Shell Gas Direct Limited

Joanna Whittington
Director, Gas Distribution
Ofgem
9 Millbank
London SW1P 3GE

3 February 2006

Dear Joanna

Gas Distribution Price Control Review – Initial Consultation

I refer to Ofgem's consultation document published in December 2005. In it Ofgem its approach for the conducting the gas distribution price control reviews (GDPCR); the context, objectives and timetable. Shell Gas Direct supplies gas to I&C customers, most of whom are connected directly to the distribution networks (DNs). We include below a number of comments on the initial consultation paper.

Shell Gas Direct response to specific consultation questions.

Related projects

Are there any projects, other than those listed in paragraph 2.24, that Ofgem should take into account in the context of GDPCR?

Whilst there are no other projects that would have a direct impact on the GDPRC there are a number of other activities taking place in the industry which will also require providing resource from the limited availability of staff within the shipping and supply community. These are:

- Transmission Pricing Methodology Forum
- Review of Supply Licences
- Gas Safety Reserve Requirements meetings
- Major changes to the I&C metering contracts

Additionally, extra work is anticipated in reviewing the emergency provisions for next winter.

When carrying out project planning the workload of the above will need to be factored in to any response times required from the industry and also in the scheduling of meetings to avoid clashes where practicable and also to look for synergies with meetings on the same day being scheduled either in the same venue or at least in the same town or city. Ofgem may wish to consider

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

prioritising some of this work, including delaying or cancelling new projects to ensure that the industry is able to properly consider these proposals in practice.

Objectives and framework

For the purposes of setting GDPCR, what should Ofgem consider to be the outputs of a GDN?

Shell Gas Direct support the list of outputs provided in the consultation. However, we would request that 2 others be added:

- The timely exchange of file flows
- The quality of the data for which the DNO is responsible.

Problems have been experienced in both of these areas and particularly with the latter there seems very little appetite within the DNOs to tackle the issue.

What services offered by GDNs are valued by consumers?

The end consumers are generally unaware of the services that DNOs provided except where this provision falls short of expectations. End consumers have the following expectations:

- Provision of offtake capacity
- Assistance in making changes to consumptions
  - Access to network pressures
  - Time taken to get authority to set governors
  - The extension of the lead time for connections and meter fit works
- Ease of changing supplier
  - This can be undermined by poor data quality; we consider that the DNs themselves must contribute towards ensuring good quality data as part of their licence obligations to promote competition.
- Good quality emergency response when required.

What aspects of GDNs' activities give rise to concerns?

The fragmentation of existing processes and the manner of industry engagement is a key concern regarding the sold DNs. These would seem to militate against the projected benefits of rivalry between the management teams as there is insufficient open debate of the issues to allow the development of informed opinion of the various operational strengths of each DNO.

Are the objectives for the review proposed by Ofgem appropriate?

Shell Gas Direct supports Ofgem's objectives as described in the consultation. However, we believe that there should be a specific objective to tackle the outstanding, even long standing, issue of data quality.

Additionally, there should be a mechanism to identify best practices and a financial incentive on DNOs to adopt best practice where reasonable.

Xoserve

Are the current funding arrangements for xoserve satisfactory?

Shell Gas Direct does not support proposals to amend the current arrangements. Xoserve was created to ensure the on-going functioning of the competitive market with the DN sale. We consider that this solution was satisfactory and that the industry should not be subjected to further, unnecessary change. We are aware that some DNs want to focus only on their pipeline activities however the central management of information flows to allow competition is a monopoly service which should remain part of the price controlled monopoly businesses. We consider changes to ownership, funding etc are likely to lead to further fragmentation of the industry with associated higher final costs to consumers and lessened competition in supply.

The problem is not with the funding arrangements, but with the governance arrangements to ensure that xoserve delivers the service level that was in place before the DN sale. At a recent Gas Forum meeting where xoserve stated that the responsibility for cleaning industry data laid with suppliers as they were the hub of the industry. This completely ignores the fact that suppliers are directly responsible for only a very few data items and that the vast majority of data issues relate to data that is or has been the responsibility of the transporters. We do not consider that it is for xoserve, or its owners, to decide unilaterally the role that it should take. The "supplier hub" principle has not been subject to consultation with the industry and is not supported by Shell Gas Direct.

A longer term concern is how the replacement of the current industry systems will be carried out. Experience of the Gemini implementation would suggest that the present regime is not suited to such a large scale project that has major impacts and ramifications for all parties in the industry. It will be essential to ensure that any new major IT project is governed through the UNC so that the we do not have xoserve and/or the DNs imposing solutions on the industry.

If not, should change be limited to refinements on the status quo or more substantial reform?

Change should be limited to the status quo with a focus on proper governance and transparency.

Process
Should Ofgem conduct its consultation process in a different way to the process outlined in Chapter 7?

The involvement of shippers appears to be limited to responding to consultation documents and 3 seminars. It is not clear why shippers, as the direct customers of DNOs, are not involved in the GDPRC Working Group, or at least involved in any sub-group discussing key issues such as quality of supply and measurement.

Ofgem have previously stated that transparency is one of the key principles that they would expect to see underpinning any governance regime, but it is unclear how deliberations at the various meetings planned by Ofgem will be circulated to a wider audience so that any decisions made by Ofgem can be placed in context.

Use of Impact Assessments
How should Ofgem incorporate Impact Assessments into the price control process?

Shell Gas direct has previously questioned the quality of the data used in Impact Assessments and based on the projected consultation process can not see how fully balanced benefits and costs will be identified such that meaningful and relevant Impact Assessments can be developed. Ofgem should ensure that if an impact assessment is to include data from industry participants (ie shippers and customers) that sufficient time is provided for the collection of this data. Six weeks would be a recommended minimum time period to give to the industry. Any proforma used should be consulted upon to check the validity of the cost information being required.

Timetable
Is the timetable shown on page 66 appropriate?

There are a number of other activities taking place in the industry which will also require resourcing from the limited availability of staff within the shipping and supply community. These are:

- Transmission Pricing Methodology Forum
- Review of Supply Licences
- Gas Safety Reserve Requirements meetings
- Major changes to the I&C metering contracts

Additionally, extra work is anticipated in reviewing the emergency provisions for next winter.

When carrying out project planning the workload of the above will need to be factored in to any response times required from the industry and also in the scheduling of meetings to avoid clashes where practicable and also to look for synergies with meetings on the same day being scheduled either in the same venue or at least in the same town or city. This high level of industry workload will need to be taken into account if Ofgem is asking for detailed information from the industry and/or expects a high level of participation in seminars or workshops.

Are there any issues that the draft timetable does not sufficiently take into account?

The draft timetable, as a stand alone project, seems reasonable based on current levels of understanding and assuming that data is made available to the industry in a timely manner. However, given that Ofgem have identified a number of projects that will interact with the review, a separate timetable or plan showing these interactions would have been useful.

A number of previous large scale projects and industry implementations have suffered from a lack of formal project or programme management. Shell Gas Direct would suggest that a project manager be appointed for the duration of the project to add a degree of rigour to progressing issues.

Ofgem views sought – Issues for initial views

Principles for the conduct of the review

Are the proposed principles for the conduct of the review appropriate?

Shell Gas Direct is generally supportive of the principles for the conduct of the review. However, we have a few comments on specific issues raised in this section of the consultation and which are not tackled elsewhere by Ofgem's questions. These are covered below.

The definition of some expenditure above the Ofgem levels as "efficient expenditure" is a concern particularly that this could encourage overspending to increase revenue flows. The lack of a definition of "significant benefit to customers" and the lack of clarity about which types of expenditure could be included in this class – capacity increases, support services (improved systems), etc. – causes further alarm regarding this proposal.

It would seem appropriate to remove "shared assets" these from the RAV and to include an allowance in the opex calculations, dealing with these as provision of services contracts as would be the norm for similar contracts with third parties for the provision of other services.

Shell Gas Direct support a review of "treatment of non-operational capital expenditure such as IT and office furniture for network companies" as normal accounting procedure is to regard outsourcing as an opex issue, with exceptions where assets may revert to the company at the end of the contract.

Quality of service is a key output issue and there is some anecdotal evidence of reduction in service since sales – operation Moscow for an example shows considerable variation in the response of the DNOs.

The key incentive for I&C is the provision of capacity followed by quality of service and price third. With regard to price the limitation of price shocks is more important than overall pricing level, recognising the current sensitivities in the market place due to high wholesale gas prices.

Setting the one year control - capital and replacement expenditure

What is the appropriate scope of the work on capital and replacement expenditure for the one year control?

It is not clear how the sales process for the disposal of the DNs affected capital and replacement spending nor have the new DN owners been in position long enough to have significant effect on the policies that they inherited. As such it would seem prudent to take a minimal interference approach and roll forward the existing regime for the 1 year period. This should have the advantage of reducing the number of price shocks to the market, but could be found later to be building up under- or over- recovery scenarios which would need to be addressed as part of the longer term review.

What techniques should Ofgem seek to use in assessing capital and replacement expenditure?

These should be limited to the mechanisms for rolling forward the existing regime taking account of any substantial variations from the forecast spending patterns.

Setting the one year control – operating expenditure

What is the appropriate scope of work on operating costs for the one year control?

It is not clear how the sales process for the disposal of the DNs affected operating expenditure and the search for efficiencies nor have the new DN owners been in position long enough to have significant effect on the policies that they inherited. As such it would seem prudent to take a minimal interference approach and roll forward the existing regime for the 1 year period. This should have the advantage of reducing the number of price shocks to the market, but could be found later to be building up under- or over- recovery scenarios which would need to be addressed as part of the longer term review.

What approach should Ofgem use to set the operating costs allowance for 2007-8?

Ofgem state that any additional operating costs as a consequence of loss of economies of scale will not be recoverable. As such the opex should be set at similar levels to as would have been appropriate if the sales had not proceeded. The longer term review can take account of some of the projected benefits as described by Ofgem in their decision to support the DN sale.

What approach should Ofgem adopt for shrinkage for 2007-08?

The debate on possible changes to the shrinkage regime is still underway and may not to be resolved in time to have a significant impact on the short term price review. The prudent position would be to continue with the present regime and to take account of the outcome of the current debate in the longer term review.

Should the debate on shrinkage cone to an early conclusion there may be a limited opportunity to incorporate the conclusions at least partly in the short term review, but this should be assessed if the opportunity arises.

Should Ofgem apply the principles relating to pensions costs to GDNs as part of the one year control or the main review?

National Grid were well aware of the consequences of the manner in which pensions provision of active and non-active participants was handled in the DN sales process. Any debate over the pensions issue is likely to be long and involved and such an important issue should not be rushed to be included in the short term review. Therefore, it would seem prudent to park this long term issue until the longer term review. This is not to say that work could not be undertaken in parallel to the short term review.

Setting the one year control – incentives

Should rolling incentives be applied for capital, replacement and operating expenditure for the one year control?

Whilst there is a perception that not applying rolling incentives reduces their effectiveness towards the end of a price review period and so for a 1 year period would have little or no effect, by electing to adopt a changed regime for the 1 year price period this could be deemed to pre-empt the discussion of whether they are appropriate on a long term bases and what an appropriate period for the incentives may be. Also, it exposes the industry to risks of price shocks associated with adopting a changed regime which may only be in use for 1 year before reversion to the existing regime. On balance it would be better to continue the current regime and debate the possible introduction of rolling incentives as part of the main review.

Structure of the price control

Should Ofgem consider setting GDPCR for a period other than five years?

Whilst there is no reason to believe that 5 years is the optimal period for price review periods, the continuation of the existing period length, albeit off set by a year, provides a degree of consistency which Shell Gas Direct supports in the absence of any analysis to support a change in the period of the price review. We would welcome further analysis of the benefits of a longer control period in providing certainty for any required investment.

Is the pass through mechanism that applies under the current price control review still appropriate?

It continues to be appropriate to have pass through arrangements for charges that are clearly beyond the power of the DN owners to control and where such charges can be externally audited and verified.

Are any changes required to the correction mechanism that applies under the current price control?

Ofgem has recently consulted on the IAE threshold for the interim period and in line with Shell Gas Direct's response we would support the continuation of the right of a DNO to seek to re-open the price review period should a substantive change take place in their operating environment that could not have reasonably been foreseen at the time the setting of the price control. The terms of such a scheme and the threshold at which such a right might trigger should be a matter of debate for the main review.

Scope of the price control

Is the scope of the current price control appropriate for GDPCR?

Whilst supporting the concept that the DNOs should be able to provide excluded services where the profit from the sale of these services would not be included in their regulated income, such services must not be provided at the detriment of the provision of regulated services. Thus, until and unless regulated services are being provided in line with customer expectations and requirements the right of DNOs to seek additional revenue should be curtailed.

Which services provided by GDNs should be considered to be excluded services?

In Ofgem's list of excluded services "the provision of training and information services" is included. This should not include the provision of information services regarding data or processes associated with interacting with Users and others in the energy supply chain, nor training in the use of or interaction with systems and process between the GDO and Users. As an example, if there are new IT systems introduced, we expect that the training for these would be included in the price control and not made an excluded services.

Sliding scale incentives

Should Ofgem adopt a sliding scale mechanism similar to that used in DPCR4 to encourage more realistic BPQ submissions?

A wider issue here is the data asymmetry between Ofgem and the DNOs. If this were to be addressed there would be no value in DNOs submitting unrealistic BPQs as this would be spotted by Ofgem and appropriate action taken. Given that the comparative regulation of DNs was the key customer benefit identified by Ofgem in their approval for the DN sales then this issue should be tackled as a matter of urgency.

SOMSAs

Should Ofgem respond to the new developments in relation to SOMSAs and if so how?

In 1.4 Ofgem state "In particular, the creation of separately owned, managed and operated GDNs will allow more effective comparisons to be made between the businesses, building on the sense of rivalry which exists between independent management teams." Shell Gas direct finds it hard to understand how this statement can be supported if the existing SOMSA terms continue as clearly all the network subject to SOMSAs will be operated along similar if not identical lines.

The extension of SOMSAs in the short term is probably unavoidable given that some of the control centres for the DNs will not be operational by the time the current SOMSAs run out. However, DNs should be financially encouraged to begin independent operation of their networks as soon as reasonably practicable in line with the industry's commitment to safety.

Conclusion

We note that Ofgem suggests that the benefits of comparative regulation will be built up in *future reviews*. We do not consider this to be consistent with the impact assessment carried out when National Grid sold four of its DNs. We are concerned that the benefits claimed for consumers from the sale will not be realised.

If you have any query regarding this response, please feel free to contact me. Shell Gas Direct advocates an approach to the DCPR which is transparent, minimises unnecessary administrative burdens to the industry and minimises change to that which only requires it (eg by not changing the arrangements with xoserve).

Yours sincerely

Tanya Morrison

Tanya Morrison
Regulatory Affairs Manager