

**Gas Forum Paper on the Proposed Sale of Four of Transco's
Regional Gas Distribution Networks**

**RESTRUCTURING OF GAS TRANSPORTER
LICENCES: A COMMENTARY ON THE LEGAL
ASPECTS OF OFGEM'S PROPOSALS**

1. Summary

- 1.1 At the request of Gas Forum members, this paper considers from a legal perspective the "initial thoughts" set out by Ofgem in its recent consultation document on the restructuring of the Transco gas transporter licences.
- 1.2 In this paper, we assume as a matter of fact that the relevant gas distribution businesses of Transco will be sold and that the transporter licences will need some restructuring to facilitate this sale. We also operate on the assumption that there are a number of ways in which such restructuring might be achieved and that we should therefore consider whether Ofgem's initial thoughts offer, from a legal point of view, the best and most robust approach.
- 1.3 The following parts of this paper:
 - (a) summarise our understanding of the Ofgem proposals;
 - (b) consider the proposed use of "special" licence conditions in the relevant gas licences;
 - (c) consider the proposed "special" mechanism for collective licence modification; and
 - (d) outline the alternative methods by which Ofgem might achieve its policy objectives.
- 1.4 We conclude that the policy intent would be better delivered by alternative means, and we suggest what we think is the best of those.

2. The Policy Proposals

- 2.1 The consultation document lacks clarity and is quite difficult to assess. As we understand it, however, the proposed policy of Ofgem will, in brief, give rise to the following state of affairs in relation to gas transportation licensing.
- 2.2 First, there will continue to be a core of standard licence conditions applying to every gas transportation licensee: that is, all those who are "independent" licensees (the IGTs), and also Transco and those of its subsidiaries which are granted licences for the purpose of facilitating the distribution business sales.

- 2.3 Second, there will be a large quantity of new “special” conditions attached to the licences of the Transco companies. Whether these take the form of new self-standing conditions or amendments of existing standard conditions, they would have effect as special licence conditions by virtue of section 23(6A) of the Gas Act 1986.
- 2.4 Third, while some of these new conditions will be unique to individual Transco companies, a number of others will be common to all of those companies. These will be subject to a collective licence modification process that will be written into licences (as a special condition) in reliance on section 7B(7) of the Gas Act. Ofgem refers to this process as “a private process”. As those words suggest, its purpose is to operate as a surrogate for the statutory collective modification process (under section 23 of the Gas Act) and so provide that the common parts of Transco licences remain consistent for all those licences.
- 2.5 The practical effect of these provisions is to create two classes of licence. One class, which will be for the IGTs, will consist almost entirely of “standard” licence conditions, perhaps with some minor amendments made by means of special conditions to deal with the circumstances of individual cases. The other class, which will be for the Transco companies, will consist of some “standard” conditions, a number of special conditions applicable to individual cases, and a set of “standardised” special conditions which are subject to a collective modification process (the so-called private process) in which only the Transco companies are involved.

3. The Use of Special Conditions

- 3.1 The Gas Act establishes a set of arrangements under which transportation licences are subject to “standard” conditions – initially determined by the Secretary of State, and later modified collectively in a process involving all transportation licensees. The standard conditions embody a series of public policy objectives, with the purpose of ensuring consistency, fairness, and non-discrimination between all licensees of the same type.
- 3.2 The standard conditions are mandatory – they “shall be incorporated...in each licence” (section 8(1) of the Act) – and are clearly intended to be normative in that, while they can be departed from where the individual circumstances of the licensee require it, a clear justification must exist for this.
- 3.3 The second of these points is obvious from section 23(6) of the Gas Act. This provides a mechanism for modifying licences by including new special licence conditions. The mechanism has the following steps:
 - (a) Ofgem must consider whether any variation on the standard licence conditions is appropriate in the circumstances of the individual licensee;
 - (b) Ofgem may decide to propose such variations only if in its opinion the special conditions needed to give effect to them are “requisite to meet the circumstances of the particular case”;

- (c) there must be a period of statutory consultation on the proposals; and
 - (d) in the light of any responses received, Ofgem must be satisfied that the special conditions would not discriminate either in favour of or against the licensee in competing with other licensees of the same type.
- 3.4 The main test in these statutory provisions is that the special conditions must be “requisite to meet the circumstances of the particular case” (our emphasis). This clearly means that departure from the standard conditions is permissible only where it is appropriate in order to make a particular licence bespoke to the circumstances of an individual licensee: not in itself a surprising position, given the obvious policy aims of the standard licensing regime in the form established by Parliament.
- 3.5 However, special licence conditions which are the same for several different licensees cannot, by definition, be addressed to the circumstances of any individual case. (The mere fact that these modifications will all be made at the same time and are to be subject to collective modification confirms beyond doubt that there is a lack of “particularity” in relation to them.)
- 3.6 Therefore, while there is no reason why the Transco licences should not be modified by the use of individual special conditions, Ofgem’s proposal for a set of “standardised” special conditions is of distinctly questionable vires, out of line with statutory policy, and thus not legally robust.

4. The Special Mechanism for Collective Licence Modification

- 4.1 In constructing a “private” collective licence modification procedure within the new licences, Ofgem appears to rely on section 7B(7)(b) of the Gas Act. We note that this can only be discerned from a small footnote on page 20 of the consultation document and that the entirety of Ofgem’s legal case seems to rest on this. Section 7B(7)(b) provides that:

“Conditions included in a licence may contain provision for the conditions to...be modified in such manner as may be specified in the conditions at such times and in such circumstances as may be so determined”.
- 4.2 These modification powers are in addition to other rights to modify licences that are specified on the face of the Act, but should be interpreted restrictively in the sense that their use must be consistent with the general policy intent of Parliament. It cannot be the purpose of these additional powers to operate in such a way as to effectively displace or override the other provisions.
- 4.3 The wording of section 7B(7)(b) is in fact very tightly drawn. In this regard, it must be distinguished from its analogous but looser provision in the Electricity Act 1989 (prior to the Utilities Act 2000). That earlier provision allowed for licences to be modified in a manner determined by or under the conditions. As an indicator of the policy intent, it is significant that the Utilities Act aligned the electricity provision with the tighter gas provision, rather than vice versa.

- 4.4 Section 7B(7)(b) is deliberately narrow. In particular, it distinguishes between two things. On the one hand, there are the circumstances and timing under which a licence modification may be made. These can be determined “by or under” the conditions (because the words “so determined” refer back to the words “by or under” at section 7B(7)(a)). On the other hand, there is the nature of the change (the “manner” of modification), which must be “specified in” the conditions themselves.
- 4.5 This distinction has a purpose. The reference to “times” and “circumstances” is fairly self-explanatory, encompassing the means by which a condition can be modified. Those means may be determined “by or under” the condition, which allows the licence to spell out a mechanism for making the change. It follows that the “manner” of the change must therefore refer to its content, which is the natural reading of the word in its context. On this basis, that content must be pre-emptively specified on the face of the licence.
- 4.6 Therefore, for example, it was intra vires for the Secretary of State to use the powers to make some extensive modifications to the gas licences in late 1996 for the specified purpose of securing that they had the same effect (as closely as may be) where a supplier and shipper were the same person. But this is by no means the same thing as providing for an open-ended process of self-modification (with no specified content) as Ofgem now suggests.
- 4.7 Taking the matter in the round, it seems unlikely that section 7B(7)(b) allows licence conditions to provide for a process of self-modification except where either the modification, or its detailed policy objective, is itself spelt out in the conditions in advance. This view is consistent with the policy of the Act that the primary mechanism for modifications should not be materially bypassed.
- 4.8 It follows that, as with the proposal for standardised special licence conditions analysed under section 3 above, Ofgem’s proposal to provide for a collective modification process for those conditions is of very questionable legality.

5. Alternative Process

- 5.1 Ofgem’s proposals for a restructuring of the Transco licences are technically complex and not likely to be readily comprehensible even to many lawyers. The sheer quantity of explanatory text in the consultation document makes this obvious. In our view, this is not a recommendation of what is proposed.
- 5.2 More seriously, however, there must be a number of concerns, for the reasons outlined above, about the legal robustness of the proposals. It seems to us to be in the interests of no party (including of Ofgem itself) for those proposals to be so questionable and, therefore, so exposed to challenge.
- 5.3 There are two alternative methods by which Ofgem can achieve effectively the same licence restructuring as its current proposals envisage, but without the legal difficulties (or the complexity) that those proposals entail. In summary, these methods are as follows:

- (a) Since it appears to be Ofgem's intention to create two largely distinct types of transportation licence – one for IGTs and the other for Transco companies – this arrangement could be formalised by altering the definition of activities requiring to be licensed under the Gas Act. This can be done by means of an order in the form of a statutory instrument (made by the Secretary of State) under section 41C of the Gas Act.

It should be noted that this order-making power to alter licensable gas activities includes power to make all necessary consequential provision including the amendment or repeal of any provision of the Gas Act and the determination of new standard licence conditions, and is subject to the affirmative parliamentary procedure.

Though use of the section 41C process might in some cases be time-consuming, there is good reason to believe that a properly constructed alteration of the licensable activities in this case could be achieved fairly quickly. Such use of the process would be attractive because of the transparency, clarity, and legal robustness of the outcome when compared with Ofgem's present proposals.

- (b) As an alternative, the statutory mechanisms for establishing standard licence conditions make allowance for conditions to be "switched on" or "switched off" in appropriate cases, so as to accommodate within one set of standard conditions a number of licensees who are carrying on the same licensable activity but are substantially different in size and function. The practical usefulness of these provisions, which have been implemented already for licences of several types, is well understood.

What Ofgem is proposing for the Transco licences could readily be dealt with by modifying the standard transportation licence conditions to include a new section containing conditions that are switched off for all licensees but the Transco companies. Again, in comparison with the current proposals, this seems to us to have the benefits of clarity and of established legal precedent, while at the same time delivering an equivalent policy outcome.

- 5.4 We consider that either or both of these options should be explored in more detail as an alternative to Ofgem's current proposals. However, for full legal robustness, and since it could be argued that the disposal of the four regional gas networks is an industrial restructuring of the kind that Parliament would have had in mind when enacting the section 41C process, we believe that the latter recommends itself as the most appropriate option.

Roger Barnard, EDF Energy

John Cooper, Wragge & Co

November 2004