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Sonia Brown
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Dear Sonia

POTENTIAL SALE OF GAS NETWORK DISTRIBUTION BUSINESSES

**OFGEM CONSULTATION: INITIAL THOUGHTS ON ENDURING INCENTIVE SCHEMES
SUPPORTING THE OFFTAKE ARRANGEMENTS**

This document is the formal response to the above consultation by MGN Gas Networks (UK) Limited (MGN). MGN has signed an Option Deed with National Grid Transco (NGT) to acquire the Wales and the West (W&W) Distribution Network (DN) being sold by NGT. The transaction is conditional on a number of events, including the consent of the Gas and Electricity Markets Authority.

Please feel free to contact either Ed Beckley (020 7065 2039) or Nick Wye (020 8540 7691) should you wish to discuss any of the contents of MGN's response to your consultation.

Yours sincerely
MGN Gas Networks (UK) Limited



Howard Higgins
Division Director



PP Edward Beckley
Senior Manager

POTENTIAL SALE OF GAS NETWORK DISTRIBUTION BUSINESSES

OFGEM CONSULTATION: INITIAL THOUGHTS ON ENDURING INCENTIVE SCHEMES SUPPORTING THE OFFTAKE ARRANGEMENTS

MGN GAS NETWORKS (UK) LTD RESPONSE TO CONSULTATION

In the comments that follow, we have structured the response in the format produced in the consultation paper. Paragraph references are to those in the consultation paper.

Chapter 3

3.52 - The most appropriate methodology for the setting of baselines for NTS exit capacity and NTS exit flow flexibility;

Ofgem identifies four possible approaches for determining NTS exit baselines. MGN is of the view that the baseline quantities for the two products, exit capacity and flow flexibility, should be defined independently as they are discrete products serving specific customer requirements. The NTS has been designed and constructed to meet 1 in 20 end of day demands, whereas the flexibility contained within the system is effectively a by-product of pipeline capacity. The level of available flexibility is dependent upon a number of variables e.g. overall pipeline capacity, locational and aggregate supply and demand for gas, and NTS SO operation of the system, including compressor operation and within day commercial decisions (linepack stocking/depreciation and OCM activities).

We believe that baseline exit capacity should approximate design standards, because there is no other rational basis available. Baseline flexibility, however, should be set at a level which reflects the uncertainty in definition and the level of fluctuation likely to be experienced over the year and during a Gas Day.

In terms of the four options discussed for baseline exit capacity, we believe that Transco should be required to release 1 in 20 firm demand plus interruptible. We think that this is the most logical capacity that relates to present planning and operation of the system, and provides a sensible balance between limiting NTS buyback exposure and ensuring that NTS is encouraged to maximise the release of the primary products. For flow flexibility, we think that a figure approximating theoretical maximum physical capacity would be appropriate, as this product is new and should reflect incentives for NTS to manage the system appropriately, so that costs are only imposed on DNs to the extent necessary.

3.52 – The indicative baseline numbers for TNS exit capacity provided by Transco in Appendix 1

We note that the figures provided in Appendix relate to NTS exit capacity with no provision made for quantities of flow flexibility, which we understand will be determined on a national basis. We request that Transco provides the industry with figures for baseline flow flexibility for each of the scenarios described. We are not in a position to comment on the accuracy or otherwise of the various figures presented.

3.52 – Whether some growth in baselines over time should be assumed

We believe that where appropriate the enduring exit incentive schemes should mirror the entry incentive schemes and for this reason would support profiling of baselines over time. We would expect that the determination of the profiles would require co-ordination with the relevant offtaking “customers” i.e. DNOs and shippers.

3.67 – The proposed treatment of substitution and investment as part of the enduring incentive schemes

We concur with Ofgem’s statement of the focus of enduring incentives set out in paragraph 3.66; however, we are unclear as to how Ofgem will monitor the investment effects as

described. In order to remove investment uncertainty and regulatory oversight it may be simpler to “factor in” substitution effects in the initial calculation of the baseline quantities. The application of uplift to the firm 1 in 20 baseline quantities would require NTS to effect substitution where possible in an attempt to mitigate against buyback exposures. We believe that the proposals laid out in our response to baseline quantities would be adequate and ensure that these objectives are realised.

3.71 – The proposed approach to calculating UCAs for NTS offtake points

We agree with Ofgem that the methodology to be employed for the calculation of offtake UCAs should reflect that followed at entry.

Chapter 4

4.2.8 - The initial proposals regarding the form of NTS enduring incentive schemes

We support the simplification to the “sustained demand” test outlined in paragraph 4.21. The complex interaction of exit flows due to the quantity and proximity of the offtake nodes means that NPV tests would be difficult to perform and likely to produce ambiguous outputs.

The treatment of incremental SO revenue detailed on paragraph 4.22 appears acceptable, although the detail regarding the recovery of under/over recovery requires further exploration. Ofgem propose that the SO commodity charge may be an appropriate mechanism for recovering such variances, which by definition requires a high degree of socialisation of these costs/revenues. In addition to the merits of applying the SO commodity charge to balance revenues further consideration needs to be given where the charge will be targeted. We wish to retain the right to explore this option when Transco sets out its proposals for transportation charges associated with the enduring regime.

With regards the situation where incremental capacity is provided through substitution, we have already commented upon this in our response to the queries raised in paragraph 3.67 above.

4.4.3 - The initial proposals regarding the form of NTS enduring incentives outlined for the medium/short term incentives

The sliding scale set of incentives outlined by Ofgem are consistent with those applied at entry. They are simplistic and have operated successfully since the overhaul of the entry regime. On this basis, we believe that a similar approach should be adopted for the exit products, although significant work remains to be done to determine appropriate target levels.

The 50:50 sharing factors seem appropriate in the short term and we would encourage Ofgem to impose conservative caps and collars during the initial years of operation.

The process for determining the location and duration of maintenance upstream of offtakes is far more complex than NTS maintenance which affects entry points. Primarily, this is due to the fact that there is a greater number of offtake points, many of which are interrelated. The UNC and more particularly the Offtake Arrangements Document, which is to form part of the UNC, provide for a high degree of co-operation between NTS and DNs in developing maintenance programmes. Because of these complexities, we believe that it may not be appropriate to include maintenance in buy back exposures. This suggests that the two options outlined in paragraph 4.42 should be considered; our preliminary view is that assigning a fixed amount of expenditure might be the simplest approach, although the amount would need to be reviewed carefully to ensure that it is set at an appropriate level.

4.6.2 - The most appropriate way of including demand growth in the incentive schemes defined for the DNs.

In accordance with our views expressed under paragraph 3.52, we believe that an ex ante approach to allowing for demand growth should be pursued. This approach would be simple to administer and establish a predetermined target for DNs to plan their purchases of offtake capacity. The issue of forecast uncertainty does need to be considered, however, if the target

period exceeds 3 years, the accepted period for constrained sales. we suggest that it may be appropriate to consider a “re-opener” for periods greater than 3 years forwards, allowing for resetting of the targets as more robust planning information becomes available. The “re-opener” could be based on a fixed percentage increase above that forecast for years 4 and 5. For example, if additional requests for LDZ capacity are received in year 2 for year 5 operation and the additional demand is material, then the target could be modified. The materiality test could be as simple as; if the additional capacity requests within the LDZ produce an increase of aggregate demand which is equal to, or more than [1%] of total forecast demand then the cost performance target may be modified with the consent of Ofgem.

4.66 – The most appropriate form of the volume and price elements of the cost performance

With regards to the price element of the cost performance, MGN believes that the process outlined in our comments relating to demand growth is equally valid. Again, the aspiration should be to promote certainty in targets whilst at the same time recognising where a material change is experienced in either component of the cost target formula, then the methodology needs to be flexible so as not to expose the DN to unmanageable risks. Similar to the proposed demand forecast “re-opener” we suggest that for years 4 and 5 of the incentive, it would seem appropriate to apply a materiality test to increases in offtake baseline prices.

Under paragraph 4.64, Ofgem states that it considers that DNs should be exposed to the overall value of NTS exit capacity and NTS flow flexibility. We find this statement confusing. We understand that the costs of purchasing these products will be incurred by the DNs, but subject to the incentive caps and collars and the relevant sharing factor, the remainder of the costs will be “passed through” to shippers via the DNs charging methodologies. Can Ofgem confirm that our understanding is correct in this regard?

4.84 – Whether it is appropriate to express DN caps and collars in terms of a percentage of the cost performance target

We are of the view that Ofgem's proposal to adopt a fixed percentage approach, rather than an absolute value, in the setting of cost performance targets, is appropriate. This would ensure that the locational nature of exit charges is better reflected in the incentive schemes. We would bring your attention, however, to the comments made previously concerning the potential for re-opening the targets so that unexpected changes to the volume and price components of the target value can be accommodated.

Under paragraphs 4.71 – 4.74, Ofgem identifies the issue relating to DN price control allowances for NTS offtake investments. Ofgem sets out two alternative approaches to deal with this issue; the “inclusion approach” and the “exclusion approach”. For reasons explained in paragraph 4.72, the inclusion approach is complex and may be difficult to justify on a cost-benefit basis. The exclusion approach is, by its very nature, simpler and better reflects current practice in the assessment of the efficiency of investments. The ex-post review of investments made by a DN at the time of the price control can be expanded to incorporate the review of NTS offtake related investments under the incentive schemes. The issue of “tagging” is an added complication, but we would argue that it would not necessarily “significantly complicate the price control process” as suggested by Ofgem. In addition, both approaches have a degree of complexity, and we believe this would still be less in the exclusion approach.

Ofgem states that a sharing factor lower than 100% would be likely to distort the trade-off decision faced by DNs. We fail to see why the application of a sharing factor to the DN target would be any different to similar applications in other incentive schemes. The level of under/over recovery related to the DN activity, be it investment in the network, purchase of offtake rights and demand management would provide proportionately the same outcome, independent of the level of the sharing factor. For this reason MGN proposes that a sharing factor is introduced and that a 50:50 share would be appropriate, consistent with that applied in the NTS scheme.

END