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Dear Robert,

Transmission Price Control – Second Consultation

I refer to the above document published by Ofgem in December 2005. It sets out Ofgem's next steps in developing the next price controls for the electricity transmission systems and gas transmission system. I outline below a number of points arising from the consultation. Detailed responses to views sought are attached in an appendix to this letter.

As set out in Shell Gas Direct's response to the first consultation, we consider that success in the TPCR for gas will be measured by the extent to which there is reduced complexity and better clarity. This will be in keeping with Ofgem's commitments to reduce the burden of regulation. We are also aware of the work being carried out by the Better Regulation Task Force (BRTF) on reducing administrative burdens from regulation. As we suggested in our previous response, an obtainable and realistic target is to halve the amount of pages required for the price control. This could reduce the burden for the regulated entity and would significantly reduce the administration burden for those who use the network and the consumers attached to it. Associated with this, is the requirement to provide a stable framework to allow for investment not only by the natural monopolies but also by those who use the transportation network to ship gas to consumers and for the consumers themselves. There had been support for long term entry capacity auctions as a way of delivering certainty; we do not consider that this has been achieved.

In the second consultation, Ofgem sets out a number of consultation points relating to the future exit capacity regime. As SGD has noted previously, we do not consider that Ofgem has presented robust analysis to support any change to the current regime. We note that Ofgem has yet to address many questions that have arisen through discussions on changes to the regime nor has it responded to the NERA work. A concern that has been expressed during industry discussions is that there is not enough detail and earlier proposals have been unworkable. We consider it to be for Ofgem to provide detailed proposals upon which a robust impact assessment can be made. While we have commented on suggestions made in the document in our attached paper, this should not be read as suggesting support for Ofgem's initiative to change the exit /offtake arrangement (or those that could be made by National Grid). We reserve the right to object to, and challenge, proposals for change when being implemented; eg through proposals to change the contractual arrangement through the Uniform Network Code. In addition, the volume of work currently being undertaken by industry participants means that some of the questions raised by Ofgem cannot be given the full consideration that they deserve. Ofgem will need to consider whether it has provided sufficient opportunity for consultation and may wish to

review the work it is currently undertaken to ensure that it has prioritised only that work which is necessary now.

The aim of this review should be to provide stability and an attractive investment climate to secure gas supply to consumers. Discussions as part of the current Energy Review have already highlighted regulatory uncertainty as being a key issue in ensuring sufficient investment to secure future energy within environmental constraints. It will be important for Ofgem to find a clear, simple framework that avoids complexity and gives all of the industry the certainty that is required to invest for the future.

Yours sincerely

Tanya Morrison

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Regulatory Affairs Manager

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Shell Gas Direct Views

How should Ofgem assess the need for additional capital expenditure allowances to provide flexibility in the availability of network capacity in advance of firm demands for capacity by network users? What, if any, reasons might there be for consumers placing a higher (or lower) value on such network flexibility over the next price control period as compared to the current (or past) price control periods?

> Consumers place value on having access to gas – any underinvestment is likely to lead to high commodity prices; the cost of minor overinvestment is much lower. Flexibility within the system should be limited to the scenarios covered in the TBE process and limited to a 2-3 year planning horizon in line with the normal timescale for development of incremental transmission capacity. Further, each project should be subject to audit over the basis on which the project was initiated, what alternatives were considered and why the preferred solution was chosen. Should the audit identify any avoidable costs the Authority should have the power to limit National Grid's return on the invested asset to that that would have been achieved if the optimum investment had been made.

How should allowances be set for investment to support efficient system operation, and how, in the case of electricity transmission, should interactions between NGET and SPTL and SHETL be managed in this context?

> Investment to promote system operational efficiencies should be self financing with savings being equal to or greater than the costs when an appropriate costing model is utilised. It would simplify matters if the Authority determined a suitable project assessment model.

How can Ofgem minimise the adverse consequences of price control reopeners if they prove to be unavoidable – even in the context of more sophisticated mechanisms for adjusting revenues automatically within the price control period?

> Re-openers should be avoided except for unusual and unforeseen event. One test will be that the event is one which the transporter could not have foreseen at the time of the price review subject to the test of a reasonable and prudent operator. As with all businesses, there is risk inherent in business operations which cannot be predicted. Ofgem needs to ensure that the monopolies can fund their activities but this should not result in risk being taken from shareholders in these companies and transferred instead to consumers. Given the long lead time for transmission projects re-openers should normally only be allowed towards the end of a price period. It could be appropriate at this stage to suggest that there should be very limited recovery within the price period with any income foregone by the transporter treated as an under recovery and input to the next pricing review. This should ensure that any re-openers are rare events and that there effect on the price period within which they occur is minimised.

How should the information on NGET's and National Grid NTS's performance under their current SO incentives, as set out in the report compiled by National Grid, be interpreted by Ofgem in developing an appropriate regulatory regime for these activities from 1 April 2007 onwards?

Whilst the data compiled in the report is useful it is not clear how this should be utilized. We would welcome further detail. In particular, we would welcome a clear statement of how much revenue NG NTS has made from selling non-obligated entry capacity at existing entry terminals. We understand that no investment resulted from this.

How might the differences between transmission and distribution, discussed above, influence the design of information quality and rolling incentives as part of the TPCR?

It is by no means clear that there is value in allowing either distribution or transmission to benefit from the information quality regime. Rolling incentives can have a place in the pricing regime, but the targets need to be firmer with the consequences for failing to be more severe.

Whether respondents agree that Ofgem's focus on 'user commitment' options is appropriate, or whether they consider that there are other traditional price control options (or de-regulated revenue options) that might better meet Ofgem's objectives for the TPCR, particularly in the context of the Authority's statutory and other legal duties?

We have significant reservations regarding Ofgem's 'user commitment' option. It has the potential to unbalance the relationship between risk and reward with all the risk lying with the User and any benefit lying with the transporter. Further the use of a "user commitment" model should not automatically mean that the charging for different types or classes of exit point need to be the same provided that any difference reflect the physical and performance variations of the exit points. Other concerns include the barriers to entry that Ofgem could introduce and the negative consequences for large industry needing to pick up credit risk which more appropriately belongs with the regulated monopoly.

Whether it is appropriate to seek to separate, both formally and operationally, the issue of how charging and reserve prices are set at gas entry from the issue of how incremental revenues are determined under the price control?

Given the very long lead times on investments in offshore capacity it is unclear whether the risk of 5 yearly price shocks has a substantial impact on where gas is landed. A bigger concern is Ofgem's support for the same process to be adopted for exit as well as entry. As set out in our covering letter, Shell Gas Direct continues to have significant concerns about Ofgem's proposals to change the exit regime. We consider that there remain numerous outstanding issues to be resolved and note that Ofgem has yet to respond to the NERA report and has not been able to respond to many queries raised over the years on the various proposals to change the exit regime.

Revenue drivers for entry and offtake

(a) Should the revenue driver be nodal, zonal/locational or global? What are the advantages and disadvantages of these different options – and to what extent do these advantages and disadvantages differ between entry and offtake? If a zonal approach is preferred, then how might zones be defined?

A nodal approach may simplify the administration and determination of the exit point pricing review, but it is difficult to determine a set of criteria that would not introduce a degree of skew into the process, either between DN offtakes and direct connects or

between the transporter and Users. A global revenue driver would achieve the aim of simplicity and transparency.

(b) What are the key cost drivers of incremental capacity – and how might these vary between entry and offtake? How should these be quantified? (c) Should revenue drivers be fixed for the price control period or should they be adjusted during the price control period?

This is again a refection of the balance of risk and reward between users and the transporter. Where the majority of risk lies with the User the revenue driver should be for a fixed period if it is to be in line with the philosophy adopted for the IExCR and ARCA review. Also, the opportunity for upside to the transporter should be minimal as should any change to the RAV. If the transporter is willing to adopt more risk then a more general approach could be taken with the revenue driver feeding through into the price control and having a larger effect on the RAV and long term revenue streams

Entry capacity baselines

(d) Should the baseline be a measure of capacity and if so, should it reflect the level of existing capacity or the level of anticipated capacity?

The current approach used for baselines appears not to reflect any physical reality. Due to the network nature of the pipelines, it is difficult to see a purely physical arrangement that will not be complex, open to interpretation or subject to change based on future events. A single baseline would assist in avoiding some of the complexities that can be introduced. If using anticipated capacity, this will need to be based on planning information. Again, we consider such an approach to be most appropriate for regulated monopolies.

(e) For revenue restriction purposes should the baseline be set 'flat' for the five years of the price control period or should it incorporate growth (or decline)?

As the market is a movable feast it would be unreasonable to set the baseline to a flat profile. A revenue driver based on volumes may resolve the conflict as it will allow for growth and decline.

(f) Should the baseline be set on an entry point specific, zonal or network wide basis or should no ex ante baseline be defined? What are the advantages and disadvantages of the different options?

A simple approach such as a network wide regime may be favourable. However, a significant concern will be the impact of such a change on commitments already made through long term auctions and the potential to change their value. We do not consider this necessarily irresolvable but it will need careful consideration with the industry.

Approaches to offtake reform

(g) Do you believe that Ofgem's proposals for a long term user commitment model are appropriate?

No. The long term user commitment model is not appropriate for direct connections where an individual shipper will only have a requirement for that capacity for the period of their contract with the supplier providing gas to the end consumer. To utilise such a model at direct 24 connects would be best facilitated through the transporter contracting directly with the end consumer for the capacity rights. The same is not true of DN offtakes where the relationship between the transporter and the DN is expected to be a log one as the DNO is merely reflecting the aggregated demand within their area. In addition, there are significant problems with the operation of such a model for interconnectors and storage points. This could have a negative impact on future investment and security of supply.

(h) Are there any alternative models, including those which could be characterised as variants of the status quo, that would meet the defined objectives?

It would seem prudent to carry out detailed analysis to identify if there are any major issues with Ofgem's preferred models before devoting additional resource into the identification of other possibly more esoteric solutions. This should not be taken to suggest that Shell Gas Direct supports Ofgem's proposed models, but is a pragmatic response to the current volume of work within the industry.

Offtake product definition and baselines

(i) Which of the options described for product definition and baseline determination do you believe is most appropriate?

None of the proposed models recognises the inherent differences in operation between direct connects, storage offtakes, interconnector offtakes and DN offtakes. This is key to determining a regime that is fair to all parties. Beside this lack of differentiation it is difficult to determine a model that would not be unduly discriminatory to one or other parties.

(j) Are there any alternative models that would meet the defined objectives? Eg a nodal model without the substitution incentive or a "no baseline" option?

It would seem prudent to carry out detailed analysis to identify if there are any major issues with Ofgem's preferred models before devoting additional resource into the identification of other possibly more esoteric solutions. This should not be taken to suggest that Shell Gas Direct supports Ofgem's proposed models, but is a pragmatic response to the current volume of work within the industry.

(k) Should the baselines be fixed for the five year period, or increase over time?

As the market is a movable feast it would be unreasonable to set the baseline to a flat profile. However, there should be mechanisms to address the situation where the forecast proves to be incorrect.

(l) What method of determination of baseline levels (as discussed in Appendix) is most appropriate for the determination of the level of offtake baselines?

We have no further comments to make on this.

Offtake access arrangements and incentives

(m) What threshold should trigger the release of incremental offtake capacity eg a percentage of the deemed cost of providing the incremental capacity, a fixed number of years of commitment or another approach?

Incremental capacity should always be made available where it is economic to do so. The only real way to determine of the value of incremental capacity is the end consumer. Where incremental capacity physically exists this should be made available at minimal cost. Where reinforcement is required this should be provided in a reasonable timescale to meet the end consumer's requirements. Shell Gas Direct considers that the approach that the Authority adopted in the Langage decision is appropriate; ie shallow connection policy. We would welcome better understanding as to why the Authority considers its original decision to no longer be appropriate.

(n) How should National Grid NTS be incentivised to release incremental capacity as soon as possible, and should the limit on release be set as a fixed period, for example, three years, or linked to a fixed interval once the relevant planning consents have been obtained?

With direct connects the end consumer is subject to similar planning constraints as National Grid. Any proposal must be reciprocal in nature and should recognise that the management of risk is the key aspiration of project management. Allowing for 1:1 agreements between National Grid and the party requiring any new investment should allow for appropriate incentives and penalties to be negotiated specific to each project.

Transitional offtake incentives and revenue drivers

(o) To what extent should incentives and revenue drivers for National Grid NTS in relation to capacity for the transitional period represent a continuation of the current "interim" NTS incentives, including the 15 day interruption incentive on the NTS?

The NTS has only infrequently been subject to interruption for capacity constraints for many years, even before the 15 days interruptions incentive was introduced. We see no reason for the "interim" arrangements to continue.

p) To what extent should incentives and revenue drivers for National Grid NTS in relation to capacity for the transitional period be consistent with the enduring NTS incentives that will be determined?

We do not consider that the transitional arrangements should restrict development of new arrangements. The important consideration is to develop robust new arrangements which benefit users of the networks and consumers who obtain the gas through these networks.

Buy back incentives for entry and offtake

(q) Would it be appropriate to treat buy backs from operational constraints differently compared with buy-backs resulting from delayed investment for incremental capacity? If so, should there be two different buy-back mechanisms and what would the advantages and disadvantages be? How could we distinguish between the two types of constraints?

As we have stated separately, we do not support Ofgem's proposals for offtake and therefore do not support buy back arrangement for this. How would consumers understand the difference between these two types of buy back costs? To the end consumer non-availability is not an acceptable option and the reason for that non-availability is moot.

(r) Should the existing buy back incentive be refined to ensure an appropriate allocation and management of risk or should a different type of buy back incentive be considered, and if so, what form might this take?

If the existing auction arrangements are to be kept then the existing model could be retained to give a degree of stability and to reduce that volume of work for the industry. However, the allocation of risk and reward needs to be reviewed as it seems only to mitigate the risks of National Grid not providing capacity for reasons that are similar to those to which the end consumer is also exposed but with no similar recognition in the model.

(s) Should delay to incremental investment due to connecting pipelines be included in the buy back incentive?

No. This should be subject to penalty arrangements specific to each project.

(t) How should risks be allocated between shippers, National Grid Gas and consumers

There is no simple answer to this question. Any regime would have to balance a number of competing issues covering the risk and reward scenario for each participant in the process. However, we do consider that Ofgem's proposals indicate a transfer of risk away from NGG to consumers which can not be seen as further consumers' interests.

(u) Would it be desirable for the regulatory regime to enable more flexible contractual arrangements between shippers and National Grid Gas (for example in relation to construction scope)? How might this achieved? What would the advantages and disadvantages be, especially how might this impact on consumers?

Flexibility in contract negotiation is the norm in commercial contracts where all parties agree on the terms of the contract. However, the provision of additional capacity on the NTS is not a free market and so some control over the operation of the monopoly player is required. Shell Gas Direct would welcome further discussion on whether direct contracting between consumers and NGG should be allowed to provide the ability to negotiate the scope of the contract to be closer in line with the requirements of the end consumer. We would expect any penalties for non-compliance with such a contract to be substantially stronger than any currently on offer from National Grid.

Interactions between entry and offtake options

(v) What are the main interactions between entry and offtake, and how does this affect the approach to baselines, revenue drivers and buyback mechanisms? The key interactions between entry and exit points are a reflection of the models used to determine the price control.

As such this question is too open-end to answer, but could be a useful topic for debate in an open forum. We note that the entry regime has existed alongside the current offtake regime with no major issues identified. Arrangements between gas transporters (NTS and DNs) should not be confused with those needed for other offtakes.

(w) Should the same approach to baselines and the revenue driver be adopted for entry and offtake? What would be the advantages and disadvantages of doing so?

Shell Gas Direct are happy to consider the detail of any proposal put forward by Ofgem.

(x) Should there be one buy-back incentive covering both entry and offtake?

Buy back regimes should be reflective of the consequence of the nonprovision of capacity. There is philosophically no reason why a single regime could not cover both entry and exit, but there would have to be incentives and penalties appropriate to each case in the regime. This may be more easily achieved by separate regimes for entry and exit.

Financial issues

We note that financial issues will be discussed in future consulations. As there has been a transfer of risk from the regulated to the monopolies, and it appears that there are proposals to continue to transfer this risk, we assume that this will be reflected in Ofgem's proposals for the regulated rate of return.