ROYAL DUTCH SHELL PLC

OBSERVATIONS TO THE EUROPEAN COMMISSION'S PRELIMINARY REPORT ON THE SECTOR INQUIRY UNDER ARTICLE 17 OF REGULATION 1/2003 ON THE GAS AND ELECTRICITY MARKETS

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Submitted via e-mail to comp-energy-sector-inquiry@cec.eu.int

INTRODUCTION

These observations are submitted by Shell International Limited on behalf of Royal Dutch Shell plc and its Group companies[1] in response to the Preliminary Report on the sector inquiry on the gas and electricity markets, published on 16 February 2006 (the "Preliminary Report"). Whilst Shell companies have responded to numerous DG Competition questionnaires as part of the sector inquiry process (including as consumers of electricity), these observations are focused on Shell's activities as a producer and supplier of gas in the EU.[2]

Shell broadly welcomes DG Competition's inquiry into the energy sector, as well as the European Commission's broader review into the future of the European Union's energy policy. Shell firmly believes that any review of the European Union's energy policy must balance the demands of competition, security of supply and the protection of the environment. All these objectives have to and can be progressed in parallel.

Shell therefore welcomes, in this regard, the opportunity to provide a reaction to the Preliminary Report and the Green Paper on European Energy Strategy of 8 March 2006 (the "Green Paper"), as well as the European Commission's on-going review of the energy liberalisation directives and the establishment of the High Level Group on Competitiveness, Energy and the Environment. Shell will comment separately on broad energy policy and the regulatory environment in response to the consultation on the Green Paper.

We would, nonetheless, expect these various initiatives to be coordinated and, whilst we acknowledge that DG Competition's sector inquiry plays a very significant role within this framework, we would also expect any competitive assessment to take into account the broader policy issues affecting the industry.

[1] The companies in which Royal Dutch Shell plc directly and indirectly owns investments are separate entities. In this document, the expressions "Shell", "Group" and "Shell Group" are sometimes used for convenience where references are made to Group companies in general. Likewise, the words "we", "us" and "our" are used to refer to Group companies in general or those who work for them. These expressions are also used where there is no purpose in identifying specific companies.

[2] This document does not purport to cover the views of those entities in which Shell has an interest but which have otherwise responded to DG Competition's questionnaires separately, namely, Nederlandse Aardolie Maatschappij B.V ("NAM"), BEB Erdgas und Erdöl GmbH ("BEB"), Rohöl-Aufsuchungs Aktiengesellschaft ("RAG") and Gasunie Trade & Supply B.V.

As the European Union shifts towards greater dependence on extraneous gas sources and as producers face an increasingly challenging environment in terms of gas exploration and production, Shell hopes that the outcome of the various initiatives will result in the promotion of those factors that are critical to underpinning the future of the sector, namely:

- Free and competitive markets;
- Security of supply;
- A regulatory environment that is clear, stable, predictable and applied equally throughout the European Union
- A regulatory environment (including the competition rules as applied to the sector) that encourages continued investment and allows companies the necessary flexibility to manage risk; and
- The protection of the environment.

GENERAL OBSERVATIONS

These observations do not address issues raised in the Preliminary Report, which relate to the application of the energy liberalisation directives. As indicated above, Shell will address these issues in its reaction to the Green Paper.

Shell acknowledges that the Preliminary Report represents "work in progress" and that there are a number of issues that remain "under review". Whilst we reserve the right to make further comments once DG Competition's thinking crystallises further, we set out below some preliminary remarks.

General

Shell would welcome a further clarification of the European Commission’s concerns relating to the application of the existing European competition law framework to the gas sector. Shell nevertheless at this stage wishes to point out that in its view the existing legal framework is more than sufficient to maintain competition in the gas sector, without there being a need for additional sector specific competition rules.

Long-term contracts

Based on the Preliminary Report, it would appear that DG Competition's emphasis is on the desirability of increasing competition through the further development of short-term markets, hub trading, liquidity and spot prices. Whilst Shell acknowledges that there is a role for short-term business in the gas market, Shell also sees that the gas business in Europe is fundamentally long-term orientated.

Shell has followed (and contributed to) the discussion around long-term contracts since the beginning of the debate on gas market liberalisation and the Gas Directive. We are therefore concerned about the renewed debate about the validity and desirability of long-term contracts.

Long-term contracts are essentially a risk management tool. They exist to limit the risk for an investor but also to give security of supply and thus mitigate the risk of disruption to energy supplies. In many cases long-term contracts have been and are a precondition for major investments.

Given the increase in import dependence that Europe is facing, we believe that a major proportion of primary gas supplies will continue to be based on long-term contracts.

Gas/oil price linkage

In the Preliminary Report, DG Competition invites comments on "the competitive assessment of the gas/oil price linkage in many contracts". Shell will in its reaction to the Green Paper provide further comments on this topic, but wishes at this stage to make the following comments.

A look at energy price indices in general shows gas prices follow a similar trend as other sources of energy, with oil as the lead. This is the case for systems that are indexed to oil, as well as those that are not.

Oil price indexation of gas prices does not lead to overall higher gas price levels. Given that spot indices, like the NBP or Henry Hub, show a considerable volatility, a meaningful comparison can only be made based on a longer time period.

Looking specifically at the UK gas market, an analysis of price indices shows that even though the NBP price is not linked in any formal way to oil, it still follows the general trend. NBP indices tend to fluctuate between gas oil prices (in winter) and fuel oil prices (in summer).

Shell also wishes to point out that, although oil price indexation is the main pricing mechanism that Shell has agreed with its customers for gas contracts in continental Europe, it is by no means the only one. Price formation is agreed between seller and buyer and Shell has agreed in its contracts other mechanisms like gas spot prices, coal prices or other indices. There are also different combinations of contract duration and pricing mechanism possible.

In oil indexed contracts the cost of flexibility/seasonality is reflected in the overall product and the overall price represents an average price. Despite the absence of summer/winter fluctuations in prices, sufficient storage has been developed on the continent, based on the value of flexibility that is part of the contracted price. The way in which this has been achieved could provide learnings for application elsewhere.

Furthermore, our experience in continental Europe suggests that industrial users are foremost interested in price stability.

This view was also reflected during the recent panel discussion on the occasion of the presentation of the DG Competition's Preliminary Report in Brussels. Philippe Varin, CEO of Corus, highlighted that the most important aspect of the market to a customer, such as Corus, is price stability.

Shell therefore advocates freedom of contract between willing sellers and willing buyers.

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