



Shippers, Customers, Transco and
other interested parties

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to customers*

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Dear Colleague,

Gas distribution network sales - Consultation on network code arrangements

The purpose of this consultation is to give interested parties the opportunity to comment on the detailed industry code proposals to support a divested industry structure with multiple gas transporters. It brings together three key streams of work, namely:

- ◆ Transco plc's (Transco) Modification Proposal 0745, which proposes to modify Transco's Network Code into an individual ('short form') network code that incorporates by reference the Uniform Network Code (UNC);¹
- ◆ the UNC itself, which has been prepared by Transco in consultation with shippers and potential purchasers of the gas distribution networks (DNs); and

¹ Transco submitted Urgent Modification Proposal 0745 to Ofgem on 23 February 2005. Ofgem granted urgency status on 25 February 2005. Urgent Modification Proposal 0745 is currently being progressed in accordance with Transco's Network Code modification rules, using a parallel but separate process to this consultation process.

- ◆ the proposed Gas Transporter (GT) licence conditions which support this, namely Standard Special Conditions A11, A12 and A15.²

The Gas and Electricity Markets Authority ('Authority') granted its consent to Transco's proposed disposal of four of its DNs on 20 January 2005, subject to the satisfaction of a number of conditions³. One of the conditions to the Authority's consent requires satisfactory industry code arrangements to be in place. As part of the process of assessing this, the Authority will be required to make a number of inter-related decisions. In particular, the Authority's decision in relation to Transco's Modification Proposal 0745 may have implications for some of the proposed licence modifications contained within the formal section 8AA and section 23 notices which were issued for industry consultation on 14 February 2005. Given the inter-relationship between these issues, Ofgem believes it is important that interested parties have the opportunity to provide comments on the overall package of reforms. To this end, this letter:

- ◆ sets out the background to this consultation;
- ◆ briefly describes how proposed changes to the licensing regime will support changes to the network code arrangements;
- ◆ describes the proposed contractual framework that will give effect to the network code arrangements;
- ◆ describes the process that has been adopted by Transco in relation to the development of the UNC;
- ◆ explains the role of the Authority; and
- ◆ invites the views of interested parties.

Transco has developed and prepared the UNC in consultation with shippers and potential DN purchasers. Transco has now submitted the draft UNC to Ofgem for the purposes of this consultation. To assist interested parties in preparing their responses to this consultation, Transco's draft UNC is provided with this letter in a number of formats:

² *National Grid Transco – Potential sale of gas distribution network businesses, Formal consultation under section 23 and section 8AA of the Gas Act 1986, Ofgem, February 2005, 45/05.*

³ *National Grid Transco – Sale of gas distribution networks: Authority decision – Transco plc applications to dispose of four gas distribution networks, Decision document Ofgem, February 2005 21/05*

- ◆ consolidated and by individual section; and
- ◆ marked up (relative to version 3.09 of Transco's Network Code) and clean.

Also provided with this letter are summaries (prepared by Transco) of the key changes that Transco proposes to make to the provisions of the existing Network Code in order to create the UNC, and a copy of Transco's UNC Development Forum action log. Finally, Ofgem has today published on its website a number of documents, prepared by Transco, that are related to the UNC, including the Agency Services Agreement, the Joint Governance Agreement, and the Incremental Exit Capacity Statement.

It is important to note that nothing in this consultation fetters the discretion of the Authority in relation to any future decisions to be taken in relation to Modification Proposal 0745 and/or to DN sales more generally, including, without limitation, any decisions in respect of the proposed licence modifications and/or any modifications which may be proposed to the Network Code, the proposed UNC and/or the various 'short form' network codes, now or in the future.

Further, in publishing Transco's draft UNC and related documents it is important to note that the Authority takes no responsibility for the accuracy or completeness of the documents and in particular gives no assurance that all modifications which have been directed have been incorporated by Transco into the draft UNC. The Authority is not to be construed as endorsing or in any way designating the document, and there can be no expectation on the part of Transco, potential DN purchasers, or any other interested party as to the final decision by the Authority in relation to Urgent Modification Proposal 0745 and/or any of the other decisions referred to in the previous paragraph.

1. Background

Following Transco's announcement in May 2003 that it would consider the sale of one or more of its gas DNs, Ofgem has undertaken a significant programme of work and consultation to investigate the potential benefits that such a transaction could deliver for consumers.⁴ This process has included the establishment of a number of industry workgroups, including the Development and Implementation Steering Group (DISG), which are (and have been) open to all industry participants to attend.⁵ It has also included consultation on a series of Regulatory

⁴ A full list of all documents published by Ofgem in respect of DN sales can be found at <http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/gasdistributionnetworksale>

⁵ The minutes and papers of the DISG and other workgroups are available on Ofgem's website.

Impact Assessments (RIAs) which considered key aspects of the regulatory, commercial and operational framework required to protect the interests of customers in the event of a sale.

The completion of these RIAs, and associated conclusions documents, culminated in the publication of a Final Impact Assessment (Final IA) in November 2004.⁶ As part of the Final IA, Ofgem undertook an examination of the costs and benefits associated with the overall industry framework that would protect the interests of customers under a divested industry structure and derived an estimate of the potential net benefits that could be achieved for customers if the transaction were to occur. Ofgem's base case estimate highlighted that net benefits to customers could potentially be in the order of £225 million, in present value terms, if a DN sale were to proceed.⁷

On 20 January 2005, the Authority met at a duly convened meeting to consider four applications made by Transco for consent to dispose of four of its relevant DNs to four wholly owned subsidiary companies, the shares in which would subsequently be sold to third party purchasers. After careful consideration of the applications and respondents' views to the various consultations, including without limitation, the November 2004 Final IA, the Authority:

- ◆ granted its consent to Transco's applications;
- ◆ endorsed the previous decisions that it had reached in 2004 regarding the regulatory, commercial and operational framework that would be necessary to protect the interests of customers in the event that the sale of one or more DNs proceeds; and
- ◆ concluded that consent should be granted subject to certain conditions.⁸

The conditions attached to the Authority's consent include (without limitation):

- ◆ that the Authority must be satisfied with the proposed arrangements for industry codes; and
- ◆ that Transco must consent to the modifications to its six gas transporter (GT) licences necessary to protect the interests of customers in a divested industry structure; and

⁶ *National Grid Transco - Potential sale of gas distribution network businesses Final Impact Assessment* Ofgem November 2004.

⁷ The net benefits were calculated in net present value terms over the period between 2005/06 and 2022/23.

⁸ *National Grid Transco – Sale of gas distribution networks: Transco plc applications to dispose of four gas distribution networks Authority decision*, February 2005 21/05, pg 2.

- ◆ that the Authority must have consented under section 8AA of the Gas Act 1986 to the transfer of four of Transco's GT licences to new wholly owned subsidiary companies.⁹

The Authority's decision on Transco's requests has been arrived at having had due regard to its statutory objective and duties as well as its public law duties. In addition, the Authority has taken into account the statutory and licence obligations of GTs.

2. Proposed modifications to Transco's GT licences

At present, the commercial arrangements between Transco and shippers are set out in Transco's Network Code in accordance with Amended Standard Condition (ASC) 9 of Transco's GT licences.¹⁰ The existing Network Code, developed in compliance with this requirement, is a contract between Transco and shippers which defines the rights and responsibilities attributed to all users of the gas transportation system.

As stated in previous documents,¹¹ if the sales occur, the commercial arrangements, including the Network Code arrangements, need to be restructured to support a multi-transporter environment. Consequently, it is necessary to amend Amended Standard Condition 9 of Transco's existing GT licences. In this context, Ofgem's formal section 8AA and section 23 notices¹², published in February 2005, propose to:

- ◆ provide for the establishment of a UNC by introducing Standard Special Condition A11 with the consequential switching off of ASC 9 following the introduction of A11;
- ◆ provide for the joint administration of the Network Code modification process by introducing Standard Special Condition A12; and
- ◆ protect against the inefficient fragmentation of the services and systems that are required to implement the transportation arrangements by introducing Standard Special Condition A15.

⁹ *National Grid Transco – Sale of gas distribution networks: Transco plc applications to dispose of four gas distribution networks Authority decision*, Ofgem, February 2005 21/05, pg 85.

¹⁰ In November 2004 Transco plc was granted 5 additional new GT licences, which have substantially mirror terms to the original Transco plc licence.

¹¹ See for example *National Grid Transco – Potential sale of gas distribution network businesses, Consultation Document*, Ofgem, July 2003 77/03, pg 58.

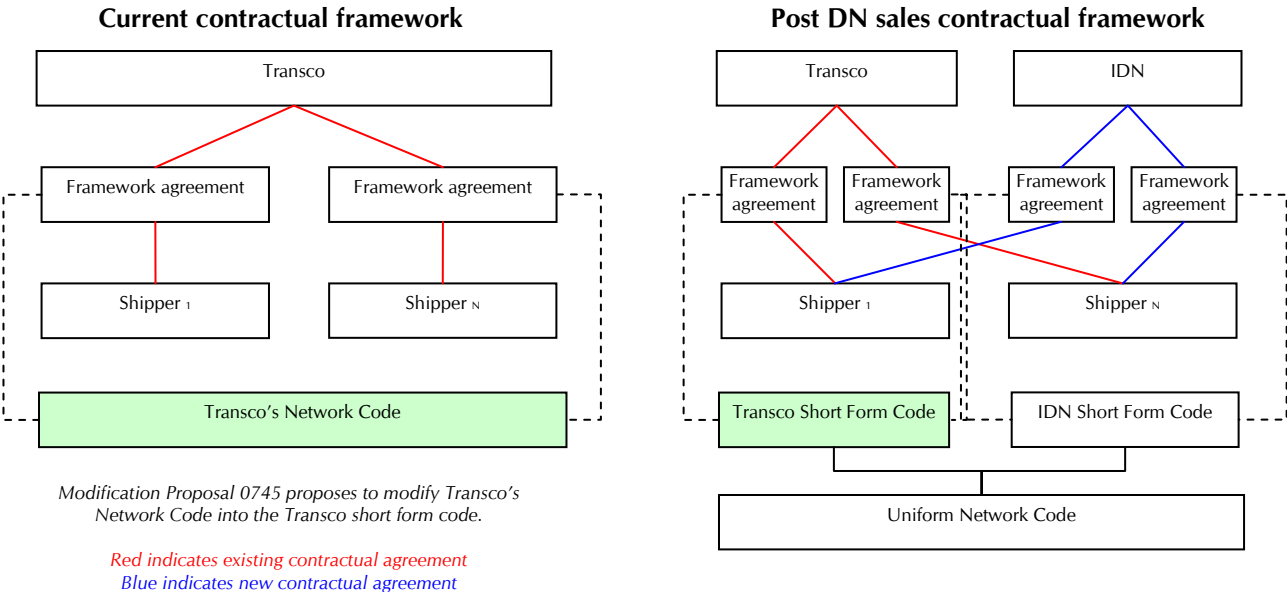
¹² *National Grid Transco – Potential sale of gas distribution network businesses, Formal consultation under section 23 and section 8AA of the Gas Act 1986*, Ofgem, February 2005, 45/05. This consultation relates to the restructuring of Transco's licence in order to protect the interests of customers under a divested industry structure. The s8AA consultation relates to the amendment and transfer of four of Transco licences to new wholly owned subsidiary companies, whilst the s23 consultation relates to the amendment of the remaining two Transco licences, which will

These conditions are described in detail in Ofgem’s formal section 8AA and section 23 document.

3. Proposed contractual framework

Under the contractual framework, which was proposed by Transco and discussed at DISG 14,¹³ Transco and each independent DN (IDN) would have its own ‘short form’ network code setting out the terms of its transportation arrangements, which would incorporate by reference the applicable terms of the UNC document. In addition, Transco and each IDN would prepare jointly a UNC which sets out, to the extent that terms are common between relevant GTs, the transportation arrangements and modification rules. Each ‘short form’ network code would also include the code modification rules to the extent that the modification rules which apply to the GT’s ‘short form’ network code differ from those set out in the UNC. Figure 1 depicts the proposed pre and post sales contractual framework.

Figure 1 Pre and post DN sales contractual framework



continue to be held by Transco NTS and Transco RDN, consistent with the Authority’s decision regarding legal separation.

¹³ NGT paper, DISG 14, UNC Structures and Process

This contractual framework seeks to ensure the continuity of the existing contractual arrangements. The Network Code as a contractual arrangement between shippers and Transco would be maintained throughout the transaction, and Transco's Network Code would continue to exist, albeit modified to a 'short form' network code incorporating, by reference, the UNC. At the point that the new licensed GTs come into being, it is proposed that the 'short form' network codes will contain minimal substantive provisions except to incorporate by reference the UNC. Initially, the UNC will contain all substantive provisions including the modification rules, however, it is possible that this could change over time.

In addition, it is proposed that Transco and the IDNs will establish a Joint Office to administer the network code modification procedures. The Joint Office would increase transparency and visibility by ensuring that all network code modification proposals are administered in a consistent and non-discriminatory manner, regardless of their origin.

4. Development and implementation of the UNC

This section describes the process that Transco has adopted in developing the UNC. It also describes Modification Proposal 0745, which is the modification by which Transco proposes to amend its Network Code into 'short form', which will then incorporate the UNC by reference.

Development of the UNC

Following the development of the proposed high level regulatory, commercial and operational framework to protect the interests of customers in a divested industry structure, in September 2004 Transco commenced a process to develop the transportation arrangements business rules that would be needed under the proposed framework. To start the process, Transco put forward a document containing terms identical to Transco's prevailing Network Code, and overlaid on those terms a number of proposed changes to support a multi-GT environment (hereinafter 'UNC changes'). This document has formed the base reference point for the process to deliver the UNC.

As part of this process, Transco:

- ◆ established a UNC Development Forum which reviewed the business rules that Transco proposed to reflect in the drafting of the UNC;¹⁴
- ◆ established an Exit Reform Development Forum to focus specifically on the business rules required to govern arrangements for the offtake of gas from the NTS to ensure that the interests of customers are protected under a divested industry structure;¹⁵
- ◆ published a consultation document, *Towards a new industry framework*,¹⁶ which invited views from interested parties regarding the business rules to apply to each section of the UNC, as well as more specific views regarding the proposals developed to accommodate the NTS offtake arrangements;
- ◆ published an update note which set out certain issues raised by respondents to Transco's *Towards a new industry framework* consultation (excluding issues raised in relation to the enduring offtake arrangements) and explained how Transco proposed to respond to various issues;¹⁷ and
- ◆ held a series of legal drafting workshops which discussed the changes that Transco proposed to make to create the UNC based on the text of its existing Network Code. Transco's proposed drafting was based on the business rules developed through the previous process.

The associated papers are available on Transco's website.¹⁸ The output of this process is Transco's draft UNC, which is provided with this letter for comment.

Given the large volume of changes involved in developing the UNC, and in particular the need to restructure the UNC to incorporate the Offtake Arrangements Document¹⁹, Transco has sought to structure discussion by categorising each of the UNC changes follows:

¹⁴ The UNC Development Forum action log, prepared by Transco is provided with this document for information.

¹⁵ The high level offtake arrangements are described in Chapter 5 of Ofgem's Final IA. See footnote 6.

¹⁶ *Towards a new industry framework: A consultation by Transco December 2004*

¹⁷ Ofgem notes that Transco's update note did not respond to issues raised in relation to the process by which Transco has carried out its UNC consultation.

¹⁸ See <http://www.transco.co.uk/network%5Fsales/uncp.htm> and <http://www.transco.co.uk/network%5Fsales/erf.htm>.

¹⁹ The Offtake Arrangements Document is a new constituent document of the UNC that sets out the arrangements between transporters at NTS/LDZ offtakes (where LDZ is Local Distribution Zone) and

- ◆ Category 1 – changes to terminology, such as references to industry parties to ensure that obligations were attributed to the correct industry participant (eg transmission or distribution);
- ◆ Category 2 – changes to existing provisions that require modification to allow multiple licensed GTs to be party to the UNC;
- ◆ Category 3 – changes which introduce new provisions required to allow multiple licensed gas transporters to be party to the UNC; and
- ◆ Category 4 – changes which include various housekeeping amendments e.g. correction of typographical errors and cross references etc;
- ◆ Category 5 - changes which involve moving existing provisions to a new location.

Each section of the UNC accompanying this consultation letter contains a table, prepared by Transco, which summarises the Category 1, 2, 3, 4 and 5 changes made in relation to that section (excluding the Transition Document²⁰ and Offtake Arrangements Document, which are new).

As set out in its letter of 8 February 2005²¹, Ofgem has attended the various forums organised by Transco as an observer. Ofgem has not been involved in the detailed drafting of the UNC. Transco is responsible for both the process surrounding the UNC and the content of the UNC as attached to this document and will also be responsible for addressing any issues raised as part of this consultation process.

Ofgem has attended many but not all of the various meetings organised by Transco. It has on occasion, in the interests of regulatory clarity, noted issues where the proposed drafting of the UNC was not likely to protect the interests of customers in the event that the sale proceeds. As stated in its letter dated 8 February 2005, and its various consultation documents, Ofgem has at no stage fettered the discretion of the Authority with respect to any matters it may consider in the future, including without limitation any future network code modification proposals that may be received and/or the proposed licence modifications.

LDZ/LDZ offtakes. Transco explained and sought feedback on the Offtake Arrangements Document and the revised structure of the code at industry meetings at Buckingham Gate 28 February and 2 March 2005.

²⁰ The Transition Document is a UNC constituent document that sets out transitional provisions relating to the arrangements in the Uniform Network Code.

²¹ http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/10120_20040208_20050208MAletterparticipationinUNCworkgroups.pdf

Modification proposal 0745

On 23 February 2005, Transco raised a modification proposal which seeks to amend Transco's existing Network Code to reflect the changes required to support a multi-transporter environment. To achieve this, Modification Proposal 0745 proposes to modify Transco's existing Network Code by removing virtually all of the operative text, and introducing in its place text which has the effect of incorporating the provisions of the UNC by reference (as established by the requirements of proposed Standard Special Condition A11).

On 25 February the Authority granted urgent status to Modification Proposal 0745, for the reasons set out in its letter.²² In accepting this request for urgency, Ofgem has made no assessment of the merits of the modification proposal.

Modification Proposal 0745 will be subject to consultation on a timeframe that is consistent with the timeframe for this consultation process, which is explained below. If this modification is approved, and the necessary licence amendments are also directed and come into effect, then the Transco Network Code will be modified into a one page 'short form' network code that incorporates by reference the UNC.

Role of the Authority

The role of the Authority is to consider whether Modification Proposal 0745 better facilitates the relevant code objectives and, if the Authority decides that the proposal better facilitates the relevant code objectives, to consider Modification Proposal 0745 against its principal objective and statutory and other duties. The Authority will also consider, having regard to respondents' views, whether to direct the licence modifications proposed under the section 23 and section 8AA notices, in particular, for the purposes of this consultation, Standard Special Conditions A11, A12 and A15.

In reaching its decision on these matters, the Authority will, among other things, need to consider whether the UNC, the 'short form' network codes, and the revised industry arrangements generally, will establish commercial arrangements that protect the interests of customers in a multi-transporter environment.

²² http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/10389_745urgencydecision.pdf

Given the substantial consultative process in relation to DN sales, including four RIAs on the key areas of change and the Final IA on whether the Authority should consent to Transco's disposal of four DNs, the Authority does not intend to carry out a further IA as a part of its consideration of Urgent Modification 0745.

5. Views invited

Ofgem welcomes the views of interested parties in relation to Transco's proposed drafting of the UNC, and also in relation to the package of reforms that would bring the UNC into effect including the proposed licence modifications and Modification Proposal 0745.

Finally, Ofgem welcomes views on the related documents released by Transco, including the Agency Services Agreement, the Joint Governance Agreement, and the Incremental Exit Capacity Statement.

In order to allow interested parties an opportunity to comment on these issues in the round, Ofgem proposes to adopt the following two stage consultation process. Interested parties are invited to provide comments in accordance with the following timetable:

- ◆ **Stage 1. Responses due 18 March 2005.** Stage 1 responses should be sent to both Ofgem and Transco. Ofgem will use information received at this stage to further its understanding of the relevant issues that need to be considered in the context of Modification Proposal 0745 and the current section 8AA and section 23 licence consultation. In addition, Transco will have the opportunity to update its draft UNC and related documents in response to feedback received. Transco will reissue the draft UNC, for further consultation, with a table of changes and an explanation of the reasons for change on 29 March 2005.
- ◆ **Stage 2. Responses due 12 April 2005.** Stage 2 responses should have regard to the draft UNC to be reissued by Transco on 29 March 2005 and need only be sent to Ofgem. Responses provided in relation to Stage 2 of the consultation will inform, among other things, the Authority's decision in relation to Modification Proposal 0745 and the current section 8AA and section 23 licence consultation.

This approach is intended to give all interested parties the opportunity to review and provide comments on the draft UNC (as put forward by Transco). The two-stage consultation process provides an additional opportunity for Transco to reflect any concerns raised.

Responses should be addressed to:

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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.

If you wish to discuss any aspect of this paper, Jessica Hunt (telephone 020 7901 7431) or Hannah Cook (telephone 020 7901 7444) would be pleased to help.

Yours sincerely,

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