We note that there were incentives prior to the 2002-07 price control being agreed but that these were included in the Network Code. The incentives were moved into Transco NTS's licence as part of the agreement on the control. This approach should be reviewed. Some reasons associated with this change are no longer applicable, eg both licence changes and Uniform Network Code modifications now can be appealed to the Competition Commission. Furthermore, including the incentives in the licence has resulted in *decreased* flexibility in the contractual arrangements as changes are stymied by the need for licence changes which are slower and subject to the agreement of one party. Much of the incentive structure should be reduced or removed. Other parts, such as the balancing incentive, should again be part of the Code. Incentives placed in the Code will allow again for a flexible framework and ensure that any new issues can be dealt with effectively by the industry.

Objectives for review

We agree with the objectives Ofgem has set out but they should be expanded. But this needs to be widened to ensure that this work furthers Ofgem's stated objectives to reduce regulatory burden. For gas in particular, success should be measured by the extent to which the length of the legal drafting associated with the Transco NTS price control is reduced. An obtainable and realistic target is to halve the amount of pages. Ideally, Ofgem should aim to have the same brevity that was achieved in the 1997-2002 price control. This may reduce the burden for the regulated entity. More importantly, it will reduce the burden for those who use the network and the consumers attached to it.

Another objective should be to ensure that the timetable set out by Ofgem is adhered to. We note that Ofgem plans to publish final proposals in November/December 2006. It is essential as part of its objective to be transparent that proposals are well enough defined by this stage for full legal drafting of any changes proposed are available in final proposals document. There were significant delays with the 2002-07 legal drafting

which we expect will not be repeated. A lesson which could be drawn from this is that complexity results in delays as well as opacity for users of the system.

The timetable for this review should include details of when new UCAs will be developed, the timing of any pricing proposals and UNC proposals which may result from changes to the price control. While these are consultations which will be conducted by Transco NTS, we consider it essential for a complete picture to be developed early on to ensure an efficient process for all interested parties.

Incentives and Outputs

The focus of the TPCR4 should be on implicit output measures. While we note that explicit output measures have been the focus of more recent regulatory approaches, we are not convinced that this has wholly proven to be a more successful approach. It does appear appropriate to continue with output measures focussing on those items consumers value, such as a reliable power supply.

Shell supported the long term entry capacity auctions as a way of providing certainty to upstream producers and others making large capital investment decisions regarding the availability and price for entry rights. We are no longer convinced that the certainty we required is being provided and, indeed, the LT auctions are subject to considerable regulatory risk.

As we have stated above and in previous responses to Ofgem, we do not consider that the LT auctions with the associated complex incentives schemes to have succeeded in providing signals for investment. We reviewed the example regarding the current incentive arrangements, we note that incremental capacity has not been released at any of the existing entry terminals to date. That is, it has not resulted in capital investment by Transco NTS. The situation at new entry terminals is, of course, different but not without difficulties and it has not been demonstrated that it has been more successful than approaches used elsewhere.

We do not consider it appropriate for Ofgem to be encouraging users and potential users to signal their future requirements except through planning mechanisms. As we have already noted, it is no more possible for individual market participants to predict future entry flows than it is for Ofgem or the licensee (ie Transco NTS). Given the various scenarios for investment that Transco NTS has published, it will be necessary for the impact on UCAs for each scenario to be made clear early in the process. Changes in flow patterns appear to have significant changes on prices and therefore the valuation of entry capacity holdings. This only introduces risks for any party making long term commitments to purchase entry capacity.

An objective that Ofgem has set out for TPCR4 is that risks are allocated appropriately. A trade-off needs to be made between the risk of a reasonable level of “stranded assets” which are paid for by all against the costs of complex arrangements which transfer network risk to competitive parties and can act as a barrier to entry. We do not consider that this trade-off has been fully considered and analysis should be provided as part of the initial impact assessment.

As stated above, we consider that the revenue driver approach, while it has its disadvantages, has been relatively successful. It is consistent with the RPI-X approach, is transparent and does not result in unnecessary complexity. This approach has its drawbacks but these are not as significant as the drawbacks with other approaches. This should be considered in the IA that is produced.

As part of the IA, Ofgem should list all of the documents it has published relating to entry capacity auctions and incentives *since* setting the 2002-07 price control, decisions it has made on related Code modifications, IECR changes, etc. We consider that this is likely to show that these arrangements create a high degree of regulatory involvement which is not in keeping with a light touch regulatory approach.

We consider that further work needs to be done by Ofgem, including detailed analysis, before further views can be provided on the type of output measure required (eg zonal or nodal). Baseline outputs should be consistent with prevailing commercial arrangements. Baselines and incentives should not be developed in isolation. The question remains whether this approach is necessary or desirable at all. If this approach is to be adopted, we consider that further detailed consultation will be required. However, from the discussion in this document, it would appear that the approach adopted for NGC with a national output measure would be worth considering for the Transco NTS price control.

For new users of the network, a firm financial commitment for any *incremental* capacity which needs capital investment by the Transmission licensee can be, and has been, successfully addressed through an Advanced Reservation of Capacity Agreement (ARCA). This framework for ARCAs may need to be considered further but they appear to have worked sufficiently well to date in ensuring appropriate commitments are made.

Conclusion

We welcome this initial consultation. SGD considers that the RPI-X framework has worked well and should be continued. Any refinements to this should fit as closely to it as possible. We see no need to align gas and electricity approaches and in particular can see no value in electricity adopting the gas approach. Ofgem's objective in these reviews should be in keeping with its aim of reducing regulatory burden and risk.

Yours sincerely

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