

Shippers, Transco, DN purchasers
and other interested parties

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Dear Colleague,

Ofgem has received a number of questions from potential purchasers of the distribution networks (DNs) and other interested parties requesting further details on the proposed licensing arrangements. The purpose of this letter is to inform potential purchasers and other interested parties of the proposed regulatory process to be followed by the Gas and Electricity Markets Authority ("the Authority") in modifying any and/or all of the licence conditions in the Gas Transporters ("GT") licences held (either now or in due course) by Transco plc ("Transco") for the purpose of the DN sales process.

In issuing this letter to all potential DN purchasers and other interested parties and describing the proposed regulatory process to be followed, it is important to make clear that there can be no expectation on the part of National Grid Transco plc (NGT), Transco and/or potential DN purchasers or any other interested parties either as to what the Authority's final decision in relation to the proposed transaction may be, or as to the regulatory framework which may be implemented if the Authority decides to consent to the proposed transactions.

The information contained in this letter is not binding on the Authority. Nothing in this letter is to be construed as granting any rights or imposing any obligations on the Authority. The Authority's discretion in this matter will not be fettered by any statements made in this open letter and all references to the proposed timetable or decisions by the Authority are qualified by this statement.

We nevertheless hope that the information provided helps to give further clarity on Ofgem's position at this time.

Overview

In May 2003, NGT publicly announced that it would consider the sale of one or more of Transco's DNs if it were to maximise shareholder value. It should be noted that any such sale

would require the consent of the Authority, the Health and Safety Executive and the Secretary of State for Trade and Industry.

Transco is currently the holder of a GT licence under the provisions of the Gas Act 1986. This covers (amongst other things) its operation of the National Transmission System (NTS) and the DNs. As part of the process of a potential sale of DNs, Transco's current GT licence will need to be restructured to facilitate separate GT licences. The resulting independent DNs (IDNs) (and any retained DNs (RDNs) which may be required by the Authority to be legally separate from the NTS) will need to hold GT Licences in order to be able to convey gas.

Transco has applied to Ofgem for eight new additional GT Licences for the DNs to be granted to Transco to accommodate a potential sale. Depending on the outcome of the sale process Transco's current expectation is that some of these DN's will be hived down and the relevant licences transferred to wholly owned subsidiaries ("DN companies") and the shares in certain of these subsidiaries could be sold to third parties¹.

Issue

The Authority is currently consulting on Transco's applications for the new additional GT licences and has indicated that subject to the outcome of consultation responses, it is minded to grant these new additional GT licences to Transco. It is proposed that, if granted, the effect would be that the Authority would grant 8 new GT licences to Transco (in addition to its existing GT licence) which would, on grant, largely "mirror" Transco's existing GT licence in that the provisions of these Licences will, initially, be largely the same as Transco's existing GT licence. It should be noted that the Authority has reserved its position and may revoke some or all of the additional licences in the event that the sale does not proceed or the Authority finds that it cannot approve the transactions.

As set out in the open letter 16 July and at the following Development and Implementation Steering Group (DISG) meeting, the next stage in the DN sales process is to identify the conditions of these 8 new additional GT licences and the existing GT licence held by Transco which would require to be modified as part of the sale process.

Process

Once the process of identifying the required modifications to these new additional GT Licences and to the existing GT licence held by Transco has commenced, these proposed modifications will be the subject of an informal consultation document that Ofgem intends to release in early September 2004. Ofgem will additionally be explaining the proposed changes at the DISG.

This informal consultation document will have been informed by the development of the commercial and regulatory framework that has been undertaken through the DN Sales industry work group process in recent months.

The informal consultation document will give interested parties, such as, but not limited to potential DN purchasers and the holder of the relevant GT licences at that time, Transco, the

¹ See Ofgem notice 22 July

http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/7942_Transco_new_notice.pdf

opportunity to make representations on the structure and content of the GT licences. Ofgem would encourage the potential DN purchasers to be actively involved in this process as they may ultimately own the shares in a DN company which will hold the relevant GT licence.

Subject to consideration of consultation responses, it is envisaged that the informal consultation would be followed by the issue of a formal section 23 notice on 2 November to formally modify each of Transco's GT licences (ie Transco's existing GT licence and, if granted, the new additional GT Licences). The notice would be formally consulted upon for 28 days.

The formal process for modifying licence conditions is for the Authority to consult on the proposed modifications in accordance with the requirements of section 23 of the Gas Act 1986 and (among other things) for the holder of the licence which is to be modified, in this case Transco, to indicate whether it consents to this modification. Transco would be required to provide this consent in respect of each of the licences it holds.

As mentioned above, it is important to note that subject to complying with the requirements of section 23 of the Gas Act 1986 and having regard to representations or objections made and not withdrawn, in order to make a modification to the conditions of a licence, (in this case in respect of each of Transco's GT licences (i.e, Transco's existing GT licence and, if granted, the new additional GT Licences) it will be Transco's consent which will be required in accordance with the requirements of section 23 (6) as it will be the holder of the relevant licences at the relevant time. This means that Transco will be asked to provide its consent to the modification to its existing GT licence and to the modifications to the 8 new GT licences, if granted, including for the avoidance of doubt any special conditions. Subject to compliance with due process as outlined above, this consent, if provided by Transco, would enable (but not oblige) the Authority to direct that that the modifications be made and this would prescribe the content of the licences for the DN's to be sold and for those to be retained by Transco.

However, in light of the proposed sale of the DN businesses, Ofgem would particularly hope to receive comments on the proposed content of Transco's existing GT licence and, if granted, the new additional GT licences from, among other people, potential DN purchasers in order to inform its thinking on the content of the section 23 notice.

If you have any questions in connection with this letter, please do not hesitate to contact me on the above number. Alternatively please contact Catherine Saponar.

Yours sincerely,

Sonia Brown
Director, DN Sales