

**Financial ring fencing for new and existing
independent gas transporters**

Final proposals

September 2005

Summary

This document sets out final proposals for the introduction of financial ring fencing provisions into the licences of new and existing independent gas transporters (IGTs). These proposals are consistent with the existing arrangements for electricity distribution network operators (DNOs), independent distribution network operators (IDNOs), the gas national transmission system operator (NTS) and the gas distribution networks (DN).

The final proposals are to:

- ◆ introduce financial ring fencing provisions into the licences of new and existing IGTs;
- ◆ introduce a threshold of 500,000 connected customers to trigger the licence requirement for an investment grade credit rating;
- ◆ allow alternative arrangements to an investment grade credit rating for all IGTs below the threshold; and
- ◆ allow temporary derogations and/or consents from certain financial ring fencing conditions for existing IGTs in order to facilitate compliance with the new obligations.

Furthermore, the document sets out for the first time cash lock-up arrangements for IGTs. Similar arrangements have recently been included in the licences of DNs, the NTS operator and the DNOs. In its July 2005 decision document¹, Ofgem has also expressed its intention to introduce cash-lock up obligations in the licences of IDNOs. Views are invited on Ofgem's proposals to introduce these further financial ring fencing provisions into the licences of IGTs.

Final proposals will be implemented by switching on the relevant licence conditions in Section C of IGT licences and by carrying out a collective licence modification under section 23 of the Gas Act. A draft of the proposed licence conditions and amendments is provided in Appendix 1.

¹ *Regulation of Independent Electricity Distribution Network Operators - Decision document, July 2005.*

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1. Introduction

Purpose of this document

- 1.1. This document sets out final proposals to introduce financial ring fencing provisions into the licences of new and existing independent gas transporters (IGTs). It also outlines Ofgem's² views on a number of issues raised by respondents to its previous consultation and sets out a possible timetable for implementation of the new arrangements.

Background

- 1.2. Financial ring fencing of monopoly businesses provides important safeguards for the financial stability of licensed companies. In particular, it provides protection from certain events that may otherwise lead to the insolvency of the licensee and possible disruption to consumers. It also allows a licensee to retain access to financial markets on reasonable terms, thus facilitating the funding of future investment.
- 1.3. Financial ring fencing obligations are included in the gas transporter (GT) licences relating to the National Transmission System (NTS) and the gas distribution networks (DNs). On the electricity side, the transmission network operators, the distribution network operators (DNOs) and the independent electricity distribution network operators (IDNOs) are also covered by these arrangements. At present, IGTs are the only network operators that are not required to comply with such provisions as part of their licence obligations.
- 1.4. There are fourteen companies that hold an IGT licence. These licensees are often part of larger groups which manage more than one IGT licence, resulting in only six IGT businesses with about 700,000 customers connected to their networks.
- 1.5. Extending financial ring fencing arrangements for IGTs was first discussed in the final proposals paper governing new IGT charging arrangements in July 2003³.

² Ofgem is the administrative office of the Gas and Electricity Markets Authority.

³ *The regulation of Independent gas transporter charging - Final proposals*, July 2003.

Financial ring fencing for new and existing independent gas transporters - Final proposals.

This was followed by the initial proposals publication in November 2004⁴, which set out Ofgem's proposals to introduce financial ring fencing for new and existing IGTs. The November 2004 initial proposals document contains more detailed background on the development of financial ring fencing provisions for IGTs. This document is available from Ofgem's website at www.ofgem.gov.uk under the area of work entitled IGT regulation.

Other relevant documents

- 1.6. In July 2005, Ofgem published a decision document on the regulation of IDNOs⁵. As part of that paper, Ofgem proposed a number of modifications to the financial ring fencing obligations that are currently in place for IDNOs. Those proposals are consistent with financial ring fencing provisions in the licence of DNOs, DNPs and both the gas and electricity transmission operators.
- 1.7. In particular, Ofgem proposed to modify standard condition 47 (Indebtedness) of the gas transporter's licence to include a cash lock-up mechanism. This mechanism is outlined in chapter 3.

Structure of this document

- 1.8. This paper contains the following chapters:
 - ◆ chapter 2 provides a summary of responses to Ofgem's November 2004 initial proposals document;
 - ◆ chapter 3 sets out Ofgem's views on the main issues raised by respondents and outlines its final proposals;
 - ◆ chapter 4 sets out a proposed process and timetable for the introduction of financial ring fencing arrangements into the licences of IGTs; and
 - ◆ appendix 1 includes the proposed draft of the licence conditions for financial ring fencing.

⁴ *Financial ring fencing for new and existing independent gas transporters - Initial proposals*, November 2004.

Views invited

- 1.9. Views are invited on the cash lock-up mechanism outlined in chapter 3 and on the proposed implementation process and timetable. Comments should be received by **28 October 2005** and sent to:

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- 1.10. All responses will be held electronically in Ofgem's Research and Information Centre. Non-confidential responses will be published on the Ofgem website. Where possible, respondents should put any confidential material in appendices to their response. If you wish to discuss any aspect of this document, please contact Samanta Padalino or Indra Thillainathan (020 7901 7294).

⁵*Regulation of independent electricity distribution network operators - Decision document, July 2005.*

2. Summary of responses

- 2.1. Ofgem received seven responses to the November 2004 initial proposals on the financial ring fencing of new and existing IGTs. The three responses marked non-confidential have been placed on Ofgem's website. The respondents comprised of IGTs, shippers, suppliers and one gas storage operator.
- 2.2. Views were invited on all aspects of the proposals and, in particular, on the following issues:
- ◆ whether a threshold for an investment grade issuer credit rating is appropriate and what should it be;
 - ◆ whether the alternative financial arrangements in lieu of an investment grade issuer credit rating adopted for IDNOs should be extended to IGTs; and
 - ◆ whether it is appropriate to grant temporary derogations to certain financial ring fencing conditions to existing IGTs in order to facilitate their compliance with the new obligations.

Financial ring fencing arrangements in general

- 2.3. Support for the financial ring fencing provisions was generally divided between the views of IGTs and those expressed by shippers and suppliers. Shippers and suppliers welcomed Ofgem's initial proposals on the basis that they would bring greater financial stability to IGTs, thus improving the protection that IGT customers would enjoy against the risk of insolvency of these network operators.
- 2.4. However, most IGTs were generally opposed to Ofgem's initial proposals, as they believed that the proposed financial ring fencing conditions would be disproportionate to the size and nature of their business. IGTs highlighted that to date their financial record had produced no IGT insolvency, which they took to be evidence of the low risk nature of their business. As such, imposing the new arrangements on IGTs was perceived to be costly and unnecessary. Some said that there would be plenty of bidders to buy an IGT quickly in case of insolvency.

- 2.5. IGTs further criticised the need for financial ring fencing obligations in light of the introduction of the new special administration regime under the Energy Act 2004, which ensures the continued delivery of essential services if an IGT were to go into administration. Some maintained that the costs of complying with financial ring fencing conditions could force existing IGTs out of business and discourage new entrants in the IGT market.
- 2.6. Some respondents put forward alternative arrangements in lieu of financial ring fencing provisions in general. One respondent suggested that Ofgem should introduce obligations with respect to published accounts and auditor statements which would give sufficient comfort about the financial health of the regulated companies by providing an indication as to whether a company can meet its liabilities. Another respondent suggested a flexible approach in which the financial strength of the IGT could be assessed on a case by case basis.
- 2.7. Overall, while the principle of introducing financial ring fencing was recognised to be important, respondents considered that financial ring fencing obligations must be proportionate to the companies under consideration.

Comments on specific issues

Investment grade credit rating threshold

- 2.8. Views were invited on the proposed threshold for introducing an investment grade credit rating and on what specific number within a range of between 300,000 to 500,000 connected customers was most appropriate. Respondents generally supported an investment grade credit rating for larger IGTs and the adoption of a threshold that would trigger the requirement for an IGT to obtain and maintain an investment grade credit rating.
- 2.9. However, views differed as to what the threshold should be. Two respondents considered 500,000 connected customers to be an appropriate threshold while another respondent thought that protection of customers would be better served by a number closer to the lower end of the proposed range. On the other hand, one IGT believed the threshold of 500,000 supply points to be too small and stated that one million supply points would be a more realistic level.

- 2.10. Some respondents also questioned whether the revenue generated from 500,000 supply points would be sufficient to secure an investment grade credit rating from a rating agency. Another respondent asked whether the number of supply points was an appropriate measure to determine the size of a company. Alternative measurements were suggested, including financial turnover, level of capacity, throughput and installed asset value.
- 2.11. One respondent stated that it is unrealistic for IGTs to be expected to obtain an investment grade credit rating even when they reach the threshold of 500,000 connected customers.

Alternative financial arrangements to an investment grade credit rating

- 2.12. Respondents were asked to consider whether the alternative financial arrangements to an investment grade credit rating currently adopted for IDNOs could be extended to IGTs.
- 2.13. There was general support for alternative financial arrangements to an investment grade credit rating in recognition of the difficulties and costs that small IGTs would face in obtaining an investment grade credit rating. As regards the actual arrangements, some respondents considered that the costs of financing both a keep well agreement and cash in escrow were unnecessary and burdensome.

Temporary derogations for existing IGTs

- 2.14. Views were invited on the appropriateness of granting derogation from certain conditions for a limited time period for existing IGTs in order to facilitate compliance. Three respondents recognised the need for transitional arrangements which would allow IGTs time to make the required changes to comply with the new financial ring fencing obligations. One respondent requested a derogation period of up to one year.

Other comments

- 2.15. Respondents provided further comments on other areas covered by the initial proposals. These views are summarised below.

Consistent arrangements with IDNOs

- 2.16. A further split in opinion between shippers/suppliers and IGTs centred on whether there was a need for consistent arrangements between the gas and electricity sectors. Shippers and suppliers generally agreed that IGTs should mirror arrangements with the IDNOs, including the financial ring fencing provisions so that customers on different networks did not face different risks.
- 2.17. Most IGTs took the view that consistency with the IDNOs was not appropriate as applicants for an IDNO licence had no alternative but to accept financial ring fencing conditions in order to acquire an IDNO licence. Furthermore, some respondents stated that IDNOs, as new businesses, have been able to structure their operations in a manner that would enable them to fulfil financial ring fencing requirements from the start of their activities. In contrast, existing IGTs, which have established their businesses, financing and corporate structure at a time when financial ring fencing obligations did not exist, would find it more onerous to introduce those changes that are necessary to comply with the new provisions.

Impact Assessment

- 2.18. Some respondents did not believe that Ofgem's impact assessment (IA) in the November 2004 initial proposals document was sufficiently detailed to determine the effects of the proposed provisions on both IGTs and customers. It was therefore suggested that Ofgem should undertake an IA with a full cost/benefit analysis ahead of any proposals being finalised.

De minimis activity

- 2.19. Two respondents considered that the current level of de minimis activities is too small and only proportionate for a large business like Transco's. One respondent suggested that this limit should be increased to 10 or 20 per cent.

- 2.20. Some respondents also highlighted that connections and metering activities are currently not included in the definition of transportation business in the licence. They stated that, since these activities may represent a large proportion of an IGT business, they should be allowed either in the definition of transportation business or in the range of activities permitted by the Gas and Electricity Markets (Authority) for the purpose of complying with financial ring fencing provisions.

Cross-default obligations

- 2.21. Some respondents stated that derogations from the obligation of not entering into any agreement incorporating cross-default obligations should be granted for pre-existing agreements due to the difficulties and costs of undoing these arrangements.

Treatment of gas storage operators

- 2.22. Gas storage operators normally operate a dedicated pipeline for the sole purpose of conveying gas between the storage facility and the distribution or NTS network. In some cases, gas storage operators hold a GT licence. One respondent stated that these operators should be exempt from the financial ring fencing arrangements on the basis that they do not serve domestic or industrial and commercial (I&C) premises.

3. Ofgem's final proposals

3.1. This chapter outlines Ofgem's views on the issues raised by respondents and sets out final proposals for the introduction of financial ring fencing for new and existing IGTs.

Introduction

3.2. In broad terms, financial ring fencing conditions currently included in GT licences require the licensee:

- ◆ to procure an undertaking from its ultimate controller that the ultimate controller will refrain from taking any action which would be likely to cause the licensee to breach its obligations under the Gas Act or the GT licence;
- ◆ not to create any form of security over the assets, and undertake any indebtedness or enter into any guarantee other than on certain specified terms, for a permitted purpose, and with the consent of the Authority;
- ◆ not to conduct any business other than its transportation business, subject to certain exceptions and specific limitations on the turnover and investment of permitted non-core activities;
- ◆ to ensure that the licensee has sufficient resources to carry on its transportation business and to submit a report to the Authority each year confirming availability of financial resources;
- ◆ to take all appropriate steps to maintain an investment grade issuer credit rating; and
- ◆ not to enter into an agreement incorporating a cross-default obligation without consent of the Authority.

3.3. In addition, certain restrictions are placed on the transactions a licensee may enter into with any affiliate or related undertaking.

3.4. Similar obligations apply to the electricity transmission operators, DNOs and IDNOs. Further, IDNOs with less than 500,000 connected customers are

allowed to adopt alternative financial arrangements in lieu of maintaining an investment grade credit rating.

- 3.5. These provisions are currently in section C (standard conditions 43 to 47) of IGT licences. However, licence conditions under section C of the IGT licence do not have effect at present. A more detailed discussion of these arrangements is available in Ofgem's November 2004 initial proposals document. In addition, appendix 1 of this document provides the proposed licence drafting for the licence conditions relevant to IGT financial ring fencing.
- 3.6. Ofgem maintains the view that, where possible and appropriate, consistency across network operators in gas and electricity should be achieved. In this respect, the gas and electricity transmission operators, DNs, DNOs and IDNOs, the last of which are similar sized business to IGTs, have financial ring fencing arrangements in place.
- 3.7. Ofgem's general approach is to:
 - ◆ introduce financial ring fencing provisions into the licence of new and existing IGTs in line with the terms set out in the November 2004 document; and
 - ◆ allow temporary derogations and/or consents to address the practicalities and costs of complying with financial ring fencing obligations for existing IGTs.
- 3.8. This should ensure that financial ring fencing obligations do not unfairly disadvantage existing IGTs by recognising that they have established their businesses under a different regulatory framework and therefore could face some difficulties in re-organising their corporate structure to comply with the new arrangements.
- 3.9. Financial ring fencing provisions would protect customers connected to IGT networks from the risk that such transportation service providers might experience financial distress. IGT customers would avoid the disruption associated with any insolvency procedure, while continuity and certainty of service would be less likely to be jeopardised.

- 3.10. Further, Ofgem considers that the new special administration regime under the Energy Act 2004 introduces complementary rather than alternative arrangements to financial ring fencing. Although the special administration regime may reduce the benefits arising from financial ring fencing provisions in terms of preventing disruption of gas supply and service to customers due to IGT insolvency, Ofgem still considers that significant benefits from financially ring fencing IGTs would arise from the enhanced ability of ring fenced companies to obtain access to financial markets on reasonable terms. Financial ring fencing would also act to prevent cases of insolvency, thus protecting customers from any costs associated with the management of the special administration regime.
- 3.11. Ofgem's view that financial ring fencing conditions are proportionate is supported by the fact that these conditions were introduced and accepted by relevant network operators following extensive consultation, and were determined by the Secretary of State under the Utilities Act 2000.
- 3.12. Some respondents suggested alternative arrangements to financial ring fencing and, most importantly, stated that published accounts and auditor statements should provide sufficient indication as to whether the company could meet its liabilities.
- 3.13. Ofgem does not consider published accounts and auditor statements to provide sufficient comfort about the financial standing of a company. Audited accounts indicate what has happened in the past and provide at best some comfort that liabilities can be met in the next 12 months. However, they provide no comfort regarding the future conduct of management, or another body with influence on the licensee, relating to the licensee's business.
- 3.14. Ofgem therefore would not consider it appropriate for IGTs to use published accounts and auditor statements as an alternative to financial ring fencing requirements.
- 3.15. Ofgem has therefore decided to introduce financial ring fencing provisions into the licences of new and existing IGTs by the end of 2005. Ofgem's final proposals are broadly in line with the terms set out in the November 2004 initial proposals document. In addition, they reflect recent developments of the ring fencing regime applied to other network operators and address some of the

concerns expressed by respondents to Ofgem's November 2004 initial proposals document.

- 3.16. The details of these proposals are outlined in the subsequent sections and summarised at the end of this chapter.

Investment grade credit rating threshold and alternative arrangements

Initial proposal

- 3.17. It was proposed that a threshold to trigger the requirement for an investment grade credit rating should be set in terms of the number of connected customers within a range of between 300,000 to 500,000 customers. Alternative financial arrangements would be allowed for IGTs below this threshold.

Ofgem's views

- 3.18. Ofgem considers that the top of the proposed range should be adopted as the threshold that would trigger a requirement for an investment grade credit rating.
- 3.19. Although Ofgem recognises that there could be alternative measures to using the number of connected customers for determining the investment grade credit rating threshold, it also considers that any alternative measure will have its drawbacks and will require some degree of judgement. Using 500,000 connected customers as the threshold has the advantage of being consistent with the arrangements for IDNOs. It also has the advantage of being independent of accounting measures, such as asset value or turnover, which can be affected by the specific accounting policy used and may not provide a straightforward measure of the size of a company.
- 3.20. Alternative arrangements in lieu of an investment grade credit rating were generally supported, with only some concerns expressed as regards the nature of the keep well agreement. Ofgem provided an example of a keep well agreement in appendix 2 of its November 2004 initial proposals document. Although this example represents the current standard format of a keep well agreement that Ofgem would expect to receive from IGTs, it is also open to IGTs

to propose changes to the standard drafting of the keep well agreement to address specific issues they might have. Ofgem will consider whether these proposed changes are appropriate on a case by case basis. Ofgem can also review and change this standard keep-well agreement to make sure that it still is appropriate to meet its purpose.

Final proposals

- 3.21. IGTs will be allowed to adopt alternative financial arrangements if they have less than 500,000 connected customers. This threshold would apply to the total number of customers served by a group of companies, regardless of the number of licences it held. Any IGT that reaches or exceeds the threshold will be required to take all appropriate steps to obtain and maintain an investment grade issuer credit rating.
- 3.22. If, however, after having taken all appropriate steps to obtain an investment grade credit rating, an IGT fails to obtain one, Ofgem will take into consideration the practicalities of fulfilling this requirement in deciding whether it is satisfied that the IGT has complied with licence condition 46 (Credit rating of licensee). The Authority may then allow the IGT to continue adopting alternative financial arrangements.
- 3.23. For instance, if an IGT with more than 500,000 customers were to find that credit rating agencies considered it still too small to be willing to provide it with a rating, Ofgem would not be likely to find such IGT in breach of licence condition 46. In this circumstance, it would therefore be possible for such IGT to continue adopting alternative financial arrangements.
- 3.24. The Authority's discretion as to the application of alternative arrangements in lieu of an investment grade credit rating will be embedded in the drafting of licence condition 46, as set out in appendix 1.
- 3.25. Companies below the threshold of 500,000 customers will be required to comply with the following alternative financial arrangements as outlined in the November 2004 initial proposals document:
- ◆ a keep well agreement with the parent company of the licensee if the parent company has an investment grade credit rating; or

- ◆ if the parent company does not have an investment grade credit rating, a keep well agreement with the parent company of the licensee and cash in escrow or an on-demand bond issued from a third party with an investment grade credit rating of a value of no less than six months operating costs and six months asset replacement expenditure.
- 3.26. Operating costs would include all those costs necessary to run the IGT's business for a period of six months. An IGT would be able to use the money held in escrow and secured by the bond in the event that its parent company did not fulfil its obligations under the keep well agreement. If the account or bond were to be drawn upon, then the keep well agreement would require the parent company to reinstate the monies. If the parent company did not do so, then it would be required to sell the IGT or its network.
- 3.27. These alternative financial arrangements should be considered as interim arrangements, which could be changed as a result of future consultations and reviews. In any event, the use of alternative arrangements to an investment grade credit rating would require the written approval of the Authority. This is consistent with Ofgem's views for IDNOs as set out in an open letter⁶ issued on 29 July 2004.

Transitional arrangements for existing IGTs

Initial proposal

- 3.28. In order to facilitate compliance with the new arrangements, existing IGTs would be able to derogate from certain conditions for a limited period of time.

Ofgem's views

- 3.29. Ofgem recognises that existing IGTs have established their businesses under a different regulatory framework and therefore, they may face some difficulties when re-organising their corporate structure to comply with the new arrangements.

⁶ Financial ring fencing alternative arrangements for new IDNOs, 29 July 2004.

- 3.30. In recognition of the difficulties that existing IGTs may face in complying with financial ring fencing conditions, Ofgem considers that specific derogations from particular conditions should be allowed for a limited period of time. Requests for derogations from specific provisions will be assessed on a case by case basis.

Final proposals

- 3.31. Ofgem will allow existing IGTs specific derogations from certain conditions. The derogations would last for a limited period of time and would seek to provide existing IGTs with sufficient time to facilitate compliance with the newly activated obligations.

Impact Assessment

Initial proposal

- 3.32. Ofgem did not consider it necessary to undertake a full IA in advance of finalising its proposals. Nonetheless, in its initial proposals, Ofgem provided a summary of the impacts of financial ring fencing.

Ofgem's views

- 3.33. Ofgem maintains the view, as set out in its initial proposals paper, that the proposals to introduce financial ring fencing do not warrant a full IA. Specifically, activation of financial ring fencing provisions does not:
- ◆ involve a major change in the activities carried out by the Authority; or
 - ◆ have a significant impact on the gas and electricity sectors, the general public in Great Britain or the environment.
- 3.34. In this respect, these proposals are not considered 'important' for the purpose of Ofgem's obligations to carry out an IA under section 5A of the Utilities Act.
- 3.35. The proposals to introduce financial ring fencing conditions are consistent with an established Ofgem policy of financially ring fencing gas and electricity network operators, the details of which were consulted on extensively before the necessary licence conditions were determined by the Secretary of State pursuant to the Utilities Act 2000. Financial ring fencing conditions have since been in

effect in the licences of all network operators with the exception of the IGTs. The conditions are also not expected to impose significant costs or have significant impact on participants in the gas and electricity sectors, the general public or the environment.

Final proposals

- 3.36. For the reasons given above, Ofgem does not consider it necessary to carry out a further, more detailed IA.

Permitted activities

Initial proposal

- 3.37. Some concerns with the definition of permitted purpose were raised by respondents to the November 2004 consultation document. Specifically, these respondents maintained that connection and metering should be considered as permitted activities for the purpose of complying with financial ring fencing conditions.

Ofgem's views

- 3.38. Some respondents requested clarification of the definition of transportation business. Specifically, they highlighted that connection and metering for legacy sites are an essential part of the business of an IGT and should be considered as permitted activities for the purpose of complying with financial ring fencing.
- 3.39. Ofgem recognises that the connection business usually accounts for a large share of IGTs' activities. It also considers that some IGTs have been previously allowed by Ofgem to keep ownership and management responsibility for meters on legacy sites.
- 3.40. For these reasons, Ofgem does not object to the inclusion of the metering and connection businesses among the range of allowed activities for the sole purpose of complying with financial ring fencing provisions.

Final proposals

- 3.41. Ofgem has decided to allow IGTs, under their GT licences, to include metering and connections businesses within the range of activities they would be permitted to carry out for the purpose of complying with financial ring fencing obligations.
- 3.42. It is envisaged that Ofgem would provide IGTs with written consent under standard condition 43 (3) (d), which would allow them to carry out connection and metering activities without those activities being treated as de minimis business.

Cross-default obligations

Initial proposal

- 3.43. Although Ofgem did not discuss specific proposals in this area of financial ring fencing in its November 2004 document, some issues with existing cross-default obligations were expressed during the consultation process.

Ofgem's views

- 3.44. Concerns have been raised regarding pre-existing cross default obligations and how they will be treated. Currently, condition 47 (Indebtedness) provides that the licensee may continue or permit to subsist a cross-default obligation existing at the date the condition first came into effect for a period of twelve months. The licensee is expected to take all appropriate steps to eliminate such cross default obligations within the twelve month period.
- 3.45. Ofgem has previously granted derogations to this condition in recognition of circumstances in which the cessation of existing cross-default obligations cannot take place within the normal twelve-month grace period. These derogations have been granted subject to the following conditions:
- ◆ the licensee continues to use all reasonable endeavour to eliminate the cross-default obligations as soon as it can; and

- ◆ for so long as the cross-default subsists, the licensee must have an indemnity from an investment grade rated covenanter holding the licensee harmless from any costs, losses or liabilities arising directly or indirectly out of the cross-default obligation.

Final proposals

- 3.46. Where a licensee cannot reasonably obtain release from a cross-default obligation within the twelve-months grace period, Ofgem considers that it could be allowed to keep pre-existing cross-default obligations for more than 12 months from the date in which condition 47 (Indebtedness) becomes effective subject to the two conditions outlined above. Each request for derogation will be considered on a case by case basis and kept under review. This would again recognise that existing IGTs have organised their business in a licence framework which did not include financial ring fencing obligations.

Treatment of gas storage operators

Initial proposal

- 3.47. Although the treatment of gas storage operators was not a part of the initial proposals, it was highlighted as an issue during the consultation process.

Ofgem's views

- 3.48. Ofgem has considered that some GT licensees operate a dedicated pipeline for the sole purpose of conveying gas between a storage facility and a distribution network. Such licensees do not have any domestic or I&C connected premises. Since the purpose of financial ring fencing obligations is to protect the interest of customers connected to GTs' networks, Ofgem considers that such GT licensees who act only as gas storage operators could safely be exempted from complying with these provisions.

Final proposals

- 3.49. Ofgem has decided not to switch on any financial ring fencing obligations for GT licence holders that act solely as gas storage operators. This, however, is subject to the condition that there are no domestic or I&C premises connected to

their pipeline(s). If any domestic or I&C premises become connected to the pipelines of a gas storage operator, its GT licence would need to be revisited to introduce ring fencing provisions.

Cash lock-up arrangements

Initial proposal

- 3.50. The initial proposals did not include the cash lock-up mechanism, which was introduced in the licences of other network operators after the publication of that document.

Ofgem's views

- 3.51. On 1 April 2005 the licences of DNOs were modified to include arrangements, which limit access to cash, assets, rights or benefits of licensed companies by any affiliates or related undertakings under certain circumstances. These circumstances include situations where the financial health of the licensed company may be at risk.
- 3.52. On 1 May 2005, similar arrangements were included in the gas transporter licenses relating to the DNs and NTS, while, in July 2005, they were discussed in Ofgem's document on the regulation of IDNOs. In that document, Ofgem proposed to include such arrangements in the distribution licences of IDNOs.
- 3.53. Standard condition 47 (Indebtedness) prohibits the licensee, without the prior written consent of the Authority, from transferring, leasing, licensing or lending any sum or sums, asset, right or benefit to any affiliate or related undertaking otherwise than by way of certain types of transaction, and subject to certain conditions. These transactions include payment of dividends and other distributions, certain transfers of money or other valuable assets on deferred payment or repayment terms, payments of principal and interest on certain loans, fair value payments for goods, services and tax losses, and acquisitions of certain investments.

- 3.54. Under the proposed lock-up arrangements, Ofgem is proposing to continue to allow such transactions to be made in accordance with standard condition 47 (Indebtedness) without the need for prior written approval of the Authority unless a trigger event has occurred and has activated a 'cash lock up'. The trigger event for DNOs, DNAs, the NTS operator and IDNOs which do not adopt alternative arrangements to a credit rating is based on a fall in the credit rating of the licensee such that it no longer retains an investment grade credit rating or its credit rating is at the minimum investment grade level (BBB-/Baa³) and on review for downgrade or has a negative outlook. In the case of IDNOs that have agreed alternative arrangements to a credit rating the trigger event would occur if the alternative arrangements permitted by the Authority are not maintained in accordance with the conditions imposed by the Authority.
- 3.55. The details of the cash lock-up mechanism are included in the draft provided in appendix 1 under condition 47 (Indebtedness).
- 3.56. In order to reduce the administrative burden to which the need for prior approval could give rise, the Authority would, in any particular case, consider giving a general consent for certain other transactions within individual or overall limits to be discussed and agreed with the licensee in the light of the circumstances prevailing at the relevant time.

Final proposals

- 3.57. Ofgem proposes to include the cash lock-up mechanism as part of IGT financial ring fencing. This mechanism would be introduced under condition 47 (Indebtedness) of the IGT licences as set out in the draft licence conditions in appendix 1.
- 3.58. Since the cash-lock up mechanism has not been previously discussed as part of the proposed financial ring fencing provisions for IGTs, Ofgem invites views on this specific area of financial ring fencing. The outcome of this consultation will also be discussed with individual IGTs before issuing a statutory consultation to modify their licences.

Summary of final proposals

3.59. Ofgem's final proposals for financially ring fencing new and existing IGTs are as follows:

- ◆ introducing financial ring fencing conditions into the licences of new and existing IGTs by the end of 2005 and in line with the conditions currently in place for all other gas and electricity network operators;
- ◆ new and existing IGTs with more than 500,000 connected customers will be required to obtain an investment grade issuer credit rating;
- ◆ new and existing IGTs with less than 500,000 connected customers will be allowed to adopt alternative financial arrangements to an investment grade issuer credit rating;
- ◆ where appropriate, existing IGTs will be able to derogate temporarily from certain conditions in order to allow them sufficient time to take those steps that are necessary to comply with the new financial ring fencing regime;
- ◆ metering and connection businesses will be included within the definition of transportation business for ring fencing purposes;
- ◆ where appropriate, IGTs will be allowed to keep pre-existing cross-default obligations for a period of time longer than twelve months subject to certain conditions;
- ◆ gas storage operators that do not have domestic nor I&C customers connected to their pipelines will not have the financial ring fencing conditions switched on in their GT licences; and
- ◆ pending the outcome of the consultation, Ofgem intends to include the cash lock-up arrangements into the licences of new and existing IGTs.

3.60. Alternative arrangements in lieu of an investment grade issuer credit rating will require IGTs with fewer than 500,000 connected customers to:

- ◆ obtain a keep well agreement with the parent company of the licensee if the parent company has an investment grade issuer credit rating; or
- ◆ if the parent company does not have an investment grade issuer credit rating, to obtain a keep well agreement with the parent company of the

licensee and cash in escrow or an on-demand bond issued by a third party with an investment grade issuer credit rating of a value of no less than six months operating costs and six months asset replacement expenditure.

- 3.61. Finally, Ofgem will consider the practicalities of obtaining an issuer credit rating for IGTs with more than 500,000 connected supply points and, where appropriate, may allow these IGTs to continue adopting alternative financial arrangements to an investment grade issuer credit rating subject to the licensee being able to demonstrate that it has taken all appropriate steps to obtain such a credit rating.

4. Next steps

- 4.1. A number of steps are required in order to implement these proposals. These include:
- ◆ issuing, with each IGT's consent, a notice which will give effect in its licence to certain paragraphs of standard condition 2. Those paragraphs contain Ofgem's powers to switch on the ring fencing provisions in Section C of the licence, but are currently suspended in the GT licences of IGTs;
 - ◆ issuing with each IGT's consent, a Transportation Services Direction under standard condition 2, which will activate the ring fencing conditions 32, 43, 44, 45, 46 and 47;
 - ◆ publishing, under section 23 of the Gas Act 1986, a notice of proposals to collectively modify, for GTs, the ring fencing conditions in section C of the licence. The standard conditions proposed to be modified are 43, 44, 46 and 47⁷; and
 - ◆ considering any objections or representations made by relevant licence holders with respect to the proposed modifications.
- 4.2. If Ofgem were unable to proceed with the licence modification process because objections by relevant licence holders meet either of two statutorily prescribed blocking minority threshold tests⁸, then Ofgem would consider making a reference to the Competition Commission pursuant to section 24 of the Gas Act. The relevant licence holders will be holders of gas transporter licences in which standard conditions 43, 44, 46 and 47 are switched on when the section 23 Gas Act notice expires, i.e. the IGTs.
- 4.3. The proposed timetable is therefore the following:
- ◆ 28 September 2005: publication of this final proposals document;

⁷ Please note that standard conditions 32 and 45 will not need to be modified.

⁸ Section 23 (7) & (8) Gas Act 1986 and Statutory Instrument 2003 1746, The Electricity and Gas (Modification of Standard Conditions of Licences) Order 2003

- ◆ individual meetings with the relevant IGTs take place to discuss any specific requirements and their individual consents under condition 2(3) and (4) of their GT licence;
- ◆ 28 October 2005: deadline for submitting representations on the cash lock-up mechanism;
- ◆ 4 November 2005: subject to the consent of each IGTs, the Authority issues a direction to switch on standard conditions 32, 43, 44, 45, 46 and 47 on 24 November 2005;
- ◆ 4 November 2005: publication of a statutory notice pursuant to section 23 of the Gas Act proposing to modify licence conditions 43, 44, 46 and 47;
- ◆ 4 November 2005: Ofgem issues a no action letter, which would provide a grace period for IGTs regarding compliance with standard conditions 43, 44, 46 and 47 pending the implementation of the proposed modifications;
- ◆ 2 December 2005: end of statutory consultation; and
- ◆ subject to the outcome of the statutory consultation, the Authority modifies standard conditions 43, 44, 46 and 47.

Appendix 1 Draft licence conditions

- 1 This appendix includes the draft of those licence conditions that would be required to implement financial ring fencing arrangements. Conditions 32 and 45, which are currently included in section C of IGT licences, will simply be switched on without any further modifications. Conditions 43, 44, 46 and 47 will require to be switched on and then modified to reflect Ofgem's final proposals. The proposed modifications to these licence conditions are included in the drafting below.

Condition 32. Interpretation of Section C

1. In this Section of the standard conditions, unless the context otherwise requires:

“permitted purpose”

means the purpose of all or any of the following:

- (a) the transportation business or any other business or activity within the limits of paragraph 4 of Standard Condition 43 (Restriction on Activity and Financial Ring Fencing);
- (b) without prejudice to the generality of paragraph (a), any payment or transaction lawfully made or undertaken by the licensee for a purpose within subparagraphs 1(b)(i) to (vii) of Standard Condition 47 (Indebtedness).

Condition 43. Restriction on Activity and Financial Ring Fencing

1. Save as provided by paragraphs 3 and 4, the licensee shall not conduct any business or carry on any activity other than the transportation business.

2. The licensee shall not without the prior written consent of the Authority hold or acquire shares or other investments of any kind except:
 - (a) shares or other investments in a body corporate the sole activity of which is to carry on business for a permitted purpose;
 - (b) shares or other investments in a body corporate which is a subsidiary of the licensee and incorporated by it solely for the purpose of raising finance for the transportation business; or
 - (c) investments acquired in the usual and ordinary course of the licensee's treasury management operations, subject to the licensee maintaining in force, in relation to those operations, a system of internal controls which complies with best corporate governance practice as required (or, in the absence of any such requirement, recommended) by the UK listing authority (or a successor body) from time to time for listed companies in the United Kingdom.

3. Subject to the provisions of paragraph 2, nothing in this condition shall prevent:
 - (a) any affiliate in which the licensee does not hold shares or other investments from conducting any business or carrying on any activity;
 - (b) the licensee from holding shares as, or performing the supervisory or management functions of, an investor in respect of any body corporate in which it holds an interest consistent with the provisions of this licence;
 - (c) the licensee from performing the supervisory or management functions of a holding company in respect of any subsidiary; or
 - (d) the licensee from carrying on any business or conducting any activity to which the Authority has given its consent in writing.

4. Nothing in this condition shall prevent the licensee or an affiliate or related undertaking of the licensee in which the licensee holds shares or other investments (a **"relevant associate"**) from conducting de minimis business as

defined in this paragraph so long as the limitations specified in this paragraph are complied with.

- (a) For the purpose of this paragraph, **“de minimis business”** means any business or activity carried on by the licensee or a relevant associate or relevant associates other than:
 - (i) the transportation business; and
 - (ii) any other business activity to which the Authority has given its consent in writing in accordance with paragraph 3(d).

- (b) The licensee or a relevant associate may carry on de minimis business provided that neither of the following limitations is exceeded, namely:
 - (i) the aggregate turnover of all the de minimis business carried on by the licensee and the equity share of the aggregate turnover of all the de minimis business carried on by all its relevant associates does not in any period of twelve months commencing on 1 April of any year exceed 2.5 per cent of the aggregate turnover of the licensee as shown by its most recent audited historical cost accounting statements; and
 - (ii) the aggregate amount (determined in accordance with sub-paragraph (d) below) of all investments made by the licensee in de minimis business, carried on by the licensee and all relevant associates, does not at any time after the date at which this condition takes effect in this licence exceed 2.5 per cent of the sum of the share capital in issue, the share premium and the consolidated reserves (including retained earnings) of the licensee as shown by its most recent audited historical cost accounting statements.

- (c) For the purpose of sub-paragraph (b) above, **“investment”** means any form of financial support or assistance given by or on behalf of the licensee for the de minimis business whether on a temporary or

permanent basis and including (without limiting the generality of the foregoing) any commitment to provide any such support or assistance in the future.

- (d) At any relevant time, the amount of an investment shall be the sum of:
- (i) the value at which such investment was included in the audited historical cost balance sheet of the licensee as at its latest accounting reference date to have occurred prior to the date on which this condition came into effect (or, where the investment was not so included, zero);
 - (ii) the aggregate gross amount of all expenditure (whether of a capital or revenue nature) howsoever incurred by the licensee in respect of such investment in all completed accounting reference periods since such accounting reference date; and
 - (iii) all commitments and liabilities (whether actual or contingent) of the licensee relating to such investment outstanding at the end of the most recently completed accounting reference period,

less the sum of the aggregate gross amount of all income (whether of a capital or revenue nature) howsoever received by the licensee in respect of such investment in all completed accounting reference periods since the accounting reference date referred to in sub-paragraph (d)(i).

5. For the purpose of paragraph 4, “**equity share**”, in relation to any shareholding, means the nominal value of the equity shares held by the licensee in a relevant associate, as a percentage of the nominal value of the entire issued equity share capital of that relevant associate.

Condition 44. Availability of Resources

1. The licensee shall at all times act in a manner calculated to secure that it has available to itself such resources, including (without limitation) management and financial resources, personnel, fixed and moveable assets, rights, licences,

consents and facilities, on such terms and with all such rights, as shall ensure that it is at all times able:

- (a) to properly and efficiently carry on the transportation business of the licensee; and
 - (b) to comply in all respects with its obligations under this licence and such obligations under the Act as apply to those activities authorised by this licence including, without limitation, its duty to develop and maintain an efficient, co-ordinated and economical system of gas transportation.
2. The licensee shall by 31 July of each year submit to the Authority a certificate, approved by a resolution of the board of directors of the licensee and signed by a director of the licensee pursuant to that resolution, in one of the following forms:
- (a) "After making enquiries, and having taken into account in particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid by the licensee, the directors of the licensee have a reasonable expectation that the licensee will have sufficient financial resources and financial facilities available to itself to enable the licensee to carry on the activities authorised by the licence held in accordance with its obligations under the Act and such licence for a period of 12 months from the date of this certificate."
 - (b) "After making enquiries, and having taken into account in particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid by the licensee, the directors of the licensee have a reasonable expectation, subject to what is explained below, that the licensee will have sufficient financial resources and financial facilities available to itself to enable the licensee to carry on the activities authorised by the licence held in accordance with its obligations under the Act and such licence for a period of 12 months from the date of this certificate. However, they would like to draw attention to the following factors which may cast

doubt on the ability of the licensee to carry on the activities authorised by the licence held in accordance with its obligations under the Act and such licence.”

- (c) “In the opinion of the directors of the licensee, the licensee will not have sufficient financial resources and financial facilities available to itself to enable the licensee to carry on the activities authorised by the licence held in accordance with its obligations under the Act and such licence for a period of 12 months from the date of this certificate.”
3. The licensee shall submit to the Authority with that certificate a statement of the main factors which the directors of the licensee have taken into account in giving the certificate, together with a confirmation of the availability of financial facilities and a working capital statement in the format required by the UK listing authority (or a successor body) from time to time for listed companies in the United Kingdom.
 4. The statement submitted to the Authority in accordance with paragraph 3 shall be approved by a resolution of the board of directors of the licensee and must be signed by a director of the licensee pursuant to that resolution.
 5. The licensee shall inform the Authority in writing immediately if the directors of the licensee become aware of any circumstance which causes them no longer to have the reasonable expectation expressed in the most recent certificate given under paragraph 2.
 6. The licensee shall require that each certificate provided for in paragraph 2 is accompanied by a report prepared by its auditors and addressed to the Authority stating whether or not the auditors are aware of any inconsistencies between, on the one hand, that certificate and the statement submitted with it and, on the other hand, any information which they obtained during their audit work on the most recent audited accounting statements of the licensee.
 7. The directors of the licensee shall not declare or recommend a dividend, and the licensee shall not make any other form of distribution within the meaning of section 263 of the Companies Act 1985, or redeem or

repurchase any share capital of the licensee unless prior to the declaration, recommendation or making of the distribution redemption or repurchase (as the case may be) the licensee has issued to the Authority a certificate complying with the following requirements of this paragraph:

(a) The certificate shall be in the following form:

“After making enquiries, the directors of the licensee are satisfied:

- (i) that the licensee is in compliance in all material respects with all obligations imposed on it by Standard Condition 24 (Provision of Information to the Authority), Standard Condition 43 (Restriction on Activity and Financial Ring Fencing), Standard Condition 44 (Availability of Resources), Standard Condition 45 (Undertaking from Ultimate Controller), Standard Condition 46 (Credit Rating of Licensee) and Standard Condition 47 (Indebtedness) of its licence; and
- (ii) that the making of a distribution redemption or repurchase of [] on [] will not, either alone or when taken together with other circumstances reasonably foreseeable at the date of this certificate, cause the licensee to be in breach to a material extent of any of those obligations in the future”.

(b) The certificate shall be signed by a director of the licensee and must have been approved by a resolution of the board of directors of the licensee passed not more than 14 days before the date on which the declaration, recommendation or payment will be made.

(c) Where the certificate has been issued in respect of the declaration or recommendation of a dividend, the licensee shall be under no obligation to issue a further certificate prior to

payment of that dividend, provided that such payment is made within six months of the issuing of that certificate.

Condition 45. Undertaking from Ultimate Controller

1. The licensee shall procure from each company or other person which is at any time an ultimate controller of the licensee a legally enforceable undertaking in favour of the licensee in the form specified by the Authority that that ultimate controller (“the covenantor”) will refrain from any action, and will procure that any person (including, without limitation, a corporate body) which is a subsidiary of or controlled by, the covenantor (other than the licensee and its subsidiaries) will refrain from any action, which would then be likely to cause the licensee to breach any of its obligations under the Act or this licence. Such undertaking shall be obtained within 7 days of the company or other person in question becoming an ultimate controller and shall remain in force for as long as the licensee remains the holder of this licence and the covenantor remains an ultimate controller of the licensee.

2. The licensee shall:
 - (a) deliver to the Authority evidence (including a copy of each such undertaking) that the licensee has complied with its obligation to procure undertakings pursuant to paragraph 1;

 - (b) inform the Authority immediately in writing if the directors of the licensee become aware that any such undertaking has ceased to be legally enforceable or that its terms have been breached; and

 - (c) comply with any direction from the Authority to enforce any such undertaking;

and shall not, save with the consent in writing of the Authority, enter (directly or indirectly) into any agreement or arrangement with any ultimate controller of the licensee or any of the subsidiaries of any such corporate

ultimate controller (other than the subsidiaries of the licensee) at a time when:

- (i) an undertaking complying with paragraph 1 is not in place in relation to that ultimate controller; or
- (ii) there is an unremedied breach of such undertaking; or
- (iii) the licensee is in breach of the terms of any direction issued by the Authority under paragraph 2 of this condition.

Condition 46. Credit Rating of Licensee

1. The licensee shall take all appropriate steps to ensure that the licensee maintains at all times an investment grade issuer credit rating, or with the prior written permission of the Authority, any such arrangements as the Authority considers appropriate.
2. In this condition:

“issuer credit rating” means

- (a) an issuer rating by Standard & Poor’s Ratings Group or any of its subsidiaries;
- (b) an issuer rating by Moody’s Investors Service Inc. or any of its subsidiaries;
- (c) an issuer senior unsecured debt rating by Fitch Ratings Ltd or any of its subsidiaries; or
- (d) a rating which, in the opinion of the Authority, notified in writing to the licensee, is equivalent to those referred to in sub-paragraphs (a), (b) or (c) and issued by:
 - (i) any of the credit rating agencies referred to in sub-paragraphs (a), (b) or (c) or;
 - (ii) any other reputable credit rating agency which, in the opinion of the Authority, notified in writing to the licensee, has comparable standing in both the United Kingdom and the United States of America.

In relation to any issuer credit rating, “investment grade” means:

- (a) unless sub-paragraph (b) below applies:
 - (i) an issuer rating of not less than BBB-by Standard & Poor’s Ratings Group or any of its subsidiaries;
 - (ii) an issuer rating of not less than Baa3 by Moody’s Investors Service Inc. or any of its subsidiaries;
 - (iii) an issuer senior unsecured debt rating of not less than BBB- by Fitch Ratings Ltd or any of its subsidiaries; or
 - (iv) a rating which, in the opinion of the Authority, notified in writing to the licensee, is equivalent to those referred to in sub-paragraphs (i), (ii) and (iii) and issued by:
 - (aa) any of the credit rating agencies referred to in subparagraphs (i), (ii) or (iii); or
 - (bb) any other reputable credit rating agency which, in the opinion of the Authority, notified in writing to the licensee, has comparable standing in both the United Kingdom and the United States of America.
- (b) such higher rating as may be specified by those agencies from time to time as the lowest investment grade credit rating.

Condition 47. Indebtedness

1. In addition to the requirements of Standard Condition 29 (Disposal of Assets), the licensee shall not without the prior written consent of the Authority (following the disclosure by the licensee of all material facts):
 - (a) create or continue or permit to remain in effect any mortgage, charge, pledge, lien or other form of security or encumbrance whatsoever, undertake any indebtedness to any other person or enter into or continue or permit to remain in effect any guarantee or any obligation otherwise than:
 - (i) on an arm’s length basis;
 - (ii) on normal commercial terms;
 - (iii) for a permitted purpose; and

- (iv) (if the transaction is within the ambit of Standard Condition 29 (Disposal of Assets)) in accordance with that condition;
- (b) transfer, lease, license or lend any sum or sums, asset, right or benefit to any affiliate or related undertaking of the licensee otherwise than by way of:
 - (i) a dividend or other distribution out of distributable reserves;
 - (ii) repayment of capital;
 - (iii) payment properly due for any goods, services or assets provided on an arm's length basis and on normal commercial terms;
 - (iv) a transfer, lease, licence or loan of any sum or sums, asset, right or benefit on an arm's length basis, on normal commercial terms and made in compliance with the payment condition referred to in paragraph 2;
 - (v) repayment of or payment of interest on a loan not prohibited by sub-paragraph (a);
 - (vi) payments for group corporation tax relief or for the surrender of Advance Corporation Tax calculated on a basis not exceeding the value of the benefit received; or
 - (vii) an acquisition of shares or other investments in conformity with paragraph 2 of Standard Condition 43 (Restriction on Activity and Financial Ring fencing) made on an arm's length basis and on normal commercial terms,

provided, however, that the provisions of paragraph 3 or 4 below (as the case may be) shall prevail in any of the circumstances described or referred to therein;
- (c) enter into an agreement or incur a commitment incorporating a cross-default obligation; or
- (d) continue or permit to remain in effect any agreement or commitment incorporating a cross-default obligation subsisting at the date in which this condition came into effect, save that the licensee may permit any cross-default obligation in existence at that date to remain in effect for a period not exceeding twelve months from that date, provided that the cross-default obligation is solely referable to an instrument relating to the provision of a

loan or other financial facilities granted prior to that date and the terms on which those facilities have been made available as subsisting on that date are not varied or otherwise made more onerous,

provided, however, that the provisions of sub-paragraphs (c) and (d) shall not prevent the licensee from giving any guarantee permitted by and compliant with the requirements of sub-paragraph (a).

2. The payment condition referred to in paragraph 1(b)(iv) is that the consideration due in respect of the transaction in question is paid in full when the transaction is entered into unless either:
 - (a) the counter-party to the transaction has and maintains until payment is made in full an investment grade issuer credit rating; or
 - (b) the obligations of the counter-party to the transaction are fully and unconditionally guaranteed throughout the period during which any part of the consideration remains outstanding by a guarantor which has and maintains an investment grade issuer credit rating.

3. Where the Authority has not granted permission for the use of alternative arrangements in accordance with paragraph 1 of Standard Condition 46 (Credit Rating of licensee), then except with the prior consent of the Authority, the licensee shall not enter into or complete any transaction of a type referred to or described in paragraph 1(b) save in accordance with paragraph 5, if:
 - (a) the licensee does not hold an investment grade issuer credit rating;
 - (b) where the licensee holds more than one issuer credit rating, one or more of the ratings so held is not investment grade; or
 - (c) any issuer credit rating held by the licensee is BBB- by Standard & Poor's Ratings Group or Fitch Ratings Ltd or Baa3 by Moody's Investors Service, Inc. (or such higher issuer credit rating as may be specified by any of these credit rating agencies from time to time as the lowest investment grade credit rating), or is an equivalent rating from another agency that has been notified to the licensee by the Authority as of comparable standing for the purposes of Standard Condition 46 (Credit Rating of Licensee) and such rating:
 - (i) is on review for possible downgrade; or

(ii) is on Credit Watch or Rating Watch with a negative designation;

or, where neither (i) nor (ii) applies:

(iii) the rating outlook of the licensee as specified by any credit rating agency referred to in sub-paragraph (c) which at the relevant time has assigned the lower or lowest investment grade issuer credit rating held by the licensee has been changed from stable or positive to negative.

4. Where the Authority has granted permission for the use of alternative arrangements in accordance with paragraph 1 of Standard Condition 46 (Credit Rating of Licensee), then except with the prior consent of the Authority, the licensee shall not enter into or complete any transaction of a type referred to or described in paragraph 1(b) save in accordance with paragraph 5, if the alternative arrangements for which the Authority has granted permission are not maintained in accordance with the conditions imposed by the Authority when giving written permission pursuant to paragraph 1 of Standard Condition 46 (Credit Rating of Licensee).
5. Where paragraph 3 or 4 applies, the licensee may not without the prior written consent of the Authority (following disclosure of all material facts) transfer, lease, license or lend any sum or sums, asset, right or benefit to any affiliate or related undertaking of the licensee as described or referred to in paragraph 1(b), otherwise than by way of:
 - (a) payment properly due for any goods, services or assets in relation to commitments entered into prior to the date on which the circumstances described in paragraph 3 or 4 arise, and which are provided on an arm's length basis and on normal commercial terms;
 - (b) a transfer, lease, licence or loan of any sum or sums, asset, right or benefit on an arm's length basis, on normal commercial terms and where the value of the consideration due in respect of the transaction in question is payable wholly in cash and is paid in full when the transaction is entered into;
 - (c) repayment of, or payment of interest on, a loan not prohibited by paragraph 1(a) and which was contracted prior to the date on which the circumstances in paragraph 3 or 4 arise, provided that such payment is not made earlier than the original due date for payment in accordance with its terms; and

- (d) payments for group corporation tax relief or for the surrender of Advance Corporation Tax calculated on a basis not exceeding the value of the benefit received, provided that the payments are not made before the date on which the amounts of tax thereby relieved would otherwise have been due.

6. In this condition:

“cross-default obligation”

means a term of any agreement or arrangement whereby the licensee’s liability to pay or repay any debt or other sum arises or is increased or accelerated or is capable of arising, of increasing or of being accelerated by reason of a default (howsoever such default may be described or defined) by any person other than the licensee, unless:

- (i) that liability can arise only as the result of a default by a subsidiary of the licensee;
- (ii) the licensee holds a majority of the voting rights in that subsidiary and has the right to appoint or remove a majority of its board of directors; and
- (iii) that subsidiary carries on business only for a purpose within paragraph (a) of the definition of permitted purpose set out in Standard Condition 32 (Interpretation of Section C)

“indebtedness”

means all liabilities now or hereafter due, owing or incurred, whether actual or contingent, whether solely or jointly with any other person and whether as principal or surety, together with any interest accruing thereon and all costs, charges, penalties and expenses incurred in connection therewith.

“investment grade”

has the meaning given in paragraph 2 of

“issuer credit rating”

Standard Condition 46 (Credit Rating of Licensee)

has the meaning given in paragraph 2 of Standard Condition 46 (Credit Rating of Licensee)