MGN Gas Networks (UK) Limited

Level 30
CityPoint
1 Ropemaker Street
London EC2Y 9HD
UNITED KINGDOM

Telephone +44 20 7065 2000
Facsimile +44 20 7065 2041

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Sonia Brown
Director, Transportation
Office of Gas and Electricity Markets
9 Millbank
London SW1P 3GE

Dear Sonia

INFORMAL CONSULTATION ON GAS TRANSPORTER LICENCES

As you may be aware a consortium led by the Macquarie European Infrastructure Fund, through its bidding vehicle MGN Gas Networks (UK) Limited ("MGN"), has contracted with National Grid Transco plc ("NGT") to purchase the Wales & the West Gas Distribution Network ("W&W DN"). The transaction is conditional on a number of events, including the consent by the Gas and Electricity Markets Authority.

This letter is MGN's response to the informal consultation paper: National Grid Transco – Potential sale of gas distribution network businesses; Initial thoughts on restructuring of Transco plc's Gas Transporter Licences; September 2004 ("CP") that Ofgem issued on 2 September 2004. This paper sets out the approach to be adopted to transform the present single Gas Transporter ("GT") licence held by NGT to a series of licences appropriate for the new industry structure assuming the sale of four DNs by NGT is completed.

Subject to satisfactory completion of the sale process, MGN will become the licensed entity for W&W DN. As a potential GT licensee, MGN believes that the licence modification process described by Ofgem in the CP is the appropriate way forward, as are the proposals generally in relation to particular licence conditions. In the attachment to this letter we provide specific comments on a number of the issues raised in the CP, and these should be read in the context of our overall support for the proposals.

Please feel free to contact either Howard Higgins (020 7065 2385) or Julian Bagwell (020 7065 2418) should you wish to discuss any of the contents of MGN's response to the CP.

Yours sincerely
MGN Gas Networks (UK) Limited

Howard Higgins
Director

SPECIFIC COMMENTS ON ISSUES RAISED IN THE CONSULTATION PAPER

In the comments that follow, we have followed the sequence in the CP for ease of cross-reference and we have provided relevant paragraph references. If an issue is discussed in more than one paragraph the reference is to the first paragraph only.

Section 3

Para 3.8 Collective Licence Modifications

MGN accepts that there is a need for relevant licence conditions to be subject to Collective Licence Modifications ("CLM") procedures and supports the creation of Standard Special Conditions that can be modified by the private CLM procedure. Following the sale, there will be four owners of gas network businesses, and each of those businesses will be substantial. These circumstances are very different from say gas supply, where there are many licence holders of markedly different size. For the gas networks, we therefore think that there is merit in each owner alone being able to block proposed modifications under the CLM procedures, especially as in some circumstances under present rules ourselves and one other new owner may not be able to block proposals, but the other owners, by virtue of the greater number of DNs that they own, will be able to block. This issue is discussed in more detail in Appendix 1.

Para 3.18 Structure of Licences

MGN accepts the proposed structure of licences as set out in the paper. MGN believes that in certain cases it may be appropriate for particular Conditions to be repeated in the NTS and DN sections of the licence, rather than being included in the NTS and DN section. This is not because of the different majorities necessary to effect changes to them, but because in some circumstances, as the system develops, it may be appropriate to change them in one section but not the other. We await detailed drafting proposals before being more specific here, but we think at this stage that it would be helpful to recognise the principle that there may be circumstances where it is appropriate initially to have identical Conditions in the NTS and DN sections of the licence, which may diverge over time.

Section 4

Para 4.3 Transportation Charging Arrangements

MGN supports both of the new concepts put forward in the CP, namely the use of the Joint Office to co-ordinate and generally administer proposed changes to charging arrangements and the reasonable endeavours requirement to limit changes to once a year.

Para 4.9 Emergency Response at or close to DN Boundaries

MGN agrees with the principle that the first engineer despatched to an emergency should deal with it, even if it is not within his or her defined DN territory. In this regard MGN welcomes recent NGT proposals put to the Development and Implementation Steering Group ("DISG") regarding corridors around DN boundaries and sharing of relevant asset information in those corridors. With regard to the drafting of the specific licence condition, MGN's support for this principle is conditional upon MGN bearing no more (and no less) liability for the actions of our staff than if the emergency had occurred in its defined area.

Para 4.12 First Emergency Response Services to IGTs

MGN believes that DNs are best placed to provide emergency response services to IGTs. Although it would be preferable for these contracts to be the subject of competitive tendering, MGN accepts the need for a licence condition as proposed. MGN would prefer that the condition related only to first line emergency response, as it believe that other services such

as repair are more likely to be provided by a range of service providers, and not only the incumbent DN.

Para 4.14 First Emergency Response to NTS

Given present arrangements MGN accepts that the DN is best able to provide emergency response services to the NTS. As there are a number of services to be provided by the NTS to DNs, however, we feel that any reference to services being provided 'at a reasonable rate' should work in both directions, and not apply solely to DN services provided to the NTS.

Para 4.16 Regulation of NSAs

MGN have commented on this issue in our response to previous Regulatory Impact Assessments ("RIAs"). In MGN's view, there is a risk that exclusion of liability in some of the New Services Agreements ("NSAs") between independent DNs and NGT raises legitimate questions concerning the application of regulatory responsibility that Ofgem set out in its RIAs, in particular that on roles and responsibilities. One way for Ofgem to take account of those questions would be to regulate the relevant NSAs. Furthermore, there is at least one NSA, that regarding call handling, that will endure, and as that relates to important licence and safety obligations MGN feels that it would be sensible for that to be a regulated contract.

Para 4.21 Network Code and Offtake Arrangements

MGN believes that it would be better to see the offtake arrangements set out in a separate Offtake Code, rather than as part of the Network Code. MGN believes that the parties to the offtake arrangements (the NTS and the DNs) should have their own Code (similar to the SO-TO Code that has been put into place in the electricity sector as a result of BETTA), although we would not wish to restrict the ability to propose modifications to that Code to those parties alone.

MGN's view is that it is somewhat artificial to distinguish technical and commercial arrangements and that both of these areas should be covered in a separate document that is a multilateral contract between the relevant parties, namely NGT and the new DN owners. MGN also believes that, as with the Unified Network Code, responsibility for, or 'ownership' of, the Code should be a matter for the network owners involved, and not just NGT.

Finally, MGN accepts that if there are two Codes then issues such as conformity and precedence will need to be addressed, but given the recent proposals for common administration and governance we do not think that having two Codes as opposed to one makes any practical difference here. Whatever the outcome, we also believe strongly that work should proceed now on determining the offtake business rules, and if necessary draft Code paragraphs, prior to a final decision on where those paragraphs will eventually reside. We feel that it is a matter of urgency that these matters be progressed, rather than awaiting decisions on the final Code structure.

Para 4.25 Price Controls and Incentive Arrangements

We note the present position, that any DN incentive arrangements would, to begin with, last for a year, and we await the proposed November consultation on such arrangements.

Para 4.32 Planning Standards

MGN's view is that it is critical to maintain the application of the 1 in 20 planning standard to DNs for three reasons. First, it is already applied in the way in which the NTS plans to meet its obligations in relation to that standard. Second, its application is therefore understood in relation to system planning, and MGN believes it is undesirable to change such a critical standard at a time when a number of other areas are changing. Third, there is a need for some sort of planning standard at the DN level, as without a standard both the licensee and

Ofgem will find it difficult, if not impossible, to come to a common view as to investment requirements at the time of price control reviews.

In addition, given the need for a planning standard, any consideration not to impose the 1 in 20 standard has to incorporate a proposal for an alternative standard. Whilst other standards could be considered, MGN's view is that it would be better to continue with the present standard for the time being. Going forward, we also believe that it will be important to preserve the principle of a common planning standard and maintain the consistency in its application presently achieved by all relevant entities being in common ownership.

Finally, MGN believes that clear guidance needs to be given regarding the 1 in 50 planning standard, and we assume that this will not apply at the DN level, as it relates to energy and not capacity.

Section 5

Section 5 is a substantial part of the CP and goes through every Condition in the present GT licence. There was also lengthy discussion of this section at DISG 19 on 14 September, at which MGN expressed its views. MGN therefore will not comment on every Condition discussed in Section 5. In general, MGN agrees with the various proposals by Ofgem in terms of the treatment of particular Conditions, including the proposed classifications as Standard, Standard Special or Special in relation to individual Conditions. We have a number of specific comments as set out below; in this part of our response we refer to licence Condition numbers rather than paragraph numbers.

Various relating to LNG

MGN supports the proposals in the CP for LNG to be treated as an NTS matter, and would prefer to see relevant licence conditions relating to that activity to be confined to the NTS only part of the new licence.

ASC4D Conduct of Transportation Business

MGN accepts the need for a later review of potential competition concerns once the implications of the potential new ownership arrangements have been assessed. That said, at this stage we are not aware of any obligations other than those that are already in the present licence, for example those dealing with non-discrimination, that would be needed. There are separate concerns that Ofgem describe in relation to the NTS/RDN boundary and the potential for discrimination, which is discussed later.

SC5A and SC33 Registrar of Pipes

MGN accepts the need to retain the Conditions relating to the Registrar of Pipes. However, we do not believe that such a Registrar should be appointed before or on completion of the sale process, although we accept that a later review regarding such an appointment may be appropriate. This view is based on the arrangements that will apply on sale completion which include retention of a central database of relevant pipeline information, controlled and managed by NGT, to which we will have access through various New Service Agreements (NSAs). For the moment, therefore, there is no practical change in the central arrangements to hold data regarding pipeline systems and thus no immediate need for a Registrar to ensure such central arrangements persist. Over time, as MGN develops its own systems to capture and retain relevant pipeline data, we accept that it may be appropriate to investigate whether more disaggregated arrangements would lead to safety issues and if so whether the appointment of a Registrar would address them. However, given the amount of work required to reach completion of the DN sales, we do not think it appropriate or necessary to consider such issues now.

MGN also suggests that considerations on this issue should be primarily a matter for the HSE, given its specialist knowledge on such matters.

ASC6 Emergency Services

MGN notes that there are important concerns over safety that will be addressed, in part, by careful definition of responsibilities as between the NTS and the DNs, and we therefore support the policy proposals in this regard set out in the CP.

ASC9 Network Code

MGN agrees that there is substantial work to be done to create the new Unified Network Code ("UNC") and reflect it appropriately in licence Conditions. MGN accepts in principle the obligations described in the CP, although it would want to see detailed drafting here and how essentially joint and several liabilities with regard to the provision of a UNC are handled. We accept the need for an additional Code objective regarding efficiency, but again would want to see detailed drafting to understand the implications for our network business.

MGN would prefer that the consent to modify was not changed for the moment, for two reasons. First, we assume that some form of consent will still be required, and any changes would no doubt be the subject of detailed discussion, at a time when resources are already stretched. Second, we feel that any changes are not necessary to complete the sales process and that it would be preferable for a relevant modification proposal, if one is required, to be raised once the UNC is in place.

SC25 Long Term Development Statement

MGN's view is that it would be useful for interested parties to see long term statements relating to DNs as well as the NTS. MGN understands the concern that a process that puts the NTS in a central planning position could allow it to favour either its NTS business or its RDNs, at the expense of independent DNs. Given NGT's comments on the present processes that underpin the ten year statement (i.e. the resolution of NTS planning issues by reference to the need to meet DN requirements for 1 in 20 resilience) MGN believes that a way forward may be for the DNs to be required to publish statements a specified time in advance of the equivalent NTS publication. For example, if the DNs all published ten year statements every June, then the NTS could publish its statement in say, October, taking into account DN requirements. We accept that this approach does not allow iteration between NTS and DN plans, except at annual intervals (that is the DN plans in June year 2 could take into account the NTS plans of October year 1), but if discrimination is a concern then we believe that any proposals that iterate plans, and thus imply a degree of co-ordination, would be difficult to achieve. The trade-off in MGN's proposal is clearly a loss of any efficiency that would be achieved by co-ordination, and that would need to be set against the discrimination concerns set out in the CP. We think that such losses are likely to be minimal, however, given the timescales over which such plans operate, and that the annual iteration implied by our proposal ought to be sufficient.

ASC30 Regulatory Accounts and SC41 Cross Subsidies

MGN supports the proposal that regulatory accounts should be prepared for each DN (i.e. multiple DNs in common ownership should each be required to publish regulatory accounts). We also believe, but cannot be specific at this stage, that further attention may need to be given to the Regulatory Accounting Guidelines to ensure transparency in any dealings between the RDNs and the NTS. MGN's view is that it will be important to identify potential cross subsidies, and that this may require a special degree of disclosure of material transactions between the RDNs and any other part of the NGT group.

ASC39 Business Ringfencing

MGN supports the proposals for a relatively robust form of ringfencing to deal with concerns over discrimination in relation to affiliated businesses. We recognise the concerns that Ofgem raise and agree that particular arrangements do need to be put into place. For example, although not discussed in the Licences CP, we support the proposal set out in other RIA decision documents that separate legal entities within NGT hold separate licences. We also note that there are a number of other licence Conditions that relate to this, such as SC41, SC45, ASC47 and SpC2. We note that it would be helpful if the Standard and Standard Special Conditions could either be amalgamated into one overall Condition on ringfencing, so that all the relevant obligations are placed together, or if the various Conditions could be placed one after the other in the revised licence.

SpC26 Prohibited Procurement

MGN agrees in principle with the proposal to constrain procurement by the DN in relation to gas assets. We also believe that very careful consideration will be needed to drafting in this area, not only to ensure that appropriate arrangements can be made with regard to gas purchases for shrinkage management purposes, but also more generally in relation to system management. For example, if the NTS is able to contract with the DN for balancing management services, the DN may in turn need to be able to buy transportation commodities, i.e. interruption rights, to provide such services. We suggest that this issue is reconsidered as and when detailed business rules emerge.

Removal of Various Conditions

The CP proposed to remove several Conditions that are either time-expired or otherwise redundant. MGN supports these proposals, in relation to Conditions SpC5, SpC17 and SpC38.

Apart from the above, there are a number of Conditions where precise details remain to be resolved. The list includes, but is not limited to, whether SC5 will be applied at the DN level, how SpC26 will impact upon MGN ability to manage its network and how SpC27 will work in practice at the DN level. Furthermore, as mentioned at a recent DISG, we think that Conditions such as SpC27 will need careful drafting to deal with the liabilities that compliance with some of the proposed terms will create. For example, the requirement not to prejudice other systems may be redundant given all the other requirements that already exist in relation to system operation.

Section 6

Para 6.4 CLM Procedure

See comments on para 3.8 above

Para 6.6 Switch On / Switch Off Condition

MGN sees this as a necessary adjunct to the proposals to create Standard Special Conditions. For the avoidance of doubt, we think that it would be helpful if this Condition could contain the criteria under which it would be applicable. For example, we believe that its use should be restricted to technical problems relating to the creation of the relevant Conditions and that it would not be appropriate to use it more widely to remove or bring into effect particular Conditions.

Para 6.9 Implementation of Gateway Requirements

Whilst a number of gateway issues have been resolved through various RIA decision documents, others remain to be finalised, and the operational detail of those resolved remains

to be determined in some cases. Whilst MGN accepts that such issues were always part of the rationale for Ofgem's support of the sale process, it remains concerned that full implementation of some of them could delay completion, and thus could delay the realisation of the benefits from the process that have been identified not only in the December 2003 "Next Steps" document, but in several subsequent RIAs. MGN therefore believes that it is important both for there to be a robust plan to deliver the arrangements and that all parties recognise the possibility of interim measures relating to gateway requirements, with full implementation (if necessary) being achieved after completion, but as a condition of completion.

Para 6.14 Requirement not to Prejudice Other Systems

Although MGN accepts in principle the need for such a licence obligation, we think, as noted above, that it may not be required given all the other obligations imposed upon network owners. As the obligation will in effect impose liabilities on each network owner, we would want to see the detailed drafting of the relevant Condition before commenting further. We also believe that this Condition will have a material impact upon others, such as SpC27, and that the drafting will need to take that into account.

Para 6.17 Inter-Operator Service Agreements

See comments on para 4.16 above

Para 6.22 Governance of Technical Standards

MGN accepts the principle that there needs to be appropriate conformance of relevant technical standards. However, we believe that such governance would be better effected through terms in relevant Codes, both UNC and Offtake (if separate) rather than in a licence Condition.

Para 6.25 Arrangements for Gas Measurement

Our comments are similar to those on Para 6.22 above.

Appendix 1

Discussion of CLM Issues

The discussion of CLM issues that follows is based upon the comments in the CP on and the Ofgem guidance on CLM procedures[1] ("CLM Guidance Note").

In the CP, Ofgem proposes to introduce a new type of Condition, a Standard Special Condition, and to transform a number of the existing Special Conditions and most (if not all) of the Amended Standard Conditions into Standard Special Conditions. Once those changes have been put into effect, Standard Special Conditions can be amended by the CLM procedure[2], albeit a private procedure. MGN assumes, however, that all the rules and processes governing that private procedure will be as those set out in the CLM Guidance Note for the present CLM procedure.

Some existing Conditions for one of two reasons[3] cannot presently be amended by CLM. MGN supports the transformation of such Conditions into Standard Special Conditions, which can be amended by the CLM procedure, but only if there are appropriate safeguards, as discussed below.

The CLM Guidance Note describes a two stage process to determine whether or not a blocking minority to a proposed amendment is sufficient to enable the amendment not to be made. The first test is simply the number of relevant licence holders. If the number lodging a statutory objection is equal to or more than 20% of the total number, then the amendment cannot be made. If that threshold is not breached, but at least one statutory objection has been lodged, then the second test is to consider the market share of relevant licence holders. According to the CLM Guidance Note, for gas transporters this is determined by reference to gas flows. Again the criterion is that equal to or more than 20% of licence holders by market share must lodge statutory objections for the amendment not to be made.

Any assessment of the impact of these criteria is complicated by the facts that the first test is based on numbers of licence holders and that it is not yet clear, at least to MGN, how many DN licences NGT and the Scottish & Southern Energy plc led consortium ("SSE") will hold. The analysis is further complicated by its application to NTS and DN conditions, or DN only conditions.

In terms of the number of licence holders, two options are considered (others between these extremes are possible). If NGT and SSE were each to hold the minimum possible number of GT licences, there would be one NTS licence and four DN licences. If these companies were each to hold the maximum possible number of GT licences, then there would be one NTS licence and eight DN licences.

In the former case, MGN would be content with the present rules on CLM procedures remaining in force, providing no further licences were issued to DNs. This is because with only five licence holders, any one in effect could block on its own a licence amendment proposed under the CLM procedures, and could thus protect its interests as appropriate. This conclusion would apply both to NTS and DN proposals (one in five, i.e. 20%) and DN only proposals (one in four, i.e. 25%).

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[1] Guidance on modifying the standard licence conditions of gas and electricity licences: Ofgem September 2003

[2] For the avoidance of doubt, such Conditions can also be amended by Ofgem if the tests set out in paragraph 2.38 of the CLM Guidance Note are met or by reference to the Competition Commission on public interest grounds. For the remainder of this Appendix, the discussion is only on amendments being effected or blocked through CLM procedures

[3] The first is that the Condition is an Amended Standard Condition and the second is that the Condition is a Special Condition. Both such Conditions can only be amended by individual consent and CLM does not apply

In the latter case, the analysis is more complex. On the number of licences alone, NGT could block any proposed amendment. SSE could also block on its own (for DN only proposals, two in eight, i.e. 25%, for DN and NTS proposals two in nine thus 22.2%). MGN and the consortium led by Cheung Kong Infrastructure Holdings Limited could not block a proposal individually, but could do so in unison.

Any proposal to change a licence Condition under CLM will impact all four parties presently envisaged to be NTS or DN licence holders. Because MGN is affected to the same proportionate degree as other licence holders, and as our investment is substantial, we do not believe that it is appropriate for decisions on the numbers of licences to be held by third parties to affect our own position with respect to the application of CLM procedures. It could be argued that the present rules create what is presumably an unintended perverse incentive on certain parties to hold more than one licence, as to do so would allow them to retain blocking minorities that others including MGN would then not enjoy.

A short term equitable solution would be for a licence Condition to set out that, in the event of common ownership of more than one licensee, then for CLM purposes all licences in such ownership would be counted as one. This would then properly leave other licensees indifferent to the number of licences that they held in relation to CLM procedures, and any decision on the number of licences can be made on other grounds without impact on MGN.

More generally, however, MGN believes that the situation in relation to gas network ownership is different to that in say supply, where there is a range of participants ranging from the very small to the very large. All the DNs will be substantial entities and therefore we believe that it is reasonable for any one party to be able to block a proposed modification, especially as in present circumstances two parties, NGT and SSE, will always have that ability. MGN would therefore wish to see CLM rules that would endure even if more DNs were sold by NGT and/or more licences were issued to present DN licensees. Such rules should perpetuate the rights that would presently only apply if the minimum number of licences were awarded, in other words that any one DN licensee could block a proposed modification.

MGN believes it is important to include such rules in the new licences, as the alternative of assuming both that the minimum number of licences will be issued and that no further licences will subsequently be issued is unlikely to stand the test of time.

If these proposals are adopted, then given that the CLM Guidance Note says that the first test is always the number of licensees, the market share test would not apply, because any one licence holder could block on its own, and there would be no need for recourse to the market share test. If, nevertheless, circumstances arose in which that test would apply to gas network owners, then we think that consideration should be given to the fact that NGT has a dominant position and special steps may necessary to create equity with other users. That could involve lowering the market share threshold in particular circumstances, or in some way weighting the shares of other participants. As discussed above, however, given the substantial nature of our investment, we would prefer that matters be resolved as proposed rather than special arrangements being introduced regarding market share.

END