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31 March 2005

Sonia Brown
Director, Transportation
Ofgem
9 Millbank
London SW1P 3GE

Dear Sonia

POTENTIAL SALE OF GAS NETWORK DISTRIBUTION BUSINESSES

**OFGEM CONSULTATION: INITIAL PROPOSALS ON INTERIM 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

Edward Beckley
Senior Manager

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OFGEM CONSULTATION: INITIAL PROPOSALS ON INTERIM INCENTIVE SCHEMES
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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. Views are provided on the various issues raised in Chapter 5 of the document.

- **The proposed form, scope and duration of the NTS and DN interim incentive schemes**

Ofgem proposes that the interim incentive schemes should be based upon those which are currently in operation. We believe that this is appropriate on the basis that the offtake arrangements during the interim period will broadly reflect those currently in place. The incentive schemes are relatively simple to administer and have proved effective in meeting the objectives that they were designed to fulfil.

The proposed DN incentive schemes are, in our view, a pragmatic approach to promoting efficient decision making. In parallel with the NTS schemes they are simple to administer and will provide a smooth transition between the current regime and the evolving enduring incentive schemes designed to underpin the more radical long term arrangements.

- **The proposed introduction of a buy-back element to the NTS interim incentive arrangements**

We support the introduction of a buy-back element to ensure that firm capacity can be market valued during periods of firm transportation constraints.

On the basis that the NTS has been designed to meet 1 in 20 conditions we support the application of a buy back target of zero during the period under consideration.

- **The proposed options for parameters for the buy-back element to the NTS interim incentive arrangements**

We note that the targets provided for in the "greater than 15 day interruption" incentive vary during the period; in particular there is an increase in 2007/08 followed by a decrease in 2008/09. We request that Ofgem/NGT provides the industry with further information to explain these variations. We note that paragraph 4.33 provides forecast changes in interruptible load; it would be useful if these could be expanded further in the interests of transparency. For example, it would be helpful to understand the information used to support these forecasts.

Ofgem outlines the assumptions underpinning the variable collars and sharing factors in options 1 and 2 of Table 4.2. We assume that the analysis performed by Ofgem relating to the probability of interruptible to firm switching is confidential; it would be helpful, however, if we were able to understand in more detail the statistical tests employed, including the basis on which the probability of switching was calculated.

On the assumption that the analysis is fairly robust, we suggest that option 2 is pursued. This allows for greater deviation from the modelled expectations and will provide some protection, albeit limited, to the industry of any significant buy-back activity.

- **The proposed options for parameters for the charges foregone and exit investment incentive**

Please note our earlier comments regarding the forecast change in interruptible load during the period under consideration.

With regards options 1 and 2, we believe that incentives should be aligned with commercial exposure and therefore, suggest that option 2 “the revision approach” should be pursued. We would caveat this statement, however, by commenting that the full uplift should only be realised if it is proposed that all exit charges are increased by 8.9%. In the event that there is some regional variance in price increases then it would seem appropriate that the target amounts reflect the spread of interruptible load and the related locational charge changes.

- **The proposed form of the CLNG incentive**

We support the Ofgem proposals, subject to the outputs from the further analysis being carried out by Ofgem

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

In line with our response to the enduring arrangements consultation¹, we support the proposal to determine caps and collars with reference to a percentage of the performance target.

- **The most appropriate reference price for NTS offtake (flexibility) capacity**

Ofgem outlines three approaches for determining an appropriate reference price. At this stage, we support Ofgem’s proposal to price the flexibility product on the basis of NTS offtake (flat) capacity prices. The enduring arrangements are still under development and we are still awaiting proposals from NGT on appropriate pricing methodologies for the flexibility product; at this stage, it would be unhelpful to “second guess” the outcome of these developments. We therefore prefer the relative simplicity and transparency of using flat offtake capacity prices as an interim measure. In general, the industry should be relatively indifferent to the methodology adopted on the basis that the performance measure is calculated in a consistent manner in relation to determination of the target level.

We note that under paragraph 4.59 Ofgem states that; “actual annual targets would be adjusted each year in line with changes in actual NTS exit charges.” This approach is inconsistent with that proposed for the NTS foregone incentive, an 8.6% *ex-ante* uplift on the basis of forecast NTS exit capacity price increases. We do not think it appropriate to establish different pricing provisions for the NTS and DN incentive schemes.

- **The most appropriate option for the definition of caps, collars and sharing factors in the DN interim incentive schemes**

We support the implementation of Option 2 in relation to caps, collars and sharing factors. This justification for electing to support this option is consistent with that provided in earlier comments regarding NTS buy-back parameters. A higher cap and collar coupled with positive shipper sharing factors will, to some degree, protect the shipping community from any significant underperformance by the relevant DN. The application of a balanced sharing factor also affords limited protection to inexperienced DNs operating in a new environment supported by new incentive schemes.

END

¹ Ofgem consultation: Initial thoughts on enduring incentive schemes supporting the offtake arrangements, Ofgem, February 2005