

NOTICE UNDER SECTION 23(3) OF THE GAS ACT 1986

This Notice is issued by the Gas and Electricity Markets Authority (the “**Authority**”) under section 23(3) of the Gas Act 1986 (the “**Act**”) in connection with National Grid Transco plc’s (“**NGT**”) proposed sale of one or more of Transco plc’s (“**Transco**”) local gas distribution networks (“**DNs**”) (the “**Proposed Transaction**”).

Background

Transco is the holder of a gas transporters (“**GT**”) licence treated as granted under section 7 of the Act which was amended and restated by a licensing scheme made by the Secretary of State for Trade and Industry (the “**Secretary of State**”) pursuant to Paragraph 19 of Schedule 7 of the Utilities Act 2000 on 28 September 2001 as the same has been amended from time to time (the “**Original Transco Licence**”).

On 22 July 2004, the Authority issued a notice under sections 7(5) and 8(4) of the Act stating that Transco had (in connection with the Proposed Transaction) applied for eight additional GT licences which the Authority was minded to grant on the basis that any surplus licences could be revoked.

Pursuant to section 7 of the Act, on 5 November 2004, the Authority (without in any way fettering its discretion in relation to the Proposed Transaction) granted five additional GT licences to Transco (the “**Additional Transco Licences**”) rather than the eight originally applied for by Transco¹ and Transco formally withdrew its remaining three applications. As a result of this, Transco now holds in total six (6) GT licences. The Additional Transco Licences were granted and remain in substantially the same form as the Original Transco Licence and a copy of the form in which the Additional Transco Licences were granted can be found on Ofgem’s website².

The Original Transco Licence and the Additional Transco Licences are together referred to in this Notice as the “**Transco Licences**” and this Notice proposes modification of the Transco Licences.

As part of the Proposed Transaction, Transco is proposing to hive-down four of its DN businesses to four wholly owned Transco subsidiary companies. The proposed hive-down by Transco will require, inter alia, the consent of the Secretary of State and the Authority pursuant to Amended Standard Condition 29 of the Original Transco Licence. It is expected that both the Secretary of State and the Authority will decide on this matter in mid January 2005. The proposed modifications to the Transco

¹ This reflects the Authority’s decision in November 2004 not to require each of the DNs which are to be retained by NGT (“**RDNs**”) to be held in separate legal entities

² http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/9161_A_copy_of_the_GT_Licences__issued_to_Transco__05.11.04_1.pdf

Licences which are set out in this Notice would not be directed by the Authority in the event that Transco does not obtain the consents necessary to undertake the hive-down of the DNs from Transco to the wholly owned Transco subsidiary companies.

As at the date of this Notice, all gas transportation assets owned by Transco were operated pursuant to the Original Transco Licence. As at the date of this Notice, the Additional Transco Licences, whilst active, do not relate to any particular gas transportation assets owned or operated by Transco.

As part of the Proposed Transaction, the Authority proposes to modify each of the Transco Licences in the manner set out in this Notice to separate the price controls (as currently set out in the Original Transco Licence) to achieve revenue separation between Transco's National Transmission System ("NTS") and each of the DNs which are proposed to be disposed of by Transco ("IDNs") and each of those DNs which are proposed to be retained by Transco ("RDNs"). Once the modifications proposed in this Notice are made, each of the Additional Transco Licences will relate to specific DN assets and the Original Transco Licence will relate to the NTS assets only.

It should be noted that if Transco obtains the consents necessary to undertake the hive-down of the DNs from Transco to the wholly owned Transco subsidiary companies, further modifications to Transco's Licences (including modifications to the NTS and DN incentive arrangements) will be proposed in due course as part of the Proposed Transaction.

In order to make the modifications set out in this Notice to each of the Transco Licences (i.e. the Original Transco Licence and each of the Additional Transco Licences), Transco's consent will be required in accordance with the requirements of section 23(6) of the Act as it will be the holder of the relevant licences at the relevant time. This means that only Transco will be asked to provide consent to the proposed modifications. This consent, if provided by Transco, would enable the Authority, but not oblige it, to direct that the modifications be made.

However, in light of the Proposed Transaction, Ofgem would particularly hope to receive comments on the proposed modifications to the Transco Licences from, amongst others, potential DN purchasers and other interested parties.

Further details on the way forward post this section 23 Notice (in particular as regards the section 8AA process and related additional section 23 consultation) can be found in the *National Grid Transco— potential sale of gas DN business – Licensing: Next Steps – Formal consultation under section 23 and informal consultation under section 8AA of the Gas Act 1986 – November 2004*

In issuing this Notice, it is important to make clear that there can be no expectation on the part of NGT, Transco, potential DN purchasers, shippers, suppliers or any other interested parties either as to the Authority's final decision in relation to the Proposed Transaction or as to the regulatory framework which may eventually be implemented if the Authority consents to the Proposed Transaction.

The information in this Notice is not binding on the Authority. Nothing in this Notice is to be construed as granting any rights or imposing any obligations on the Authority. The Authority's discretion will not be fettered by any statements made in this notice.

The Authority hereby gives notice pursuant to section 23(3) of the Gas Act 1986 (the "Act") as follows:-

1. PROPOSED MODIFICATIONS

The Authority proposes to modify the conditions of each of the Transco Licences by amending the following conditions in the following respects:-

1.1 In the Original Transco Licence, by substituting for:

- 1.1.1 Special condition 28A: Revenue restriction definitions;
- 1.1.2 Special Condition 28B: Restriction of revenue in respect of the NTS transportation owner activity, Distribution Network transportation activity and NTS system operation activity;
- 1.1.3 Special Condition 29: Allocation of revenues and costs for calculations under the price control;
- 1.1.4 Special Condition 30: Supplementary provisions of the revenue restrictions;
- 1.1.5 Special Condition 33: Information to be provided to the Authority in connection with the transportation system revenue restriction;
- 1.1.6 Special Condition 34: Licensee's methodology for determining incremental entry capacity volumes;
- 1.1.7 Special Condition 35: NTS performance reporting;
- 1.1.8 Special Condition 36: LDZ incentive scheme and performance reporting; and

- 1.1.9 Schedule A: NTS output measures for the price control;
- the following conditions:
 - 1.1.10 Special Condition 28A: Revenue restriction definitions in respect of the NTS transportation owner activity and NTS system operation activity;
 - 1.1.11 Special Condition 28B: Restriction of revenue in respect of the NTS transportation owner activity and NTS system operation activity;
 - 1.1.12 Special Condition 29: Allocation of Revenues and costs for calculations under the price control in respect of the NTS transportation owner activity and NTS system operation activity;
 - 1.1.13 Special Condition 30: Supplementary provisions of the revenue restriction in respect of the NTS transportation owner activity and NTS system operation activity;
 - 1.1.14 Special Condition 33: Information to be provided to the Authority in connection with the transportation system revenue restriction in respect of the NTS transportation owner activity and NTS system operation activity ;
 - 1.1.15 Special Condition 34: Licensee's methodology for determining incremental entry capacity volumes;
 - 1.1.16 Special Condition 35: NTS performance reporting;
 - 1.1.17 Special Condition 36: Not used; and
 - 1.1.18 Schedule A: NTS output measures for the price control.
- 1.2 A copy of the proposed modifications to the Original Transco Licence, which if directed would become the NTS GT Licence, can be found at Annex 1.
- 1.3 In each of the Additional Transco Licences, by substituting for:
 - 1.3.1 Special Condition 28A: Revenue restriction definitions;
 - 1.3.2 Special Condition 28B: Restriction of revenue in respect of the NTS transportation owner activity, Distribution Network transportation activity and NTS system operation activity;

- 1.3.3 Special Condition 29: Allocation of revenues and costs for calculations under the price control;
- 1.3.4 Special Condition 30: Supplementary provisions of the revenue restrictions;
- 1.3.5 Special Condition 33: Information to be provided to the Authority in connection with the transportation system revenue restriction;
- 1.3.6 Special Condition 34: Licensee's methodology for determining incremental entry capacity volumes;
- 1.3.7 Special Condition 35: NTS performance reporting;
- 1.3.8 Special Condition 36: LDZ incentive scheme and performance reporting; and
- 1.3.9 Schedule A: NTS output measures for the price control the following licence conditions and schedule:-

the following conditions:

- 1.3.10 Special Condition 28A: Revenue restriction definitions in respect of the Distribution Network;
- 1.3.11 Special Condition 28B: Restriction of revenue in respect of the Distribution Network transportation owner activity;
- 1.3.12 Special Condition 29: Allocation of Revenues and costs for calculations under the price control in respect of the Distribution Network;
- 1.3.13 Special Condition 30: Supplementary provisions of the revenue restrictions in respect of the Distribution Network;
- 1.3.14 Special Condition 33: Information to be provided to the Authority in connection with the transportation system revenue restriction in respect of the Distribution Network;
- 1.3.15 Special Condition 34: Not used;
- 1.3.16 Special Condition 35: Not used;
- 1.3.17 Special Condition 36: Distribution Network incentive scheme and performance reporting in respect of the Distribution Network; and

1.3.18 Schedule A: Not used

- 1.4 A copy of the proposed modifications in respect of the RDN business, if directed, would become the single RDN GT Licence to be held by Transco in addition to the NTS GT Licence can be found at Annex 2. A copy of the proposed modifications to the four other GT licences to be held by Transco which, if directed, would become the IDN GT licences can be found at Annexes 3, 4, 5, and 6 respectively.
- 1.5 **For the avoidance of doubt, it should be noted that the proposed modifications in the Annexes are not identical and each Additional Transco Licence will not have each of these Special Conditions amended in the same way.**

In summary, each Additional Licence will have its own unique Special Condition 28A and Special Condition 28B and, in the case of the RDN GT Licence, it will have four separate Part 1Bs (paragraphs 6-11) of Special Condition 28B.

Furthermore, Special Condition 33 is different in the RDN GT Licence when compared to the IDN GT Licences in order to reflect that this applies to the four DNs to be retained by Transco.

2. **REASONS FOR PROPOSED MODIFICATION**

- 2.1 The reasons for the Authority proposing to make these licence modifications and their effects are set out in the following documents:
- 2.1.1 National Grid Transco– potential sale of gas DN business – Licensing: Next Steps – Formal consultation under section 23 and informal consultation under section 8AA of the Gas Act 1986 – November 2004;
- 2.1.2 National Grid Transco – Potential Sale of Gas distribution network businesses – Final Impact Assessment – November 2004;
- 2.1.3 National Grid Transco – Potential sale of gas distribution network businesses – Final Impact assessment – Appendices – November 2004;
- 2.1.4 Transco plc – Form of five new additional GT licences granted to Transco plc on 5 November 2004 – 5 November 2004;
- 2.1.5 Transco plc – Notice of the grant of five new additional gas transporter licences – 5 November 2004;

- 2.1.6 Joint Ofgem and DTI open letter – Sale of NGT’s Local Gas Distribution Networks (DNs): Issue of an exemption from a shipper’s licence – 4 November 2004;
- 2.1.7 DN Sales: Ofgem note on initial draft of private CLM licence condition – 19 October 2004;
- 2.1.8 Open letter: updated timetable for potential gas distribution network sales project – 15 October 2004 – 238/04;
- 2.1.9 DN Sales: Gas distribution price controls further clarification – 6 October 2004;
- 2.1.10 DN Sales: National Grid Transco – potential sale of gas distribution network businesses – publication of NGT’s initial drafting of proposed new NTS/GT licences – 15 September 2004;
- 2.1.11 National Grid Transco – potential sale of gas distribution network businesses; Initial thoughts on restructuring of Transco plc’s gas transporter licences; Consultation document. September 2004 – 215/04;
- 2.1.12 Open letter on Special Condition 18 – 26 August 2004;
- 2.1.13 Ofgem preliminary position on business separation requirements to apply between distribution networks – 20 August 2004;
- 2.1.14 Offtake arrangements, conclusions document on framework – 13 August 2004 – 199/04;
- 2.1.15 Interruptions arrangements: conclusions on document framework – 13 August 2004 – 198/04;
- 2.1.16 DN Sales: open letter to NGT, potential DN purchasers and other parties on licence amendment process – 5 August 2004;
- 2.1.17 DN Sales: Ofgem position paper on pensions – 2 August 2004;
- 2.1.18 DN Sales: Open letter on environmental liabilities – 23 July 2004;
- 2.1.19 Transco plc – Notice of proposed grant and proposed modification of 8 new additional gas transporters licences – 22 July 2004;

- 2.1.20 Open letter: timetable for potential gas distribution network sales project – 16 July 2004;
- 2.1.21 National Grid Transco – potential sale of gas distribution network businesses. Interruptions arrangements: regulatory impact assessment. 30 June 2004 - 146/04;
- 2.1.22 National Grid Transco – potential sale of gas distribution network businesses. Offtake arrangements. Regulatory impact assessment. 11 June 2004 - 131/04;
- 2.1.23 National Grid Transco – potential sale of network distribution businesses Agency and governance arrangements – 28 May 2004 120/04;
- 2.1.24 National Grid Transco – potential sale of network distribution businesses. Allocation of roles and responsibilities between transmission and distribution network – 28 May 2004 – 119/04s;
- 2.1.25 DN Sales: RIA on options for exit reform industry letter – 20 May 2004;
- 2.1.26 National Grid Transco – potential sale of network distribution businesses. Allocation of roles and responsibilities between transmission and distribution networks – regulatory impact assessment. 20 April 2004 – 84/04;
- 2.1.27 National Grid Transco – potential sale of network distribution businesses. Agency and governance arrangements: regulatory impact assessment. 20 April 2004 – 83/04;
- 2.1.28 Open letter on Gas Distribution Price Controls – 16 March 2004;
- 2.1.29 National Grid Transco – potential sale of network distribution businesses: next steps. 17 December 2003 – 170/03; and
- 2.1.30 National Grid Transco – potential sale of network distribution businesses. 31 July 2003 – 77/03.

3. **SUMMARY OF THE EFFECT OF PROPOSED MODIFICATION**

- 3.1 In summary, the effects of the proposed licence modifications are to commence the process of restructuring each of the Transco Licences to support a divested industry structure in the event that Transco sells one or more of its DNs, subject to receiving the Authority's consent.

- 3.2 These modifications will operate to split the revenue restriction provisions in the Original Transco Licence and each of the Additional Transco Licences between NTS and DN activities. However, overall, the intention is that the revenue recovered by Transco will have the same net effect regardless of this split.
- 3.3 As at the date of this Notice, all gas transportation assets owned by Transco were operated pursuant to the Original Transco Licence. As at the date of this Notice, the Additional Transco Licences, whilst active, do not relate to any particular gas transportation assets owned or operated by Transco.
- 3.4 As part of the Proposed Transaction, the Authority proposes to modify each of the Transco Licences in the manner set out in this Notice to separate the price controls (as currently set out in the Original Transco Licence) to achieve revenue separation between the NTS and each of the IDNs and the RDNs. Once the modifications proposed in this Notice are made, each of the Additional Transco Licences will relate to specific DN assets and the Original Transco Licence will relate to the NTS assets only.

4. **DETAILED EFFECT OF PROPOSED MODIFICATIONS**

- 4.1 More specifically, the effects of the proposed licence modifications are as follows:
- 4.1.1 New Special Conditions will be inserted into the Original Transco Licence to govern the revenue restriction and incentives applicable to the NTS and the existing conditions will be disapplied. The levels of such restrictions remain unchanged at this time;
- 4.1.2 New Special Conditions will be inserted in each of the Additional Transco Licences to govern the revenue restriction applicable to each DN and the existing conditions will be disapplied;
- 4.1.3 The price control provisions contained in each of the Additional Transco Licences applicable to DNs will be separated and allocated to the individual licences. In the RDN GT licence there will be four separate price control provisions to reflect the four DNs covered by the RDN GT licence. In aggregate, the overall level of the control is unchanged.
- 4.2 More detailed information on the nature of the proposed modifications can be found in “NGT – potential sale of gas DN business – Licensing: Next Steps – Formal consultation

under section 23 and informal consultation under section 8AA of the Gas Act 1986 – November 2004” document published today, in particular chapter 3 of that document.

- 4.3 Subject to the outcome of the statutory consultation, consideration of respondents’ views and the Authority’s decision regarding this transaction, it is the intention of the Authority that these modifications, if made, would be directed on 27 January 2005, to take effect at a later date.

5. **DOCUMENTS**

Copies of the proposed licence modifications are attached to this Notice and the “*NGT – potential sale of gas DN business – Licensing: Next Steps – Formal consultation under section 23 and informal consultation under section 8AA of the Gas Act 1986*” document published today. The proposed modifications and other documents referred to in this Notice are available (free of charge) from the Ofgem Research and Information Centre (Telephone: 0207 901 7003) or on the Ofgem website at www.ofgem.gov.uk.

6. **ADDITIONAL INFORMATION**

- 6.1 Respondents should also note that Ofgem has issued today a separate unrelated but parallel section 23 notice relating to proposed modifications to the Income Adjusting Events provisions of Transco’s GT Licences.
- 6.2 This proposes changes with respect to Special Condition 28B of Transco’s Licences and will affect the drafting relating to the determination of any adjustment factor to be applied to the SORAt term within paragraph 14(1) of Special Condition 28B of the Transco Licences (the “SORAt modification”).
- 6.3 Without fettering the Authority’s discretion, it is likely that the SORAt modification, if made, would be directed on 00:00 hours on 26 January 2005. As such, if the SORAt modification is made, the modifications proposed in this Notice would be based upon special condition 28B as modified by the SORAt modification.
- 6.4 It should be noted that these are parallel consultations and are not interdependent. This modification and the modifications proposed in this Notice are capable of being made without the SORAt modification.

7. REPRESENTATIONS AND OBJECTIONS

Any representations or objections to the proposed licence modifications must be made before 5.00pm on 23 December 2004 and should be addressed to:

Sonia Brown

Ofgem

9 Millbank

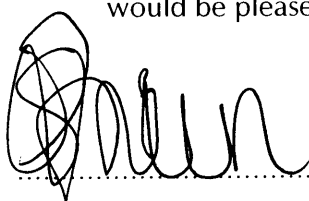
London

SW1W 3GE

e-mail: tracey.hunt@ofgem.gov.uk

Tel: 0207 901 7356

8. Respondents are free to mark their reply as confidential, although we would prefer, as far as possible, open responses that can be placed in the Ofgem library. Ofgem would also prefer that non-confidential responses are sent electronically so that they can be placed on the Ofgem website.
9. If you wish to discuss any aspect of this Notice, Helen Connolly (telephone 020 7901 7267) would be pleased to help.

A handwritten signature in black ink, appearing to be 'Sonia Brown', written over a dotted line.

Sonia Brown,

Director, Transportation,

Duly authorised on behalf of the Authority

25 November 2004