

To:

The Company Secretary  
Transco plc  
1 – 3 Strand  
London  
WC2N 5EH

## **MODIFICATION OF THE PRICE CONTROL CONDITIONS IN EACH OF TRANSCO PLC'S SIX GAS TRANSPORTERS LICENCES**

This Direction is issued by the Gas and Electricity Markets Authority (the "**Authority**") 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**"). This Direction is issued further to a notice published pursuant to section 23(3) of the Gas Act 1986 ("**the Act**") published by the Authority on 25 November 2004 ("**the Notice**").

**Whereas:**

### **Background**

1. Transco plc (a company registered in England & Wales with company number 2006000) is the holder of a gas transporters ("**GT**") licence treated as granted under section 7 of the Gas Act 1986 (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 to the Utilities Act 2000 on 28 September 2001 (the "**Original Transco Licence**").
2. On 22 July 2004, the Authority published 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.
3. 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 Transco<sup>1</sup> and Transco formally withdrew its remaining three applications. As a result of this, as at the date of this Direction, Transco holds in total six GT licences (including for the avoidance of doubt the Original Transco Licence).

4. 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 website<sup>2</sup>. Immediately prior to the date of this Direction all gas transportation assets owned by Transco were operated pursuant to the Original Transco Licence. The Additional Transco Licences, although active do not relate to any particular transportation assets owned or operated by Transco.
5. The Original Transco Licence and the Additional Transco Licences are together referred to in this Direction as the "**Transco Licences**".

#### **The Modification Process: November 2004 section 23 Notice**

6. As part of the Proposed Transaction, pursuant to section 23(3) of the Act, on 25 November 2004 Ofgem published in a manner it considered appropriate the Notice proposing modifications to each of the Transco Licences<sup>3</sup> together with an explanatory document<sup>4</sup>.

#### **Effect of the proposed modifications**

7. The Notice sought to consult on the Authority's proposal (as part of the Proposed Transaction) to separate the price controls (as 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**"). The Notice stated that the effect of the proposed modifications would be that each of the Additional Transco Licences

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<sup>1</sup> 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

<sup>2</sup> [http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/9161\\_A\\_copy\\_of\\_the\\_GT\\_Licences\\_\\_issued\\_to\\_Transco\\_\\_05.11.04\\_1.pdf](http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/9161_A_copy_of_the_GT_Licences__issued_to_Transco__05.11.04_1.pdf)

<sup>3</sup> [http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/gasdistributionnetworksale&levelids=.1\\_8936#top8936](http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/gasdistributionnetworksale&levelids=.1_8936#top8936)

<sup>4</sup> National Grid Transco – Potential sale of gas distribution network businesses. Licensing: Next Steps. Formal consultation under Section 23 and informal consultation under Section 8AA of the Gas Act 1986 November 2004 263/04

would relate to specific DN assets and the Original Transco Licence will relate to the NTS assets only.

8. The proposed modifications are more particularly detailed in the Notice and summarised below.

9. In the Original Transco Licence<sup>5</sup>, by substituting for:

- a. Special condition 28A: Revenue restriction definitions;
- b. Special Condition 28B: Restriction of revenue in respect of the NTS transportation owner activity, Distribution Network transportation activity and NTS system operation activity;
- c. Special Condition 29: Allocation of revenues and costs for calculations under the price control;
- d. Special Condition 30: Supplementary provisions of the revenue restrictions;
- e. Special Condition 33: Information to be provided to the Authority in connection with the transportation system revenue restriction;
- f. Special Condition 34: Licensee's methodology for determining incremental entry capacity volumes;
- g. Special Condition 35: NTS performance reporting;
- h. Special Condition 36: LDZ incentive scheme and performance reporting;  
and
- i. Schedule A: NTS output measures for the price control;

the following conditions:

- j. Special Condition 28A: Revenue restriction definitions in respect of the NTS transportation owner activity and NTS system operation activity;
- k. Special Condition 28B: Restriction of revenue in respect of the NTS transportation owner activity and NTS system operation activity;

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<sup>5</sup> Which in the event that the Proposed Transaction proceeds shall apply to Transco plc's NTS operations

- l. 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;
- m. Special Condition 30: Supplementary provisions of the revenue restrictions in respect of the NTS transportation owner activity and NTS system operation activity;
- n. 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;
- o. Special Condition 34: Licensee's methodology for determining incremental entry capacity volumes
- p. Special Condition 35: NTS performance reporting;
- q. Special Condition 36: Not used; and
- r. Schedule A: NTS output measures for the price control.

10. In each of the Additional Transco Licences<sup>6</sup>, by substituting for:

- a. Special Condition 28A: Revenue restriction definitions;
- b. Special Condition 28B: Restriction of revenue in respect of the NTS transportation owner activity, Distribution Network transportation activity and NTS system operation activity;
- c. Special Condition 29: Allocation of revenues and costs for calculations under the price control;
- d. Special Condition 30: Supplementary provisions of the revenue restrictions;
- e. Special Condition 33: Information to be provided to the Authority in connection with the transportation system revenue restriction;

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<sup>6</sup> which in the event that the Proposed Transaction proceeds shall apply to the DNs.

- f. Special Condition 34: Licensee's methodology for determining incremental entry capacity volumes;
- g. Special Condition 35: NTS performance reporting;
- h. Special Condition 36: LDZ incentive scheme and performance reporting;  
and
- i. Schedule A: NTS output measures for the price control

the following licence conditions and schedule;

- j. Special Condition 28A: Revenue restriction definitions in respect of the Distribution Network;
- k. Special Condition 28B: Restriction of revenue in respect of the Distribution Network transportation activity;
- l. Special Condition 29: Allocation of revenues and costs for calculations under the price control in respect of the Distribution Network;
- m. Special Condition 30: Supplementary provisions of the revenue restrictions in respect of the Distribution Network;
- n. Special Condition 33: Information to be provided to the Authority in connection with the transportation system revenue restriction in respect of the Distribution Network;
- o. Special Condition 34: Not used;
- p. Special Condition 35: Not used;
- q. Special Condition 36: Distribution Network incentive scheme and performance reporting in respect of the Distribution Network; and
- r. Schedule A: Not used

11. The Notice highlighted that the proposed modifications in the Annexes to the Notice in respect of the RDNs and IDNs were not identical and each Additional Transco Licence will not have each of these Special Conditions amended in the same way.

12. In summary, each Additional Transco Licence will, amongst other things, have its own unique Special Condition 28A and Special Condition 28B and, in the case of the one Additional Transco Licence which will relate to the RDNs, it will have four separate Part 1Bs (paragraphs 6-11) of Special Condition 28B.
13. Furthermore, Special Condition 33 is different in the one Additional Transco Licence which will relate to the RDNs when compared to the four Additional Transco Licences which will relate to the IDNs in order to reflect that this applies to the four DNs to be retained by Transco.

### **Respondents' views**

14. As explained, in the Notice, in order to make the modifications set out in the Notice to each of the Transco Licences (i.e. the Original Transco Licence and each of the Additional Transco Licences), only Transco's consent is required in accordance with the requirements of section 23(6) of the Act as it is the holder of the relevant licences at the relevant time. This means that only Transco has been asked to provide consent to the proposed modifications.
15. Notwithstanding this, Ofgem stressed in the Notice that 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.
16. Objections or representations to the modifications were required to be made on or before 5.00pm on 23 December 2004.
17. Prior to the close of the consultation period in respect of the Notice, the Authority received four responses. No responses were withdrawn. Copies of the responses were placed in Ofgem's Research and Information Centre and on Ofgem's website with the consultation document and associated appendices<sup>7</sup>.

### ***Summary of respondents' views***

18. One shipper / supplier stated that they did not have the resources available to adequately address all the issues on which views were invited.

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<sup>7</sup> [http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/gasdistributionnetworksale&levelids=.1\\_8936#top8936](http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/gasdistributionnetworksale&levelids=.1_8936#top8936)

19. Of the remaining three responses submitted, one shipper / supplier stated that the drafting, as published, broadly achieved its aims as they understood them. This respondent noted that there are a significant number of issues that will need to be addressed going forward, but that the assumption was that these would be picked up as part of subsequent licence changes proposed such as the section 8AA process (as detailed in the explanatory document which accompanied the Notice). This respondent raised a number of specific points in relation to the summation of K factors, the application of Network Code definitions, and reporting requirements with respect to volumes and exit capacity incentives. This respondent also reiterated their support for placing incentives on new DN owners from day one and noted that consequential changes as a result of the incentives proposed would be required.
20. One potential purchaser responded and stated that they supported the changes proposed. This respondent particularly commented on the attribution of prescribed rates, and asked for clarity regarding the consistency of allocation across activities.
21. Another potential purchaser responded to state that in the main the modifications set out in the Notice raise no particular issues. However, this respondent specifically requested an audit trail of the derivation of some of the total allowed revenues derived. This respondent also stated their assumption that licence calculations would be on a DN specific basis going forward, and noted that a number of further changes will be required in the future to take into account issues such as the offtake arrangements and incentive schemes.

***Ofgem's consideration of respondents' views***

22. The Authority has carefully considered the responses received.
23. The Authority notes that the intention behind the proposed modifications set out in the Notice is to separate Transco's price controls to achieve revenue separation between the NTS and each of the DNs. As such, the Authority notes that there are a number of licence issues that will need to be addressed before the completion of the Proposed Transaction, but that it was not intended that these issues be addressed as part of the Notice or this Direction. Such issues will be addressed as part of future licence modifications such as the forthcoming

formal section 8AA consultation and one (or more) subsequent section 23 licence consultations (as detailed in the explanatory document which accompanied the Notice).

24. Of the specific issues raised, Ofgem would note that:

- the treatment of the summation of K factors within one of the Additional Transco Licences which will relate to RDNs will be addressed as part of the formal section 8AA consultation;
- the application of Network Code definitions will also be addressed as part of the formal section 8AA consultation such that the necessary changes come into effect to coincide with the new network code arrangements;
- that reporting requirements will be considered as part of the one (or more) section 23 consultations that are planned to follow the section 8AA consultation;
- that the allocation of common costs other than prescribed rates is addressed by Special Condition 29 of the Original Transco Licence and the Additional Transco Licences;
- that separate licence calculations will be performed for each Distribution Network; and
- that Transco has provided the audit trail requested to the Development and Implementation Steering Group.

***Summary of drafting corrections made***

25. Following publication of the Notice, Ofgem received notification of a minor non-material error in the drafting provided in Annex 1 to the Notice for the proposed modifications in respect of Special Condition 30 (Supplementary provisions of the revenue restrictions) in respect of the NTS transportation owner activity and NTS system operation activity for the Original Transco Licence: Line one of paragraph one should have read "*....There may be treated as excluded services services provided.....*".

26. In addition, in the Additional Transco Licence drafting provided in Annex 2 to the Notice, which will relate to the RDNs, in Special Condition 28A (Revenue restriction definitions in respect of the Distribution Network), there has been a re-arrangement of two definitions, "transportation system" and "Transco plc's Network Code" to place them in the correct alphabetical order. Furthermore, the definition of "M number database" in Special Condition 36 (Distribution Network incentive scheme and performance reporting in respect of the Distribution Network) has been amended such that "in the Transco plc's Network Code" has been changed to "in Transco plc's Network Code".
27. The change to the definition of "M number database" in Special Condition 36 (Distribution Network incentive scheme and performance reporting in respect of the Distribution Network), outlined above, has also been made in respect of each Additional Transco Licence which will relate to the IDNs (as provided in Annexes 3 to 6 to the Notice).
28. Finally, one further change has been made relating to Special Condition 33 (Information to be provided to the Authority in connection with the transportation system revenue restriction in respect of the Distribution Network). In respect of each Additional Transco Licence which will relate to the IDNs (as provided in Annexes 3 to 6 to the Notice), the words "Exit Information Reporting" have been included as a heading, that was previously omitted, in the table that is proposed to follow that for 'Emergency Services' detailing the volumes of LDZ capacity curtailment rights and other matters.
29. In the Authority's view, the above corrections and changes are non-material. Having considered the errors and having regard to its powers and duties under the Act, the Authority has decided to incorporate each of the corrections and changes without further consultation and considers that these changes fall within Section 23 of the Act.

#### **Statutory Objections/Consent**

30. The Authority sent a copy of the Notice to the Secretary of State and has not received any objection or direction not to make the modifications to the Transco Licences.

31. On 31 January 2005, Transco provided its written consent to the making of the modifications (with the corrections set out above) to each of the Transco Licences in the form set out in:
- a. Annex 1 to this Direction in respect of the Original Transco Licence (which will, after the proposed modifications are made, relate to the NTS only);
  - b. Annex 2 to this Direction in respect of one of the Additional Transco Licences (which will, after the proposed modifications are made, relate to the RDNs only; and
  - c. Annexes 3 – 6 to this Direction in respect of the four Additional Transco Licences respectively (which will each, after the proposed modifications are made, relate to each of the IDNs respectively).
32. 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. Transco then intends to dispose of the shares in these companies to third party purchasers (“**the Purchasers**”).
33. It was made clear in the Notice and the accompanying explanatory document that the modifications proposed in the Notice would only be directed by the Authority if the Authority granted its consent to Transco to hive-down the four relevant DNs under Amended Standard Condition 29 of the Original Transco Licence.
34. On 12 January 2005, the Authority received four separate applications from Transco seeking the Authority’s consent under Amended Standard Condition 29 of the Original Transco Licence to dispose of the relevant DN assets from Transco to its four wholly owned subsidiary companies as part of the Proposed Transaction.
35. On 20 January 2005, the Authority met to consider Transco’s applications. After careful consideration of the applications and respondents’ views to the various consultations initiated by Ofgem, the Authority granted its consent to Transco

under Amended Standard Condition 29 of the Original Transco Licence. It should be noted that the Authority's consent was granted on a conditional basis. Transco is required to satisfy a number of conditions precedent and conditions subsequent to its consent which must be satisfied before the consent is effective. In particular, the Authority's further consent is required in relation to a number of areas of the Proposed Transaction. Without limitation, as a condition to the Authority's consent, Transco is prohibited from disposing of the shares in the four relevant wholly owned subsidiary companies without the prior consent of the Authority.<sup>8</sup>

36. On 27 January 2005, the Secretary of State granted her consent to Transco pursuant to Amended Standard Condition 29 of the Original Transco Licence.

37. In issuing this Direction it is important to make clear that there can no expectation on the part of NGT, Transco, potential shippers, suppliers or any other interested parties as to any further decisions which the Authority may be required to take or any further consents which the Authority may be required to grant (including for the avoidance of doubt any decisions or consents which may be necessary pursuant to a condition precedent or a condition subsequent attached to the consent granted by the Authority on 20 January) in relation to the Proposed Transaction. The Authority's discretion will not be fettered by the issuance of this Direction or by any statement made within it.

### **Related modifications**

38. On the same date as the publication of the Notice (25 November 2004), the Authority also published a separate, unrelated but parallel section 23 notice in respect of proposed modifications to the Income Adjusting Events provisions of the Transco Licences.

39. For the reasons noted in the modification direction issued on 26 January 2005 by the Authority<sup>9</sup>, the Authority directed that the proposed changes to the Income Adjusting Event provisions be made. This modification is reflected in the Annexes attached to this Direction.

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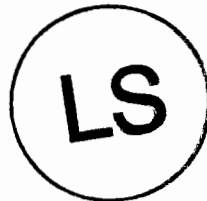
<sup>8</sup> A copy of the Authority's four Consent Directions in this respect can be found on the Ofgem website. – National Grid Transco – Sale of gas distribution network. Authority decision. Transco plc applications to dispose of four gas distribution networks.

**Now therefore**, in accordance with the powers contained in section 23 of the Act and with the written consent of Transco in respect of each of the six Transco Licences, the Authority hereby modifies the licence conditions in each of the six Transco Licences in the manner specified in Annexes 1-6 of this Direction respectively with effect from the date of this Direction.

40. Pursuant to section 38A of the Act the reasons for making these modifications are stated in the :

- a. The Notice; and
- b. The documents listed in the Notice.
- c. The decision document issued by the Authority following its decision on 20 January to grant its consent to Transco under Amended Standard Condition 29 of the Original Transco Licence allowing Transco to hive down the four relevant DNs to four wholly owned subsidiary companies.<sup>10</sup>

41. Copies of the above documents are available (free of charge) from the Ofgem Research and Information Centre (telephone 020 7901 7003) or on the Ofgem website ([www.ofgem.gov.uk](http://www.ofgem.gov.uk)).



Dated 1 February 2005

The Official seal of the Authority affixed to this modification is authenticated by:

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

**Duly authorised on behalf of the Authority**

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<sup>9</sup> [http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/9971\\_1405.pdf](http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/9971_1405.pdf)

<sup>10</sup> National Grid Transco – Sale of gas distribution network. Authority decision. Transco plc applications to dispose of four gas distribution networks