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16 December 2004

Sonia Brown
Director, Transportation
Office of Gas and Electricity Markets
9 Millbank
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Dear Sonia

**OFGEM CONSULTATION ON POTENTIAL SALE OF GAS DISTRIBUTION NETWORK
BUSINESSES – FINAL IMPACT ASSESSMENT**

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.

Our response is attached, including a single page Executive Summary. A single paragraph summary of our response is as follows:

MGN supports the assessment and conclusions in the Final IA and believes that they demonstrate clear benefits to customers. In a number of areas, it can be argued that the assessment of benefits is conservative, which underpins the robustness of the figures presented. We also believe that the benefits can only be realised if the sale proceeds. We note that there are a number of issues where appropriate detail remains to be developed, but think that is inevitable in a complex project of this nature and should not be seen as an area of major concern, nor a reason to defer a decision on the sale.

Please feel free to contact either Ed Beckley (020 7065 2039) or Julian Bagwell (020 7065 2148) should you wish to discuss any of the contents of MGN's response to your consultation on the Final Impact Assessment.

Yours sincerely
MGN Gas Networks (UK) Limited

Howard Higgins
Division Director

Edward Beckley
Senior Manager

**OFGEM CONSULTATION ON POTENTIAL SALE OF GAS DISTRIBUTION NETWORK
BUSINESSES – FINAL IMPACT ASSESSMENT**

MGN GAS NETWORKS (UK) LTD RESPONSE TO CONSULTATION

EXECUTIVE SUMMARY

MGN Gas Networks (UK) Ltd (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.

We agree with the conclusions in the final Impact Assessment (IA). We have provided a number of comments, and in summary:

- we support the assessment and the conclusions reached. In particular we believe that the assessment of benefits associated with the sale process has rightly been conservative, and that this provides a degree of robustness against concerns that some of the benefits are hard to quantify. Given that the quantum of benefits is well in excess of the quantum of costs, in all but one of a number of scenarios, we believe that it would be difficult to determine that the sale process will not yield overall benefits to customers. Further, the one scenario where benefits are less than costs is not only very unlikely, but were it to occur the safety net provisions described briefly in the IA would come into effect, thus protecting customers. We also believe that the benefits identified can only be realised if the sale is to proceed; we do not think it realistic to assume that they can be forced onto NGT were it to remain as the single entity providing transportation services as it does now;
- we believe that the IA is a sensible digest of the position reached to date. It summarises the conclusions of other consultations, presents recent developments in thinking that have taken place in fora such as the Development and Implementation Steering Group (DISG) and does not introduce new policy proposals not already canvassed in that group or elsewhere;
- we also believe that the process to date has been open and participative. A number of Consultation Papers, augmented where appropriate by Open Letters, and supported by a variety of expert groups and more recently NGT-led development groups, have allowed all concerned to express their views, usually more than once;
- in a number of areas, we comment that our support is qualified until we see more details. It is important to note that we do not believe it appropriate for the Authority to wait for the emergence of those details before coming to a decision. In a complex programme of this nature, at any point in time detail will remain to emerge and we believe that enough has been done to date for there to be confidence that the assessments are well-grounded and can support a contingent decision to proceed. Furthermore the Authority has established processes to manage the continued development of detailed policy and associated business rules, and to ensure that the conditions attached to any approval are fulfilled;
- we would like to see the conditions precedent to the sale identified in full as soon as possible, recognising that in a process such as this further conditions may emerge as and when issues are determined in more detail.

Finally, we can confirm that we strongly support the sale option presented in the IA, as we believe that it will deliver genuine and demonstrable benefits to customers.

We would be grateful if these comments could be brought to the attention of the Authority.

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. Paragraph references are to those in the IA unless we specifically reference another document such as one of the Appendices to the IA.

1 Introduction

This chapter is necessarily general and we do not have comments on particular paragraphs. We do have one general comment on the process.

The consultation processes mentioned in this chapter, and described in more detail in Chapters 2 and Appendices 1 to 3, have been very open and participative. In our view this process has allowed all views to be put forward and considered in an open manner. Whilst we are aware that some parties are critical of aspects of these processes, we do not think that much could have been done to improve them. We therefore support them as the most appropriate way of moving forward what the document itself recognises is a complex series of changes to the industry.

2 Background

Again this is a general chapter and we have no particular comments. In passing we would note that reference is made here to the UNC Workgroup (paragraph 2.33) and it might be helpful to note that a similar Exit Reform Workgroup has more recently been established.

3 Objectives

In paragraph 3.7 reference is made to a contingent approval, with the conditions that would still need to be met being discussed in Chapter 11. In fact the discussion in Chapter 11 is indicative only, and we think that it would be helpful if any conditions that are necessary could be described in more detail as soon as possible. Whilst we accept that further conditions could be imposed later in the process, we believe that to have early sight of the conditions that the Authority presently envisages would be helpful.

Various paragraphs mention the consents that will be required for the sale to proceed. The present timetable shows various processes, such as consultation and formal s23 notices. It would be helpful if these two matters could be combined on the timetable, so that it was clear what processes would lead to the fulfilment of what consents. In addition, there are other consents that will be required, for example new licensees satisfying the Authority as to their financing arrangements, and those should also be shown on the timetable.

4 Key Issues

A number of specific questions is posed in paragraph 4.34. Our answers to those questions are set out below.

Potential Benefits

Introduction of comparative regulation: as noted later in the IA, there is substantial evidence that there are benefits to be obtained from such comparisons. From our own experience as a potential new buyer, we note that the sale process inevitably creates greater transparency in a number of areas. This results from at least two separate pressures, the first simply to specify particular arrangements in more detail and the second to introduce new arrangements to deal with new interfaces that previously were internalised.

Introduction of independent management teams: there are potential benefits to be gained from such teams. In addition, the sale process itself creates a requirement to decentralise a number of business processes, which will in future fall to members of the new teams rather than to central functions within NGT. Whilst it can be argued that economies of scale allow these processes to be conducted more efficiently centrally, we believe that the counter argument, that decentralised processes allow swifter and more effective decision making, is more likely to apply. In that regard, the competitive processes of innovation means a positive outcome from more fragmented decision making – one consequence of competition is the benefit of comparing the outcomes of decisions by many participants, normally seen as worth more than relying on one central body taking such decisions.

Potential for operational improvements: many of these improvements will come about from other factors, such as new management teams. We believe that further potential will depend, as the paper mentions, on the proposed changes to offtake and other arrangements and the effective development and use of market based pricing signals for new investment.

Promotion of competition: whilst we recognise that the proposed sales can have both positive and negative impacts, on balance we are confident that net benefits exist. This is because it will be in the interests of new owners to encourage usage, and we are certain that this will lead to innovative approaches to issues confronting shippers and suppliers.

Potential Costs

Fragmentation of interfaces: there is no doubt that some fragmentation will occur, but the Agency is a sensible approach to minimising them.

Fragmentation of decision making: the IA mentions two different aspects. In relation to network operation, we accept that the price based regime at the NTS/DN interface is the appropriate way to deal with such concerns, although we believe that there are likely to be transition issues in terms of appropriate definition of products and pricing that will arise and will need to be addressed. As noted above, In addition, the competitive processes of innovation mentioned above means a positive outcome from more fragmented decision making – one consequence of competition is the benefit of comparing the outcomes of decisions by many participants, normally seen as worth more than relying on one central body taking such decisions. With regard to the risks of undue discrimination, we believe that the framework proposed by the Authority should be sufficient, providing that there are clear and acceptable ringfencing provisions in place.

Impact on competition: we believe that the Agency and the associated SPA proposal should meet most concerns here, and that others listed in the IA are marginal, in the sense that they are unlikely to have any material impact on the assessment of costs and benefits.

Security of Supply

We agree with the points made in paragraph 4.30.

5 Options

Our responses to the questions posed in paragraph 5.118 are as follows:

Allocation of Roles and Responsibilities

The proposals in the IA are consistent with those in the April Consultation Paper on these issues and the subsequent Decision Document. We support the proposal for a relatively active DN, for the reasons stated in the IA. In addition, we believe it important for the DN to be active and have the ability to manage events on its own network, as without this we do not believe that some of the benefits mentioned earlier will be achieved. For example, if the DN has no active role in network management, then it is less likely to be incentivised to consider innovative transportation arrangements of benefit to shippers or suppliers. More

generally, we think it important for the DN to have an active interest in all aspects of its network and not only some of them, for it to be able to determine how best to seek efficiencies and innovative ways of resolving issues.

Offtake Arrangements

NTS exit arrangements: We support in principle the adoption of Option 2A, as described in the IA, namely a DN booking model, subject to the product being provided at acceptable minimum pressures, an important point that we will track in the exit reform discussions. Pressure is an intrinsic component of a capacity product, and for that matter a flow flexibility product, and as a result any failure by NGT to commit to minimum/maximum pressures in conjunction with the provision of these products would render them worthless. Assuming that appropriate commitments are provided, however, we believe that the arrangement would align responsibilities properly with the allocation of roles discussed above, and represents a sensible balance between the requirements of the various participants and the risks that each face. We want to see more detail in certain areas before offering unconditional support, not least the impact of the yet to be determined incentive schemes, and what risks we face in terms of buying NTS exit capacity and effectively selling it on to shippers; for example we need to understand the credit arrangements between DNs and NTS and also whether price control modifications will allow us to buy the product in advance. On a separate point, at this stage we find it difficult to understand how the 1 in 20 obligation will sit on the NTS. We will buy NTS exit capacity to meet our 1 in 20 DN obligation, and this will presumably place an obligation on the NTS to reinforce its network. If it fails to deliver gas i.e. meet the capacity obligation, then it can buy it back from the DN owners. If no offers are available there are contingency “valuations” contained in the UNC, but we are not sure that these contingency values are appropriate following exit reform and we think it important that the consequences of the 1 in 20 NTS obligation are worked through in full.

Exit capacity definitions: We think that the products and definitions presently proposed may evolve over time, as experience is gained in their use and as market participants identify and signal what particular aspects are of most importance to them. At the start, however, we are strongly in favour of relatively simple products, for at least two reasons. First, there is a danger that complex products will discourage trading and liquidity, at least to begin with, and second there is a potentially significant amount of implementation effort that would be increased still further if the products become more complex. We therefore support the introduction of annual products defined at the nodal level, as we believe that they are relatively simple and present the least implementation issues. In addition, as exit capacity is a peak day product, it seems reasonable to be required to buy an annual strip at the peak day level.

Diurnal Storage: We support the concept of making diurnal storage a separately identified and priced product. We have not been able to assess in detail the implications of the latest NGT proposals, described in the IA, as relevant supporting information such as baseline quantities and prices are not yet available. More generally, we think it important that in this and other similar areas where new products are being proposed that will have financial impacts, there is a stage in the development and implementation process during which participants can gain understanding of the implications of these new products on their business plans. This could be done by way of some form of ‘soft landing’ introduction, or through some preliminary systems that can be used for commercial, as opposed to technical, testing.

Operational Flows: We are comfortable with the principles set out in paragraphs 5.74 and 5.75, once again subject to the products being provided at acceptable minimum pressures. In addition, it will be important to determine that the capacity and flexibility products are complete and cover all possible operational activities to which they relate. For example, in paragraph 5.27 the present practice of permitting ramp rates outside of operational rules, subject to safeguards, is outlined. If such operational flexibility is not incorporated into the flexibility products, the possibility of discriminatory behaviour arises, for example if such derogations are subject simply to a NTS SO decision. In such circumstances we would like to see what else is proposed to ensure that all DNs have equal access to such flexibility.

Business Separation: As Ofgem has recognised, this is an important issue that needs to be addressed, given a variety of concerns over potential abuse and discrimination. There are a number of licence conditions that relate to such matters, but in its Offtake Conclusions document published in August 2004, Ofgem noted that additional provisions would be required. The discussion in paragraphs 5.76 to 5.81 and in Appendix 15 of the IA describes a change in stance on the part of the Authority. Two options for separation are identified, and in one case low probability but high cost outcomes are identified, and in the other the costs of things such as asset transfer are stated to be disproportionate. We would have preferred full legal separation, but we recognise that the Authority has to take into account the issues identified. We note also that additional licence conditions are likely to be proposed and we will provide further comment as and when we have reviewed those conditions.

Governance of Offtake Arrangements: We have always felt that the Offtake Code should be a separate document, with its own governance arrangements, and we would prefer that position, rather than the proposal put forward in the IA in paragraph 5.82. We accept that there are commercial issues that ought to appear in the Uniform Network Code, but we believe that the position proposed allows too much oversight by third parties and is inconsistent in some respects with the previous decisions taken in relation to the SO-TO Code in electricity. Nevertheless, we believe it important now to focus attention on developing the appropriate offtake arrangements, wherever they reside. In that regard, we think it important that the ancillary document proposed in paragraph 5.83 is one whose governance is for the parties to it alone. In particular, we believe that there will be areas of that document, such as those contained in the Annexes of version 3.0 of the Offtake Agreement Business Rules (for example, connection facilities and utility services) which should remain confidential between the parties, and we also believe that modification proposals should only be proposed by those parties, although consulted on more widely.

Allocation of Exit Rights: We support the principles set out in the IA, namely that the allocation of long term rights should be unconstrained (noting that there is an implied assumption here that investment requirements, if they meet appropriate criteria, will be approved for inclusion in the RAV), and that appropriate constraints should apply to short to medium term allocations of rights. Whilst we also support the statements that constrained capacity should be allocated in 'an efficient and non-discriminatory manner', we would like to see more detail of how these allocations will be made. There are important commercial consequences relating to capacity allocation, in particular the transparency and application of the auction rules. For example, without having sight of the baseline quantities proposed to be sold at each node, we are unable to comment on the appropriateness of the volumes being offered for sale, and yet those volumes will be important to us in terms of managing the risks inherent in the auction process. We also support the Authority position that any reform of DN exit capacity will be handled in the longer term, and outside the sale process. We see this as a helpful and welcome stance, as we are already concerned at the amount of work necessary to implement the separation required by the sale process, and we think that whenever tasks can sensibly be deferred they should be.

Interruptions Arrangements: We support the move to more market based arrangements for interruption. We believe that there are important commercial issues still to be addressed, however, and that it is important that these are recognised. For example, whilst we agree with the removal of the automatic rights to claim interruption, it is likely that certain sites will enjoy locational or temporal monopolies. Although these monopolies can possibly be reduced in the longer term through appropriate investment, it is important that for the transitional period they cannot be exploited, and in this regard we do not know whether resorting to Competition Act powers will prove a sufficient disincentive for any exploitative behaviour. We suggest that this is an issue that needs further consideration once more details of the proposed reforms at the NTS level are made available. As for the DN level, we accept the need for reform in due course, although again, as with our comments on allocation of exit rights, it is to be welcomed that this is deferred for now. In future, there are likely to be choices on occasion between NTS and DN level interruption and this may create problems for us in determining the volumes to offer. We therefore expect the DN incentive mechanism in its early stages to be lenient and very limited in

exposure. These and associated issues are ones that we would like to see addressed in the Business Rules for exit reform presently under discussion.

Timescale: Apart from our comments on individual issues, we remain concerned that there is a considerable amount still to be done to make effective exit reform within the timescales of the sale process. We do not have any specific proposals to reduce risks here, but we would find it helpful if a more comprehensive timeline could be published as soon as possible, so that all parties can understand what needs to be done when.

Short Term Arrangements

Given the range of tasks to separate out the W&W DN and be in a position to take over the network on 1 June, we are concerned at the implications for exit reform beginning next year. Whilst the precise operational details, and the associated incentives against over or under booking remain to be determined, we want to see the relevant detail to ensure that we can understand and manage whatever commercial issues arise. Separately, we note that in paragraph 5.91 it is stated that 'all' interruptible customers, not just those connected to the NTS, can choose to be firm if they wish. This statement appears to contradict that in 5.88 that interruptions arrangements at the DN level will not be reformed as part of the sale process. We would like clarification here; we assume that until DN level exit reform occurs, the arrangements presently in place there will not alter. Furthermore, we believe that there are a number of issues still to be addressed in terms of NTS and DN level interruption; for example, if there are choices to be made between NTS level interruptions based on commercial contracts and DN level interruptions based on administered prices, are there any risks of perverse incentives arising? If so, will they have any impact on our ability to manage our network? Finally, with regard to the payment options mentioned in paragraph 5.92, we will participate in relevant discussions, assuming that this issue comes to DISG for consideration, and at this stage we have a preference for the shipper apportionment approach, simply on the grounds that we believe that this will be easier to implement in the short term.

Agency and Governance

Agency: We support the principle of establishing the Agency, and agree with Ofgem that this is an important counterweight to concerns over administrative fragmentation. We also support the proposals for the allocation of functions between the NTS, the Agency and DNs. We note, however, that operational details and processes remain to be determined, and that in some areas responsibilities will be to some extent blurred, although that is probably an inevitable consequence of the proposals. For example, the DN is charged with credit management and cash collection, but the Agency is charged with billing and the resolution of queries and disputes. It is inevitable that the latter will lead to problems with cash collection, although clear and transparent procedures relating to information regarding such matters will minimise the scope for problems. We also believe that much remains to establish the Agency as a fully functioning entity able to deal with new bodies such as independent DNs, and that as a matter of urgency a full implementation plan should be developed by the parties concerned.

Governance: We support the proposals for independent governance arrangements, as we think it important both that no one body has undue influence over things such as change proposals and also that the industry collectively accepts the need to manage such arrangements, rather than leave them to someone else. We accept the proposed scope for the governance entity set out in paragraph 5.106. Whilst we accept that responsibility for establishing appropriate arrangements should be a licence condition, we believe that more clarity is required than is apparent in the present drafting. In particular, we do not think it effective to require each licensee to be responsible, as that dilutes responsibility. One party should have lead responsibility, supported by the others, and this should be clarified in the licence conditions or in the Joint Office Governance Agreement, referenced in paragraph 5.111 but not yet available, as far as we know. With regard to the proposal to separate the governance entity, the Joint Office, set out in paragraph 5.112, we agree with the proposal, but believe that if implemented such that the Office is entirely unsupported, that would be both costly and likely to lead to low staff morale. We therefore think that the most effective approach would be to tie the Joint Office, in an administrative sense, into the

Agency. We think that this would work practically, and we envisage that the various points about acting independently and so forth could be incorporated into its operational charter, whatever form that might take. Finally, we accept the proposal to have a reasonable endeavours obligation to limit charges increases to twice a year, and for the Joint Office to administer the process of changing charging methodologies.

6 Potential Competitive, Environmental and Social Impact

We agree with the comments in chapter 6, so offer only limited responses accordingly.

Impact on Competition

As noted earlier, we believe that the overall impact on competition will be beneficial, and that matters such as the allocation of responsibility for gas balancing and the creation of the Agency are appropriate counterweights to concerns over matters such as fragmentation.

Impact on the Environment

We agree that there are no environmental impacts associated with the sales and that appropriate safeguards are already in place and do not need amending.

7 Risks and Unintended Consequences

To a certain extent, the discussion in this chapter, and hence our responses, repeats arguments presented elsewhere in the IA, albeit from the perspective of risk analysis. Our comments are therefore relatively brief, and we pick up more detailed points in our responses to other chapters, notably 8 to 10.

Risks Associated with the Benefits of DN Sales

Whilst we think that the risks are correctly identified, we also accept that their quantification is difficult, because the quantification of the associated benefits relies on a number of judgements about the outcome of future events. We therefore think that the Authority is correct to adopt a conservative approach to that quantification. In our view, the analysis is hard to criticise for over-estimating benefits, and this in turn introduces a quantitative robustness when assessing risks and their impact.

Risks Associated with the Costs of DN Sales

Fragmentation of Wholesale Market Arrangements: We agree with the conclusions in the IA that the allocation of roles and responsibilities, including those relating to gas balancing, serve to mitigate, if indeed not to remove entirely, this risk.

Fragmentation of Agency Arrangements: We agree that there should be rigorous requirements put in place to ensure that the Agency is able to fulfil the roles allocated to it. We think in the longer term there is a case to consider the functions of the Agency separately from the body charging with fulfilling those functions. If, for example, there was a requirement to maintain data and file formats, but independent service providers could be shown to offer a lower cost service that met those requirements, then there would be merit in considering that. In saying this, we also recognise that many of the Agency functions are interlinked, so that the scope for say billing to be outsourced may be reduced if an important component of the billing task is the handling of queries, and that needs to remain centralised so as to offer a single service to shippers and suppliers.

Operation of the Agency Against Customer Interests: We agree that this is very unlikely to occur. Indeed, we believe that as a separate body with a number of shareholders, it is arguable that one consequence is that the Agency will take more account of shipper and supplier concerns than hitherto, because it no longer is part of another organization with its own separate commercial interests.

Undue Discrimination in the Modifications Process: We agree that this is a low risk, indeed again as an independent entity, we think it likely that more, not less, account will be taken of customer interests.

Undue Discrimination in Offtake Arrangements: Again we agree with the comments made, although we note that effective policing of the barriers between the separate business entities will be required to ensure that the probability remains low.

8 Analysis of Benefits

A general comment on this section relates to the issue of the realisation of the sale benefits were no sale to take place. In those circumstances it can be argued that the Authority should simply assume that efficiency gains as in the analysis presented here and in various Appendices should apply. We believe that this approach is not in the interests of customers, as we do not believe that the various dynamic effects of restructuring can readily be replicated within the single incumbent organisation. Were the Authority nevertheless to impose price controls in the event of no sale consistent with the analysis of benefits arising in the sale case, the results would probably be a mix of falling customer service standards and a lowering of the actual return earned by the company, which would in turn lead to an increase in its cost of capital, as investors perceived undue regulatory risk attaching to its future investments. This means that the benefits of the sale can only be realised if the sale is to proceed, and not otherwise.

A further general comment is that we believe that the analysis presented in this chapter focuses on the principal benefits to be achieved from the sale process, namely those relating to comparative regulation of separate monopolies. Whilst we comment on individual elements of the analysis below, we have already commented on our experiences as a buyer, and believe that the sale process has already begun to produce benefits from the differing approaches being adopted by the prospective buyers on a number of issues.

Finally, we reiterate our comment that we think that the approach adopted has been conservative, and that in all three cases examined there are arguments in favour of outcomes being higher than those reported. We also believe that it is appropriate to use the figures reported, as they are defensible in terms of robustness given this inherent conservatism.

Assessment of Potential Benefits from Comparative Efficiency

Methodology Applied: We believe that there are arguments to support the use of either of the methodologies described. In terms of simplicity and transparency, we agree that the use of Methodology 1 is appropriate, and we also feel that this allows discussion to focus on a small number of key variables. That said, we think two other things important, both of which have been done. First, the analysis has to be as rigorous as possible, within the confines of whatever assumptions underpin it. In other words, we believe that it is sensible to go into detail where appropriate, but not if the underlying assumptions render such detail invalid. We believe that the IA strikes about the right balance here and that the features of the application of Methodology 1, as described in this chapter and provided in more detail in Appendix 8, are appropriate. Second, where different methodologies are apparent, it is sensible to run a check in the sense of applying the other methodology, and we note that the IA presents the result of such an analysis. The similarity of outcomes gives confidence that the base Methodology 1 approach is robust.

Assumptions Applied: The key parameter driving the benefits to be derived from the sale is the difference between efficiency gains with and without the sale. Whilst we support the general conclusion that more benefits will arise from the sale, as discussed above, we note that they could be achieved from a variety of starting points. We therefore prefer to focus on the differential rather than two separate starting points, as we believe both that there is the potential for double counting and that arguments about the absolute levels of the starting points are less important than the differences between them. On that basis, we believe that there are going to be observable differences in performance with

and without the sale, as we believe that the sale will release the competitive and innovative forces that we discuss above, for example in the response to chapter 4. Whilst we believe that quantification of these benefits is difficult, we agree with the conclusion that a differential of around 1.3% per annum is sensible. In saying that, we should point out that we do not agree with all the sources and assessments quoted; for example, if we understand the Ofwat analysis quoted in paragraph 8.43 correctly, the assessment is based on the assumption that the lost comparator is at the efficiency frontier and is in size terms one of only three companies, not 22. If that is correct, then the intuitively perverse conclusion that the loss of one comparator in 22 could lead to such enormous disbenefits as those quoted is explicable in terms of there is about a 1 in 100 probability of such disbenefits arising¹. There is also the issue of the size of the industry, its fragmentation and the scope for improvements through consolidation. In our view, in regulated network industries in the UK there is likely to be a range of comparators within which performance can be optimised and capital invested efficiently without risk of duplication – in that regard we believe that too many comparators, by spreading resources too thinly and requiring duplication in areas like overheads, can lead to diseconomies just as too few companies can. We do not know the limits of this range, but the upper end is likely to be rather less than 22. The lower end is obviously more than one, so in the present case, the creation of new comparators where none existed before leads us to believe that there are benefits to be obtained. With regard to the profile of savings adopted, we support the principle of the bell shaped distribution for the reasons given in the IA, although at this stage we find it hard to be conclusive as to what proportion of savings would arise when. That said, and given that the benefits are shown in net discounted terms, we think it sensible and conservative to assume a less than simple pro rata for benefits to arise in the short to medium term.

Economies of Scale and Scope: we agree with the comments in paragraphs 8.47 and 8.48. We believe that whilst it can be argued that scale economies exist, it can equally be argued that there are disbenefits of scale. The fact that purchasers are prepared to pay premia on RAV would appear to support this latter view. As the various buyers have different circumstances, we do not think that scope economies should be factored into the analysis, as that in effect would be encouraging certain types of buyers at the expense of others.

Assessment of Benefits from Framework of Arrangements

Further Benefits: We believe that there are further benefits that can be identified with the sale process. Although the table presented in paragraph 8.73 provides mainly a qualitative assessment of additional offtake and interruption benefits, in previous RIAs a number of quantitative benefits were associated with various aspects of the framework. Although it is therefore possible to put forward more tangible assessments, in keeping with our earlier comments on maintaining a conservative stance we believe that it is appropriate to focus on the qualitative aspects of these benefits.

Merger Policy: We accept the principle that more comparators create the potential for more customer benefits. We do not accept all of the claims for the value of such benefits, however; as noted above, we believe, for example, that the Ofwat analysis mentioned in paragraph 8.43 cannot be generalised, as inherent in the analysis is that the lost comparator is at the efficiency frontier. We also believe that the marginal benefits of additional comparators diminishes as the number of comparators increases and that, given a limited pool of management resource, there is a case to be made for diminishing returns from further comparators once an as yet undefined point is reached; put the other way, it may be that spreading experience management resources over a smaller number of companies can mean that a reduction in the number of comparators can in some cases provide net benefits to customers. In the present case, however, we support the view that the creation of comparators provides quantifiable benefits for customers. In future, we

¹ There is a 1 in 22 chance of the company being at the efficiency frontier, and a 5 in 22 chance of the company being the right size (3 companies at the Southern size, and 2 larger. Smaller companies at the efficiency frontier produce smaller disbenefits). These two probabilities need to be multiplied together, thus about 1 in 100 overall. In addition, this analysis does not take into account the possibility that a merger involving a frontier company will pull the other party to the frontier rather than push the frontier company away from it; this would render the odds calculated even higher.

believe that the assessment of future proposals should be based on knowledge of the transaction at the time that it is proposed, as set out in paragraph 10.3 of Appendix 10. We also think that the subsequent statement in 10.4 of that Appendix, to use the high case assumptions to assess detriments, is inconsistent with this proposal; we suggest instead that the matter be judged at the time, not in advance.

9 Analysis of Costs

As with our comments on benefits, we believe that a cautious approach has been taken to assessing the costs of the sales process on various participants. Furthermore, the use of estimates provided by shippers for the single largest category of costs provides further assurance. Our specific comments on the questions posed in paragraph 9.68 are as follows:

Shipper Costs

We believe that in general shipper costs and the estimates associated with them are for the shipper community to determine in conjunction with Ofgem. We therefore offer only general comments on such costs.

Methodology: the build up of costs from shipper estimates appears to us to be robust.

Assumptions Applied: we believe that the assumptions applied to cleanse the data and normalise them between shippers are appropriate. If those assumptions are disputed, however, we note that the difference between the unadjusted and adjusted amounts, using the same scenarios in each case, are less than £20m in discounted terms. That in turn is less than 10% of the net benefits of the base case. This indicates that debate over precise details of particular cost items is unlikely to have any material impact on the overall outcome of the analysis.

Other Cost Categories

Again we do not have specific comments to offer on the cost estimates associated with NTS direct connects and other parties. We note as a general comment that the sum of these costs in NPV terms, £3.5m quoted in paragraph 9.63, is less than 2% of the net benefits arising from the sale, so even if the estimates were substantially less than actual outcomes, and we have no evidence to suggest that they are, this would have no material impact on the overall assessment.

10 Results of the Cost Benefit Analysis

Our responses to the specific questions raised in paragraph 10.28 are as follows:

Ofgem's Assessment of Potential Costs: As discussed above, we believe that the cost information presented, derived as it is in large part from shipper estimates, is robust and conservative.

Ofgem's Assessment of Potential Benefits: As with the information on costs, we believe that the information on benefits can stand up to scrutiny and is conservative. Furthermore we feel that the approach taken to the calculation of net benefits is appropriate, whereby in particular the low case on benefits is combined with the high case on costs. We further note that the net benefits reported are of sufficient scale to offset any concerns over the estimates of costs or benefits.

Safety Net: We concur with the conclusions reached by Ofgem, namely that the safety net would protect customer interests were it to be needed and that it is unlikely to be needed given the present intention to sell four networks to three buyers.

Our conclusion from our review of the RIA and the associated appendices is that we are firmly in favour of the sale option, as we believe that this delivers genuine and demonstrable benefits to customers.

END