

**National Grid Transco – Potential sale of gas
distribution network businesses**

**Final Proposals for Interim Incentives and
Formal consultation under section 23 of the
Gas Act 1986**

April 2005 129/05

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1. Introduction

Purpose of this document

- 1.1. On 25 April 2005, the Authority issued a letter stating that it had concluded that the conditions precedent, which were attached to the Authority's consent (granted under Amended Standard Conditions 29 (ASC29) of Transco's original gas transporters (GT) licence) to Transco to allow it to hive-down four of its eight distribution networks (DNs) into four wholly owned subsidiary companies, had been sufficiently satisfied to allow hive-down to occur on 1 May 2005 (or such later date as the Authority may direct)¹.
- 1.2. On 25 April 2005, the Authority also issued a decision letter approving Urgent Modification Proposal 0745 (stating that Transco's existing network code could become the NTS and RDN businesses' short form code on 1 May 2005 or such later date as the Authority may direct). The Authority also directed that a number of modifications be made to Transco's six GT licences which will take effect from the date of hive-down by way of a separate implementation direction². It is proposed that the sequencing of each of these decisions will be addressed in such separate implementation directions.
- 1.3. The ASC 29 decision letter published on 25 April 2005, stated that prior to permitting hive-down to occur, Ofgem will write to Transco to seek Transco's final confirmation that all of the conditions precedent to hive-down have been satisfied in full. Transco's response to this letter will then be assessed by the Authority. Depending on Transco's response, and without fettering its discretion, the Authority would expect to issue the implementation direction on Friday 29 April 2005 effective on 1 May 2005. Following the coming into effect of that direction, hive down and transfer of the relevant GT licences will be permitted to occur.
- 1.4. Before Transco can complete the DN sales process, further regulatory consents will also be required. In this regard and without fettering the discretion of the

¹ "Ofgem approves next stage of NGT's sale of four of its gas distribution networks", Ofgem, 25 April 2005

² This is described in the section 8AA Consent to Transfer and Direction and section 23 Direction published on 25 April 2005.

Authority in future decisions, the Authority will also need to consider whether it is willing to consent to the sale of shares in Transco's four wholly owned subsidiary companies to the three third party purchasers. Any such approval will be subject to the fulfilment of the conditions subsequent, attached to the Authority's consent granted in January 2005, which will be considered by the Authority following hive-down. Without limitation, one of these conditions subsequent relates to further necessary licence modifications to the six GT licences currently held by Transco.

- 1.5. Further to the Authority consent and the decisions made at the Authority meeting on 25 April 2005, the Authority considered that further modifications to each of the six GT licences would be required in order to seek to ensure that customers' interests are protected in a divested industry structure.
- 1.6. This document sets out, for formal consultation (including the relevant Section 23 Notice), further modifications to these six GT licences held by Transco and includes:
 - ◆ Ofgem's final proposals for the interim incentives scheme that will be in place in respect of the NTS and DNs for the period to 30 September 2008; and
 - ◆ further licence changes to address respondents' views and issues identified following Ofgem's licence consultation published on 14 February 2005³.
- 1.7. Ofgem considers that the changes proposed within this document are necessary to support a divested industry structure and ensure that customers' interests continue to be protected following any DN sale. Subject to respondents' views, these changes, which include modifications to existing licence conditions as well as the introduction of a new licence condition, are proposed to take effect on or before the sale of shares in the four Transco wholly owned DN subsidiary companies to third party purchasers.

³ *National Grid Transco – Potential Sale of gas distribution network businesses, Formal consultation under section 23 and section 8AA of the Gas Act 1986, February 2005, 45/05.*

- 1.8. The statutory notice is set out in Appendix 6 to this document and the associated legal drafting is set out in Appendix 7. The appendices to this document contain the full text of the legal drafting proposed in respect of each of the six relevant GT licences. The statutory notice and the legal drafting contained in the appendices to this document set out the text and effect of the licence modifications proposed by the Authority to the six GT licences currently held by Transco.
- 1.9. It should be noted that on the date on which the licence modifications proposed in this document are envisaged to come into effect, it is envisaged that Transco will hold only two of the six GT licences it holds as at the date of this document. These two licences will be the original Transco GT licence which will relate to the National Transmission System (NTS) only and one of the five additional GT licences (which were granted to Transco in November 2004). This latter licence will relate to the four DNs which will be retained by Transco, the RDN licence. The four additional GT licences relating to the four DNs which are proposed to be hived-down to the four relevant wholly owned Transco subsidiary companies will have been transferred to these four subsidiary companies and are referred to as the IDN licences.
- 1.10. As the proposed DN sales transaction is not a regulatory initiative but a commercial transaction by NGT, Ofgem intends only to modify the six GT licences detailed above and not any other GT licences. However, in identifying the proposed modifications, Ofgem has given careful consideration to the potential impact on other GTs and, in particular, has satisfied itself that no undue discrimination would be created through the proposals set out in this document. However, if any respondent considers that any proposals set out in this document would adversely impact them, Ofgem would welcome representations on this matter.
- 1.11. In issuing this document, it is important to make clear that there can be no expectation on the part of NGT, Transco, shippers, suppliers, potential DN purchasers 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 subsequent attached to the consents granted by the Authority on 20 January 2005) in relation to DN

sales. The information in this document is not binding on the Authority. Nothing in this document 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 document.

Background

- 1.12. In May 2003, National Grid Transco plc (NGT) announced that it would consider the sale of one or more of its DNs if such a transaction was to maximise shareholder value. Any such sale would represent a fundamental change to the structure of the gas industry and would require the consent of the Authority under ASC 29 of Transco's original GT licence as well as consent from the Secretary of State for Trade and Industry. In addition, safety cases under the Gas Safety (Management) Regulations 1996 (GS(M)R) would need to be accepted by the Health and Safety Executive (HSE).
- 1.13. Following NGT's announcement, Ofgem undertook a significant programme of work and consultation to investigate the potential costs and benefits that such a transaction could deliver for customers. This process has included the establishment of a number of industry workgroups, including the Development and Implementation Steering Group (DISG)⁴, which are (and have been) open to all interested parties to attend. In addition, Ofgem has consulted on a series of Regulatory Impact Assessments (RIAs) which considered key aspects of the regulatory, commercial and operational framework required to protect the interests of customers in the event that the proposed DN sales were to proceed.
- 1.14. The completion of these RIAs and associated conclusions documents⁵ culminated in the publication of a Final Impact Assessment (Final IA) in November 2004⁶. As part of this Final IA, Ofgem undertook an examination of the potential costs and benefits associated with the proposed overall industry framework that would protect the interests of customers in a divested industry structure, and derived an estimate of the potential net costs and benefits that

⁴ Ofgem's DISG meetings were held on a without prejudice basis. At these meetings it was made clear that any discussions occurring at DISG could not fetter the discretion of the Authority in respect of any issue associated with DN Sales. The minutes of the meetings can be found at Ofgem's website, www.ofgem.gov.uk

⁵ Such documents are available on Ofgem's website www.ofgem.gov.uk

⁶ http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/9342_25504a.pdf

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 NGT were to sell four of its DN businesses.

- 1.15. On 11 January 2005, Transco submitted four applications to the Authority under ASC 29 of its original GT licence. The applications requested the Authority's consent to the proposed disposal of four of Transco's eight DNs to four separate wholly owned subsidiary companies, the shares in which would subsequently be sold to third party purchasers. These applications for consent were considered at a duly convened meeting of the Authority on 20 January 2005. On 11 January 2005, Transco also requested the transfer of the four relevant GT licences to the four wholly owned subsidiaries.
- 1.16. At the meeting held on the 20 January 2005, the Authority provided its conditional consent to Transco under ASC 29 of Transco's original GT licence in the terms described in Transco's four applications for consent. The consents (along with documentation setting out the background and reasoning behind the Authority's decision) were published on Ofgem's website on 1 February 2005.
- 1.17. At the January meeting the Authority also endorsed its previous decisions on the proposed regulatory, commercial and operational arrangements necessary to protect the interests of customers in a divested industry structure. This includes the Authority's endorsement of the continued development of the enduring offtake arrangements for the allocation of NTS exit capacity and NTS offtake flexibility through the DN sales process. The Authority has concluded that all of the proposed enduring offtake arrangements are reasonable and proportionate and will protect the interests of customers.

NTS and DN incentives for interim offtake arrangements consultation

1.18. In the Final IA⁷, Ofgem set out the arrangements that would apply for the NTS/DN interface until 2008. On 8 March 2005, Ofgem issued its initial proposals consultation for the interim offtake arrangements incentive scheme⁸.

Licence consultation

1.19. In September 2004⁹, Ofgem issued its initial analysis of the modifications to the six relevant GT licences (the September document), in terms of both content and structure, that would be required to ensure that the regulatory framework protects the interests of customers within a divested industry structure.

1.20. This was followed, by a “next steps” document¹⁰ in November 2004 (the November document), which set out respondents’ views on Ofgem’s September document and Ofgem’s revised proposals in light of these views. This document also set out the next steps and invited views on both:

- ◆ a formal section 23 Notice regarding the separation of the price control provisions between each of Transco’s six GT licences¹¹; and
- ◆ an informal consultation on further licence modifications (both in terms of content and structure) which would be proposed at the section 8AA stage (along with an associated section 23 Notice at that time) should the Authority grant its conditional consent to DN sales at its meeting in January 2005.

1.21. On 1 February 2005, (pursuant to the formal section 23 Notice contained in the next steps document) the Authority issued a direction to modify the price control

⁷ *National Grid Transco – Potential sale of gas distribution network businesses – Final Impact Assessment*, Ofgem, November 2004 255/04a Page 77.

⁸ *National Grid Transco – Potential sale of gas distribution network businesses, Initial proposals on interim incentive schemes supporting the offtake arrangements*, March 2005 79/05

⁹ *National Grid Transco – Potential Sale of gas distribution network businesses, Initial thoughts on restructuring Transco plc’s Gas Transporter Licences, Consultation document*, Ofgem September 2004 215/04.

¹⁰ *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, Consultation Document*, Ofgem, November 2004 263/04.

¹¹ Pursuant to section 7 of the Gas Act, on 5 November 2004, the Authority (without in any way fettering its discretion in relation to DN sales) granted five additional GT licences to Transco. As a result of this, as at the date of this document, Transco holds in total six GT licences. The five additional licences were granted in substantially the same form as the original Transco GT licence.

conditions in each of Transco's six GT licences¹². Following consideration of respondents views expressed in relation to the November document, Ofgem, on 14 February 2005, issued a consultation document (the February document), which included:

- ◆ a formal section 8AA consultation on the transfer and modification of the four Transco licences that related to the four IDNs to four wholly owned Transco subsidiary companies; and
- ◆ a formal section 23 consultation on the modification of the two licences which will continue to be held by Transco after DN sales i.e. the NTS licence and the RDN licence.

1.22. Following consideration of respondents' views, the Authority directed the proposed changes¹³ under the section 8AA and section 23 consultations be made on 25 April 2005 to take effect by way of separate implementation directions on 1 May 2005 or such later date as the Authority may direct¹⁴.

Respondents' views

Incentives consultation

1.23. Ofgem received eight responses to the March 2005 Initial Proposals consultation document on interim incentive schemes supporting the interim offtake arrangements. These included two responses from Transco (one from Transco NTS and one from Transco's RDNs), all three potential purchasers, two shippers/suppliers and the Association of Electricity Producers. None of the responses were confidential and all can be found on the Ofgem website (www.ofgem.gov.uk).

¹² As a result, there is revenue separation between the NTS and each of the four DNs which are proposed to be disposed of by Transco (IDNs) and each of the four DNs proposed to be retained by Transco (RDNs). Accordingly, four of the additional licences respectively relate only to each of the four IDNs to be disposed of by Transco, one of the additional licences relates only to the four RDNs to be retained by Transco and the original Transco licence relates only to the NTS.

¹³ The changes were directed as set out in the Notices with only a few minor modifications, for example to reflect correction of typographical errors.

¹⁴ Licence transfer will also take place as part of the hive-down process on 1 May 2005 or such later date as the Authority may direct.

- 1.24. Ofgem also made two presentations to the DISG, through which Ofgem received further views on proposals for interim incentives and provided additional background and detail of the analysis undertaken to support the proposals. These presentations were made on 22 March 2005 and 5 April 2005.

Licence consultation

- 1.25. In total, Ofgem received seventeen responses to the February 2005 consultation document. These respondents included Transco (the licensee), all three potential purchasers, shippers/suppliers, the Association of Electricity Producers and the HSE. None of these responses were confidential and as such all responses (with the exception of one)¹⁵ can be found on the Ofgem website (www.ofgem.gov.uk).
- 1.26. In addition, Ofgem received further views from the industry and other interested parties as part of the numerous DISG meetings and via consultation responses to related Ofgem consultations. A summary of responses to the February document and Ofgem's views on the responses was published on 25 April 2005 along with the section 8AA direction and accompanying section 23 direction.

Structure of this document

- 1.27. This document is structured as follows:
- ◆ Chapter 2 provides the background to this consultation;
 - ◆ Part A (Chapter 3) of this document details Ofgem's Final Proposals with respect to the interim incentives;
 - ◆ Part B (Chapter 4) of this document details Ofgem's proposed licence drafting changes as part of this formal section 23 process, including changes necessary to implement Ofgem's Final Proposals for interim incentives as well as further changes, as appropriate, to clarify the drafting directed on 25 April 2005; and
 - ◆ Chapter 5 of this document then details the way forward.

¹⁵ One respondent stated that their response was not confidential, but asked that it should not be posted on Ofgem's website.

1.28. In addition, there are seven appendices (which have been published separately in conjunction with this consultation document). These are:

- ◆ Appendix 1 – DN Sales timeline;
- ◆ Appendix 2 – Minutes of DISG meetings (DISG 38, DISG 39 and DISG 40);
- ◆ Appendix 3 – List of respondents to the incentives consultation and the February consultation document;
- ◆ Appendix 4 – Base allocations of (flat) capacity and (flexibility) capacity for the interim period;
- ◆ Appendix 5 – List of licence conditions proposed for modification;
- ◆ Appendix 6 – Section 23 Notice of Ofgem’s proposal to modify the six GT licences as described in this document; and
- ◆ Appendix 7 – the licence modifications proposed as part of this Section 23 Notice.

Views invited

1.29. Ofgem invites views on all of the issues raised by Tuesday 24 May 2005.

1.30. Responses should be addressed to:

Sonia Brown
Director, Transportation
Office of Gas and Electricity Markets
9 Millbank
London SW1P 3GE

1.31. Electronic responses may be sent to Helen.connolly@ofgem.gov.uk.

1.32. Respondents are requested, as far as possible, to provide non-confidential responses. Ofgem would also prefer non-confidential responses to be sent electronically so that they can be placed on the Ofgem website. Respondents are free to mark their reply as confidential if they wish. If you wish to discuss

any aspect of this paper, please do not hesitate to contact Helen Connolly (telephone 020 7901 7267) who would be pleased to help.

Way forward

- 1.33. This document represents the next step in the process towards developing a proposed licence structure which would be necessary to ensure that the interests of customers are protected in a divested industry structure after any DN sale.
- 1.34. Subject to consideration of respondents' views, Ofgem intends to introduce the proposed modifications set out in this document to the NTS, RDN and IDN GT licences on 27 May 2005 such that they take effect on 1 June 2005 but reserves its discretion to revise these dates. Before making this direction, the Authority will need to be satisfied as to the relevant conditions subsequent attached to the Authority's consent granted on 20 January 2005 in relation to DN sales.
- 1.35. A more detailed discussion of the way forward is set out in Chapter 5.

2. Background

- 2.1. This chapter sets out some of the key aspects of the regulatory framework including some of the key duties and obligations on the Authority and GTs that need to be considered when developing a regulatory framework to protect the interests of customers within a divested industry structure in the event that DN sales proceed. The description of the regulatory framework includes an outline of the current licence framework including relevant sections of the Gas Act 1986 (the Gas Act).
- 2.2. This chapter also explains the process that has been followed to date in relation to the development of interim incentives and the NTS and DN GT licences.
- 2.3. This chapter therefore outlines:
 - ◆ the regulatory background;
 - ◆ the Authority decision in January 2005;
 - ◆ the process followed to date – interim incentive scheme arrangements; and
 - ◆ the process followed to date – GT licences.

Regulatory background

- 2.4. This section sets out some of the key elements of the regulatory framework that are relevant in the context of the proposed DN sales as follows:
 - ◆ the Gas Act; and
 - ◆ the NTS and DN-GT licences.

The Gas Act

- 2.5. The Gas Act provides for the regulation of the onshore gas regime in Great Britain and for the separate licensing of GTs, gas shippers and gas suppliers. This section sets out some of the key relevant areas of the Gas Act for consideration.

Duties of the Authority

- 2.6. Section 4AA of the Gas Act provides that the principal objective of the Authority, in carrying out its functions under the Gas Act, is to protect the interests of consumers in relation to gas conveyed through pipes, wherever appropriate, by promoting effective competition between those engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas. Consumers for these purposes include both existing and future consumers.
- 2.7. In carrying out its functions under the Gas Act in a manner which is best calculated to further the principal objective, the Authority is required to have regard to the following:
- ◆ the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met; and
 - ◆ the need to secure that licence holders are able to finance the carrying on of the activities which they are authorised or required to perform.
- 2.8. In performing its duties, the Authority must have regard to the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes or residing in rural areas as well as customers generally.
- 2.9. The Authority may, in carrying out any of its functions, have regard to the interests of consumers in relation to electricity, telecommunications, and water and sewerage services, which are affected by the carrying out of those functions.
- 2.10. The Authority must carry out its functions in the manner it considers is best calculated to:
- ◆ promote efficiency and economy on the part of authorised persons and the efficient use of gas conveyed through pipes;
 - ◆ protect the public from dangers arising from the conveyance of gas through pipes or the use of such gas;
 - ◆ contribute to the achievement of sustainable development; and
 - ◆ secure a diverse and viable long term energy supply.

- 2.11. The Authority must also have regard to the effect on the environment of activities connected with the conveyance of gas through pipes.
- 2.12. In carrying out its functions in accordance with the above objectives and duties, the Authority must have regard to:
- ◆ the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed; and
 - ◆ any other principles appearing to the Authority to represent the best regulatory practice.
- 2.13. In addition, the Authority must, in carrying out its functions, have regard to any guidance issued by the Secretary of State about the making by the Authority of a contribution towards the attainment of any social or environmental policies set out or referred to in such guidance.
- 2.14. In carrying out its functions, the Authority should also have regard to European Union policy development and act in a manner consistent with European legislation.

Duties of Gas Transporters

- 2.15. In addition to meeting the Authority's statutory duties, the licence framework following DN sales must permit the NTS and DNs to fulfil their own statutory obligations under the Gas Act as GTs. These include the duty of each GT to:
- ◆ develop and maintain an efficient and economical pipe-line system (section 9(1)(a) of the Gas Act);
 - ◆ facilitate competition in the supply of gas (section 9(1A) of the Gas Act); and
 - ◆ avoid any undue preference or undue discrimination in the terms on which it undertakes to convey gas (section 9(2)(b) of the Gas Act).

The licensing framework

- 2.16. Sections 5 to 8A of the Gas Act provide for the licensing of activities relating to gas. These include the licensing of GTs, gas shippers and gas suppliers. Unlike the Electricity Act 1989, the Gas Act does not provide for the separate licensing of transmission and distribution activities. Section 7 of the Gas Act sets out the provisions relating to the licensing of GTs while Section 8 provides for standard conditions of licences.
- 2.17. Section 23 of the Gas Act sets out the provisions relating to the modification of licence conditions for which there are a number of different procedures. These are set out below:
- ◆ **Collective licence modification (CLM).** The CLM procedure deals with the modification of standard conditions under section 23(1)(b) and section 23(7) of the Gas Act. The Authority may bring forward proposals for licence modification and the CLM arrangements enable relevant licence holders who are not content with a proposed modification to a standard condition to register their formal objection. Numerical tests determine the level of objections to a proposal which is measured against a blocking minority threshold prescribed by the Secretary of State. In the absence of the blocking threshold being met, the Authority may direct that a proposed modification be made; and/or
 - ◆ **Individual consent.** The individual consent process as set out in sections 23(1)(a) and 23(6) of the Gas Act requires the Authority to gain the consent of each relevant licensee prior to modification of the licence under this process. This process can be used either in relation to amending standard conditions for individual licensees or amendments to special conditions for individual licensees. Where a standard condition has been modified by individual consent, it ceases to be subject to the CLM procedure to the extent that it has been modified.
- 2.18. In the absence of obtaining consent either through the CLM procedure or the individual consent of the relevant licensee, the Authority may refer the matter to the Competition Commission for resolution. The Gas Act provides the mechanism by which licences can be modified in the circumstances of such a reference.

2.19. Under section 8AA of the Gas Act, a licence is capable of being transferred by the licence holder, with the consent of the Authority, in accordance with the section and any terms of the licence relating to its transfer. This may include conditions which must be complied with before the licence can be transferred. Consent may be given subject to compliance with such modification or other conditions as the Authority considers necessary.

Authority decision with respect to disposal

2.20. On 20 January 2005, the Authority granted its conditional consent to the four applications from Transco, under Amended Standard Condition 29 of its original GT licence, to dispose of four of its DNs to four wholly owned subsidiary companies, the shares in which would subsequently be sold to third party purchasers.

2.21. In making its decision, the Authority gave careful consideration, amongst other things (and without limitation), to:

- ◆ the Final Impact Assessment (IA) on potential DN sales which was published for consultation in November 2004;
- ◆ the responses to the Final IA; and
- ◆ direct representations which it had received (in response to consultations undertaken by Ofgem).

2.22. In granting its conditional consent, the Authority concluded that the base case analysis presented in the Final IA of the potential net benefits to customers of approximately £225 million associated with the proposed DN sales transaction was reasonable and robust. The Authority was satisfied that the interests of customers in terms of competition and security of supply could be protected in the event of a sale.

2.23. The Authority also endorsed its previous decisions on the proposed regulatory, commercial and operational arrangements necessary to protect the interests of customers in a divested industry structure, including the continued development of the enduring offtake arrangements for the allocation of NTS exit capacity and NTS exit flexibility. The Authority also agreed that the proposed enduring

offtake arrangements are reasonable, proportionate and protect the interests of customers.

- 2.24. In view of the concerns expressed by respondents to the Final IA regarding the timetable for the introduction of the proposed enduring offtake arrangements, the Authority agreed that the implementation of the enduring NTS exit capacity and NTS exit flexibility arrangements did not need to occur prior to the completion of the DN sales transaction. However, whilst the Authority considered that a short delay in the implementation of the enduring offtake arrangements was appropriate, it considered that their introduction should not be delayed beyond September 2005. In particular, the Authority stated that any such delay in implementation of the enduring arrangements would be against the interests of customers and would increase the potential for customers to incur costs as a result of inefficient investment or system operation decisions in a divested industry structure.
- 2.25. In order to achieve implementation of the enduring offtake arrangements by September 2005, the Authority has imposed certain conditions to the consent granted to Transco and has directed the implementation from the date of hive-down a licence condition on Transco and the DNs to secure the implementation of these arrangements on a best endeavours basis.

Enduring offtake arrangements – conditions to consent

- 2.26. The first of the conditions to consent relating to the enduring offtake arrangements is that Transco must procure an undertaking addressed to the Authority from NGT specifying that NGT will, prior to the proposed section 8AA (and related section 23) licence modifications to the six Transco GT licences becoming effective, use its best endeavours to ensure that steps are taken to implement the enduring offtake arrangements by 1 September 2005.¹⁶
- 2.27. The second of these conditions is that Transco must secure undertakings addressed to the Authority from each proposed third party purchaser specifying that, prior to the completion of the sale of shares to the new purchaser, such purchaser will use its best endeavours to ensure that steps are taken to implement the enduring offtake arrangements by 1 September 2005.

Enduring offtake arrangements - proposed licence conditions

- 2.28. In order to cover the period following hive-down and the subsequent sale of shares in the DNs to the new purchasers, the Authority has directed the implementation from the date of hivedown of licence conditions on Transco and each DN regarding the implementation of the enduring offtake arrangements
- 2.29. These licence conditions are to be binding upon Transco and each of the DNs and will require them to use their best endeavours to implement the enduring offtake arrangements by 1 September 2005.
- 2.30. The Authority has also directed a licence conditions binding Transco to procure from NGT an undertaking to the Authority that it will use its best endeavours to ensure that Transco implements the enduring offtake arrangements by 1 September 2005. This obligation will take effect from the date of hivedown.
- 2.31. Further, the Authority has directed, as part of the licence conditions binding upon each independent DN, an obligation requiring it to procure an undertaking addressed to the Authority from its ultimate controller that it will use its best endeavours to ensure that the relevant independent DN implements the enduring offtake arrangements by 1 September 2005. This obligation will be implemented from the date of hive-down.
- 2.32. The proposed licence modifications were consulted upon as part of the Section 8AA and associated Section 23 licence modification proposals to Transco's six GT licences and directed on 25 April 2005.¹⁷

Separate interim incentives schemes – application of conditions to consent

- 2.33. As part of the conditions to consent, the Authority imposed a series of conditions (conditions subsequent), which provide that Transco cannot sell the shares in its four wholly owned subsidiary companies without the Authority's prior consent. In addition, the conditions provide that Transco shall consent to any licence modifications and implement any other regulatory, commercial or operational changes following hive-down that the Authority considers are necessary in order

¹⁶ The enduring offtake arrangements are described in chapter 5 of Ofgem's Final IA.

¹⁷ *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*

to ensure that the proposed sales transactions are implemented in a manner that ensures that the interests of customers are protected.

- 2.34. These conditions were considered necessary given Ofgem's intention, at that time, to issue this section 23 Notice to modify the NTS and DN licences to, amongst other things, incorporate interim incentive schemes following the scheduled hive-down date. Further, it was considered necessary for the Authority to retain control over the share sale given that other issues may arise through the detailed development of the regulatory, commercial and operational arrangements that have not yet been anticipated and addressed. As such, the Authority has the discretion under paragraph 23(c) of the February decision document to require subsequent licence modifications or the implementation of such other regulatory, commercial or operational arrangements before the conditions subsequent, attached to its consent to disposal, are cleared to have been satisfied and, thereby, allowing sale of the shares in the four wholly owned Transco subsidiary companies to third party purchasers.

Process to date: Interim incentive scheme arrangements

- 2.35. This section provides an overview of the key elements of this process relevant to the development of the interim incentives, including:
- ◆ publication of Regulatory Impact Assessments (RIAs);
 - ◆ role of workgroups; and
 - ◆ recent developments.

Regulatory Impact Assessments (RIAs)

- 2.36. Between April and June 2004, through a series of RIAs, Ofgem consulted on the regulatory, commercial and operational arrangements necessary to protect customers within a divested industry structure. These included:
- ◆ Agency and Governance Arrangements RIA, published in April 2004;

- ◆ Allocation of Roles and Responsibilities between Transmission and Distribution Networks RIA, published in April 2004;
- ◆ Offtake Arrangements RIA, published in June 2004; and
- ◆ Interruption Arrangements RIA, published in June 2004.

2.37. Of these RIAs, the Offtake Arrangements RIA published in June 2004 had particular relevance to NTS and DN incentives, making reference to the need for incentive arrangements in the context of a divested industry structure. Specifically, this document noted that in a model in which DNs have responsibility for requesting NTS offtake rights, appropriate incentives would be required on the DNs to discourage them from the “potential natural tendency to over-request” NTS exit capacity. It also stated that the incentive scheme should encourage the optimisation of any potential for the DNs to trade-off NTS offtake rights with DN investment¹⁸.

2.38. Following consideration of the responses from industry participants, and other interested parties, decision documents detailing the Authority’s conclusions with respect to these issues were published. The conclusions regarding the “Agency and Governance” and “Roles and Responsibilities” RIAs were issued in May 2004¹⁹, and those relating to the Interruption and Offtake arrangements in August 2004²⁰.

2.39. Ofgem has also published a number of (non-binding) open letters and preliminary position papers relating to various aspects of the proposed regulatory arrangements²¹. In September 2004, Ofgem published a position paper outlining an initial view that any incentive scheme that will apply to the DNs will, at the commencement of the scheme, have a duration of one year. In that document, it was noted that this would provide Ofgem, the new DN owners and interested

¹⁸ *National Grid Transco – Potential sale of gas distribution network business, Offtake Arrangements*, Ofgem, June 2004, page 52.

¹⁹ *National Grid Transco – Potential sale of gas distribution network business, Allocation of roles and responsibilities between transmission and distribution networks*, Ofgem, May 2004, 119/04 and *National Grid Transco – Potential sale of gas distribution network business, Agency and governance arrangements*, Ofgem, May 2004 120/04.

²⁰ *National Grid Transco – Potential sale of gas distribution network business, Offtake arrangements, Conclusions document on framework*, Ofgem, August 2004, 199/04 and *National Grid Transco – Potential sale of gas distribution network business, Interruptions arrangements, Conclusions document on framework*, Ofgem, August 2004 198/04.

²¹ Copies of all open letters published by Ofgem relating to the DN sales process can be found in the gas

parties with the opportunity to reconsider the target levels of costs of the schemes at a relatively early stage and in light of further information arising from the first year of operation of the scheme.

2.40. In November 2004, Ofgem also published a Final IA²², which set out:

- ◆ a proposed alternative regulatory, commercial and operational framework to the status quo, which would be necessary to protect the interest of consumers were the sale of DNs to proceed. This framework built upon each of the decisions set out in previous RIAs; and
- ◆ Ofgem's analysis of the estimated potential costs and benefits that customers are likely to accrue in the event that the proposed sale of the DNs proceeds.

2.41. The document also reiterated that appropriate incentive schemes would be required to support the offtake arrangements. Ofgem invited views from interested parties on all aspects of the Final IA. Summaries and full copies of responses to the Final IA were provided to the Authority in order to inform their decision on DN sales.

Recent developments

2.42. The Authority's January decision determined that, in the event that DN sales were to proceed, incentive schemes would be developed to support both:

- ◆ interim offtake arrangements, from the date at which the licence modifications, proposed in Part B (chapter 4) of this document, are proposed to take effect (currently envisaged to be 1 June 2005) through to the end of the period for which the interim offtake arrangements apply (currently envisaged to be 30 September 2008); and
- ◆ enduring offtake arrangements (from 1 October 2008 onwards).

2.43. In February 2005, Ofgem published a consultation document, outlining initial thoughts on the scope, form and duration of the incentive schemes necessary to

distribution networks sale area of work on Ofgem's website (<http://www.ofgem.gov.uk>).

²² *National Grid Transco, Potential sale of gas distribution network businesses, Final Impact Assessment.*

support the enduring offtake arrangements. This document outlined Ofgem's initial views on a range of issues, including the proposed form, scope and duration of the NTS and DN enduring incentive schemes, the appropriate methodology to be used in defining baselines for both NTS exit capacity and NTS exit flow flexibility and indicative baseline numbers.

2.44. Subsequently (in March 2005)²³ Ofgem issued a document setting out its initial proposals on the scope, form and duration of the incentive schemes necessary to support the interim offtake arrangements (i.e. those arrangements that will apply until the enduring offtake arrangements become effective, currently planned to be on 1 October 2008). This document described, amongst other issues:

- ◆ the proposed form, scope and duration of the NTS and DN interim incentive schemes;
- ◆ proposals for the parameters for each element of the proposed incentive schemes; and
- ◆ indicative targets for each of the incentive schemes.

Process to date: licences

Grant of licence consultation

2.45. In the context of its proposed DN sales, in July 2004, Transco applied to Ofgem for eight new additional GT licences relating to the restricted geographical area associated with each of its DNs. The applications were submitted prior to the announcement by Ofgem that NGT would not have to legally separate each of the RDNs and, as such, eight new additional licences were requested in order to accommodate this possibility (i.e. a new licence in respect of each of its eight DNs).

2.46. Following Transco's application, Ofgem issued a notice under the Gas Act in July 2004 in relation to the potential grant of new additional GT licences to Transco in connection with the proposed DN sales and invited views from

Ofgem, November 2004, 255/04a.

²³ 79/05 - National Grid Transco – Potential Sale of Gas Distribution Network Businesses: Initial proposals on interim incentive schemes supporting the offtake arrangements, Ofgem, March 2005

interested parties regarding this proposal.²⁴ This consultation was open for a period of two months.

September informal licence consultation document

- 2.47. In September 2004, Ofgem issued an informal consultation document regarding the proposed restructuring of Transco's original GT licence and the proposed new additional GT licences.²⁵ This document stated that, subject to the consideration of respondents' views, Ofgem envisaged that at least five new additional GT licences would be granted to Transco to accommodate four potential independent gas Distribution Networks (IDNs) and a single licence in respect of Transco's RDNs.
- 2.48. This document invited views from interested parties in relation to the possible modifications to Transco's original GT licence and the five new additional GT licences (if granted) in the context of the proposed sale of one or more DNs by Transco. Ofgem considered that modifications, in relation to both the content and structure of these licences, would be required in the context of a potential DN sale to ensure that the scope of the regulatory framework was sufficient to support a divested industry structure so that customers' interests were protected.
- 2.49. In the September licence consultation, Ofgem detailed that it would review the need to modify Transco's original GT licence and the five new additional GT licences as part of the DN sales process through:
- ◆ a section 23 Notice in November 2004;
 - ◆ a section 8AA consent Notice to the proposed transfer of four of Transco's new GT licences to four wholly owned subsidiary companies in February 2005 (and an associated additional section 23 Notice in relation to GT licences (in respect of the four RDNs and the NTS) which will be retained by Transco);

²⁴ Notice issued under sections 7(5) and 8(4) of the Gas Act 1986, Ofgem, July 2004.

²⁵ National Grid Transco – Potential sale of gas distribution network business, *Initial Thoughts on restructuring of Transco plc's Gas Transporter Licences, Consultation document*, Ofgem, September 2004, 215/04.

- ◆ the conditions attached to the Authority's consent to dispose of the four relevant DNs under Amended Standard Condition 29 of Transco's original GT licence (Disposal of Assets); and
- ◆ a further section 23 consultation (if required), prior to completion of the proposed sale of shares in the four relevant wholly owned subsidiary companies to third party purchasers, to reflect the development of arrangements to support a post-DN sales environment.

2.50. In the September document, Ofgem conducted an initial analysis of each of the standard conditions, amended standard conditions and special conditions in Transco's original GT licence, to assess the extent of amendments that would be required to incorporate the implementation of regulatory arrangements necessary to protect the interests of customers within a divested industry structure. In this regard, Ofgem undertook an evaluation of the licence conditions in Transco's original GT licence that, in a divested industry structure, would be appropriate to transmission activities (which would apply to the NTS only), distribution activities (which would apply to the RDNs and the IDNs only) and both transmission and distribution activities (which would apply to the NTS, RDNs and IDNs).

2.51. Ofgem also considered whether new licence conditions would need to be introduced into Transco's original GT licence and the five new additional GT licences to reflect a divested network structure. In addition, Ofgem consulted upon the possible provisions that could be implemented to accommodate metering and LNG Storage arrangements going forward.

2.52. This preliminary analysis concluded that a significant number of modifications (in relation to content and structure) would be required to Transco's original GT licence and the five new additional GT licences to address the regulatory issues associated with a potential DN sale. This was a direct consequence of the integrated nature of Transco's business which was reflected in its original GT licence.²⁶

²⁶ Transco's original GT licence covers a number of different activities including: transmission; distribution; LNG storage; and metering.

- 2.53. It is noted that following the release of the September document there were numerous consultative discussions of licence related issues at DISG meetings.

Grant of licence decision

- 2.54. Following consideration of responses received in relation to the Notice issued with respect to grant of licences, on 5 November 2004 the Authority (without in any way fettering its discretion in relation to the proposed transaction) granted five new additional GT licences to Transco.²⁷ The five new additional GT licences were approved on the basis that they could be revoked in the event that the proposed disposal of DN assets from Transco to its four wholly owned subsidiary companies does not proceed. The grant of five GT licences reflected the Authority's decision not to insist on legal separation between each of Transco's RDNs and, as such, these entities will be retained under one DN-GT licence within Transco. It also accommodated Transco's commercial decision to sell four of its DNs. Transco formally withdrew its remaining three applications.
- 2.55. The five new additional DN-GT licences were granted in substantially the same form as Transco's original GT licence. As at the date of the grant of the five new additional GT licences, all gas transportation assets owned by Transco were operated pursuant to its original GT licence. Following the grant of these additional licences, the five new additional GT licences, whilst active, did not relate to any particular gas transportation assets owned or operated by Transco. However, following a direction of the modifications proposed in the November document (issued on 1 February 2005 and discussed further below), four of the five new additional GT licences relate respectively to the four DNs to be sold; one of the new additional GT licences relates only to the four DNs to be retained by Transco and Transco's original GT licence relates only to the NTS. These section 23 modifications are discussed in further detail below.

Legal separation

- 2.56. The conclusions document on offtake arrangements outlined the Authority's position that it was minded to require Transco to undertake legal separation and

²⁷ Notice under section 7B(9)(c) of the Gas Act 1986 of the grant of five new additional gas transporter licences. This document is available on the Gas Distribution Network Sale page of Ofgem's website.

targeted structural separation.²⁸ As described in the Final IA, Ofgem worked with NGT to understand the implementation issues that would need to be addressed should legal separation be pursued.²⁹ In the course of this investigation, it became apparent that pursuing full legal separation of the NTS and the RDNs would be likely to prove problematic. This is because:

- ◆ moving Transco's NTS business into a new legal entity would create two low probability risks that could, were either to materialise, create significant costs to customers. These risks were that:
 - ◆ third party contracts that reference Transco's Network Code might need to be adjusted; and
 - ◆ the wholesale gas market might fragment into a number of individual Network Codes with separate market arrangements in each; and
- ◆ moving Transco's RDN business into a new legal entity is likely to create disproportionate costs for NGT associated with debt restructuring.

2.57. The Authority therefore concluded that it would not be appropriate to require legal separation of the RDNs and the NTS as part of the DN sales process.

2.58. Ofgem considers that Transco will require two licences under the proposed new arrangements; one for the NTS and one for the RDNs. These proposals were highlighted within the November 2004 document, and the necessary licence conditions to facilitate these arrangements are included within the section 8AA and section 23 direction and hence will come into effect on 1 May 2005 or such later date as the Authority may direct.

November 2004 licence consultation

2.59. On 25 November 2004, Ofgem published its next steps consultation on the licensing process associated with DN sales. This consultation document represented:

²⁸ *National Grid Transco, Potential sale of network distribution businesses, Offtake Arrangements Conclusions document on framework*, Ofgem, August 2004.

- ◆ a formal consultation (under section 23 of the Gas Act) on proposed changes to separate the price control provisions into each of Transco's six GT licences; and
- ◆ an informal consultation (relating to sections 8AA and 23 of the Gas Act) on proposed structural changes to Transco's six GT licences to reflect the arrangements that will need to be put in place in the event of DN sales in order to ensure that customers' interests are protected within a divested industry structure.

2.60. Whilst Ofgem endeavoured to make the consultation relating to licensing reform in the context of DN sales as wide as possible, through the September document and November document, some respondents to these consultations raised concerns regarding the process Ofgem has adopted. In particular, some respondents stated that the timescales involved throughout the process had been very tight. In addition, a number of respondents stated that due to the volume of information and other consultation documents which had been produced by Ofgem, they had not had sufficient time or resources to respond adequately to the licence consultations. In this respect, Ofgem would note the considerable degree of consultation that has been undertaken on the proposed licence changes. This has included a four week consultation on the September document, a four week consultation on the November document (both the section 23 Notice and informal consultation on the proposed section 8AA modifications) and a two month consultation on the February document (discussed below).

2.61. Ofgem has also consulted on the details of the proposed licences through weekly DISG meetings, with amended licence drafting being made available on the Ofgem website.

DTI position paper regarding the treatment of independent gas networks

2.62. In the November document, Ofgem indicated that the Authority had asked the Department of Trade and Industry (DTI) to review Special Condition 18

²⁹ *National Grid Transco, Potential sale of network distribution businesses, Final Impact Assessment,*

(Conveyance to Independent Systems) in Transco's original GT licence. Ofgem stated that during the implementation of the Gas Act 1996, the DTI took the view that customers connected to independent systems (i.e. systems which are separate from the main GB gas transportation system) that were supplied with LNG and LPG should not be denied the advantages of competition. As a result, Special Condition 18 is a condition that was included in Transco's GT licence, on 1 March 1996, at the DTI's behest.

2.63. There are five independent LNG networks in Scotland and four independent LPG networks (in Scotland, Wales and the North of England). All of these networks were independent networks when Special Condition 18 was introduced (i.e. separate from the main GB gas transportation system), and all of these systems except one (Stranraer) remain independent today.

2.64. Under the provisions of Special Condition 18, which currently constitute "alternative arrangements" as determined by the DTI for the purposes of Amended Standard Condition 29 (Disposal of Assets), customers connected to independent networks should be charged an average price for conveyance which is "no more than the average charge for conveyance to premises in Great Britain.....adjusted in line with the Retail Price Index from that date". In the case of the LPG networks, Transco is required to subsidise the cost of the gas itself, as well as the costs of conveyance.

2.65. In its November document, Ofgem highlighted that the DTI would be issuing a position paper in due course to inform the industry of the way in which it proposes to take the treatment of independent systems forward in the context of DN sales. The DTI issued its position paper in January 2005. In this paper, the DTI outlined its proposed policy that the existing arrangements for the independent systems should continue, with:

- ◆ consumers connected to independent networks charged an average price for conveyance which is no more than the average charge for conveyance to premises in GB;
- ◆ this average price calculated annually; and

- ◆ a sunset clause to exclude independent networks that have been subsequently connected to the main gas network (e.g. Stranraer).
- 2.66. The DTI further stated that, should Transco's proposed sale of DNs proceed, the Secretary of State would issue Transco with a Determination (under Amended Standard Condition 29 of Transco's original GT licence) to confirm what "alternative arrangements" are suitable and that this should apply from the proposed disposal by Transco of these independent systems. The DTI also noted that appropriate changes to Transco's licence would be implemented by Ofgem as part of the formal consultation under section 8AA and section 23 of the Gas Act.
- 2.67. It is noted that the Secretary of State has now issued three Determinations under Amended Standard Condition 29 of Transco's original GT licence. These Determinations are annexed to the Secretary of State's statement of reasons for her decision to consent to Transco's applications under Amended Standard Condition 29 for the disposal of its four relevant DNs to four wholly owned subsidiary companies. Copies of the statement of reasons and the Secretary of State's Determinations can be found on the DTI website.³⁰
- 2.68. On 25 April 2005, the modifications proposed as part of the February document were directed to take effect on 1 May or such later date as the Authority may direct. As such, Special Condition 18 will be removed on 1 May 2005, which is the date upon which the Secretary of State Determinations take effect (assuming that hive-down occurs on this date).

Direction to modify – implementation of section 23 changes

- 2.69. On 25 November 2004, as part of the next steps document, the Authority issued a notice pursuant to section 23(3) of the Gas Act. This notice sought to consult on the Authority's proposal to separate the price controls (as set out in the original Transco licence) to achieve revenue separation between the NTS and each of the IDNs and RDNs.

³⁰ See http://www.dti.gov.uk/energy/publications/policy/sale_gas_dist_networks_reasons.pdf

- 2.70. On 31 January 2005, Transco provided its written consent to the making of these section 23 modifications to each of its six GT licences.
- 2.71. On 1 February 2005, the Authority³¹ issued a direction to modify the price control conditions in each of Transco's six GT licences, in connection with the proposed DN sales transaction and in response to the notice issued.
- 2.72. The price control conditions that have been modified relate to areas such as revenue restriction definitions and related provisions, allocation of revenues and costs, information provision in connection with revenue restrictions, the licensee's methodology for determining incremental entry capacity volumes, performance reporting, incentive schemes and output measures for price controls. As a result of the modifications, four of the new additional GT licences relate only to the four DNs to be sold, one of the new additional licences relates only to the four DNs to be retained by Transco, and the original GT licence relates only to the NTS.
- 2.73. Whilst in accordance with the requirements of section 23, only Transco's consent was required as it was the holder of the relevant licences, Ofgem also sought comments on the proposed modifications from, amongst others, potential DN purchasers and other interested parties.

February 2005 document

- 2.74. On 14 February 2005, Ofgem published its formal consultation under section 23 and section 8AA of the Gas Act 1986 relating to the proposed changes to Transco's six GT licences (and transfer of the IDN licences) that it considered were necessary to protect the interest of customers in a divested industry structure³².
- 2.75. This document represented the formal consultation on:
- ◆ the Authority's proposal to grant consent to Transco to transfer (in connection with NGT's proposal to sell four of Transco's DNs) the four relevant DN GT licences;

³¹ *Section 23 Direction: Modification of the price control conditions in each of Transco plc's six gas transporter licences*, Ofgem 24/05

- ◆ on the changes proposed as part of the section 8AA licence transfer and modification process for the four relevant DN GT licences that NGT was proposing (as part of DN sales) to transfer from Transco to the four relevant wholly-owned Transco subsidiary companies; and
- ◆ on the changes proposed as part of the associated section 23 modification process to change the two NTS and RDN GT licences which will continue to be held by Transco after DN sales.

Section 8AA and associated section 23 directions

- 2.76. Following consideration of the views of respondents to the February document, the Authority decided that it was appropriate to direct the licence modifications as set out in the formal consultation issued in February with some insubstantial changes (e.g. to correct typographical or cross referencing errors).
- 2.77. These directions were issued on 25 April, along with a summary of the views of respondents and Ofgem's views on these responses³³. The modifications to the six GT licences have, therefore, been made. However, the modifications will only take effect by way of a separate implementation direction to be issued by the Authority once it is satisfied that all conditions precedent attached to its January consent have been fulfilled. The implementation direction is expected to take effect on 1 May 2005 (or such later date as the Authority may direct).
- 2.78. Under NGTs commercial timetable for DN sales, at the time of hive-down, the regulatory arrangements which, in the Authority's opinion, will be necessary to protect the interests of customers in a divested industry structure. Accordingly, the Authority does not consider that customers' interests would be protected in the event of share sale. Ofgem therefore considers it appropriate to consult on further changes to these licence conditions as set out in this document such that these changes are effective in the six licences prior to the sale of shares in the four wholly owned Transco subsidiary companies to the relevant third party purchasers.

³² *National Grid Transco – Potential Sale of Gas Distribution Network Businesses* Formal consultation under section 23 and section 8AA of the Gas Act 1986. February 2005, 45/05

³³ *Modification to two of the six gas transporter licences held by Transco plc – Direction pursuant to section 23 of Gas Act 1986*, Ofgem, April 2005.

Involvement of industry workgroups

- 2.79. As described in the November document, prior to publication of this document, a number of discussions took place through DISG meetings, which considered Ofgem's proposals for changes to Transco's six GT licences in detail, with a particular focus on a number of key issues. It is noted that attendance of DISG meetings has been open to all interested parties³⁴.
- 2.80. In recent months, following the publication of the November document, the focus of discussions in the DISG meetings on the licensing regime has continued. Indeed, licensing issues have been on the agenda at the majority of DISG meetings since the release of the September document.
- 2.81. The February 2005 document included a detailed account of the discussions that had been held at DISG regarding the proposed licence modifications up to that point.
- 2.82. Subsequent to the receipt of respondents' views to the February document, Ofgem consulted on new changes to the licence conditions through DISG. This included discussions at DISG 38, DISG 39 and DISG 40 relating to the proposed modification of the price control conditions and discussions at DISG 40 regarding proposed modifications to Standard Special Condition A3 (Definitions and Interpretation), Standard Special Condition A33 (Restriction on Use of Certain Information and Independence of the Transportation Business), Standard Special Condition D4 (Prohibited Procurement Activities) and Special Condition C4 (Prohibited Procurement Activities). Furthermore, provisional changes proposed to the entirety of Transco's six GT licences were published on Ofgem's web-site for review and comment.
- 2.83. DISG members have provided feedback both at the DISG meetings and in written form after the meetings. This process has been an important contribution to Ofgem's consultation on the proposed restructuring of the NTS and DN-GT licences.

Consent to transfer four of the gas transporter licences held by Transco plc incorporating a direction pursuant to section 8AA of the Gas Act 1986, Ofgem, April 2005

³⁴ DISG meetings have been attended by, amongst others, representatives of Ofgem, NGT, potential purchasers, and shippers.

Interaction of this Notice with the private CLM

- 2.84. On 25 April 2005, the Authority directed the modifications proposed under section 23 and section 8AA on 14 February (with some minor modifications) made to Transco's six gas transporter licences. Whilst these modifications have been made they have not yet taken effect and will take effect by way of a separate implementation direction to be issued on 1 May or such other date as the Authority directs. As a result, Standard Special Conditions A2, B2 and D2 which contains the Private Collective licence Modification procedure (the "Private CLM") while in the six gas transporter licences have not yet taken effect. Therefore, at this time, the only modification options available to the Authority are through a statutory collective licence consultation or with the individual consent of the licence holders as the Private CLM procedures are not yet in effect. It is not appropriate to use the statutory CLM in this case. The Notice in Appendix 6 has therefore been issued on the basis that the individual consent of the relevant licence holder will be sought. It should be noted that, if hive-down (and transfer of the licence) process occurs, the holders of the licences will be the four wholly owned Transco subsidiary companies in respect of the IDN GT licences and Transco in respect of the NTS and RDN GT licences. It is the consent of these companies which is required to make these modifications. If hive-down (and the transfer) does not proceed, it will be the consent of Transco as the holder of the six gas transporters licences which will be required. In light of the proposed hive-down, Ofgem would particularly hope to receive comments on these proposed modifications to the six licences from, amongst others, potential DN purchasers and other interested parties.
- 2.85. However, subject to respondents' views, Ofgem would note that, by the time the modifications proposed in this consultation are expected to be directed, Standard Special Conditions A2, B2 and D2 are likely to be in effect and available in each of the six relevant GT licences. Therefore, the modifications introduced pursuant to this consultation will be capable of being modified by the Private CLM in the future, and licensees will be asked to consent to the modifications on this basis.
- 2.86. As the private CLM conditions have not yet been brought into effect in the six Transco licences, the Authority has not proposed the modifications which are the subject of the attached Notice using the powers contained in these

conditions. However, Ofgem would note that, had the Private CLM condition been effective in each of the six Transco licences, the powers contained within those conditions could have been used in relation to conditions proposed to be introduced into parts A, B and or D respectively instead of seeking individual consent pursuant to section 23 of the Act. Therefore, no adverse inference should be drawn from the decision to issue the Notice in Appendix 6 pursuant to section 23 of the Act at this time.

3. Part A – Interim incentives – Final Proposals

- 3.1. This chapter sets out Ofgem’s final proposals for the scope, form and duration of interim incentive schemes for both:
- ◆ the NTS; and
 - ◆ the DNs.
- 3.2. At the end of this chapter, we discuss Ofgem proposals for income adjusting event provisions for the NTS and DNs.
- 3.3. As noted in the November 2004 Final Impact Assessment (Final IA)³⁵, offtake arrangements have been proposed for both the long term (i.e. “enduring” arrangements from 1 October onwards) and the “interim” (i.e. from hive-down up until the start of the enduring arrangements). These Final Proposals on incentive schemes have been designed to support these interim offtake arrangements.
- 3.4. The Final Proposals on interim incentives described in this Chapter have been used to develop licence modifications outlined in detail in Chapter 4. Ofgem therefore invites respondents’ views on these proposals in the context of the formal section 23 licence modification consultation (rather than on the proposals as they are described in this chapter).

NTS interim incentives

- 3.5. In the March consultation document, Ofgem presented initial proposals for the:
- ◆ buy-back and interruption incentive;
 - ◆ constrained LNG incentive;
 - ◆ charges foregone incentive and exit investment incentive; and
 - ◆ duration of interim incentive schemes.

³⁵ *National Grid Transco – Potential sale of gas distribution network businesses, Final Impact Assessment*, Ofgem, November 2004

- 3.6. Ofgem's initial proposals, respondents' views to these proposals and Ofgem's final proposals are discussed in turn below.

Buy-back and interruption incentive

Ofgem's initial proposals

- 3.7. Ofgem stated in the Initial Proposals consultation that an interim incentive scheme would be required to give the NTS an incentive to interrupt NTS connected supply points³⁶ and buy-back NTS offtake rights as efficiently as possible. Ofgem proposed that these incentives should be provided through a single (combined) mechanism. Ofgem also proposed that this incentive be specified in a standard "sliding scale" form. Under this approach, a target would be defined equal to the expected level of Transco's expenditure on the buy-back of NTS offtake rights and the cost of interrupting customers for more than 15 days. Deviations from this target level of incurred cost would then be shared between Transco's NTS business (Transco NTS) and customers, subject to defined (upside and downside) sharing factors, a cap and a collar.
- 3.8. As described in the Final IA, Transco NTS stated that, in the interim period, capacity would be released on an unconstrained basis, subject to its statutory and licence obligations (so as to ensure that the allocation of offtake rights in the interim period is on a not unduly discriminatory basis). Consistent with this allocation methodology, Ofgem proposed that the target for the buy-back element of this incentive should be set at zero for each year of the interim arrangements. This was based on analysis presented to Ofgem by Transco NTS that stated, given the current and forecast levels of capacity use on the NTS (and subject to its statutory and licence obligations), Transco NTS believed that such capacity could be allocated to all users of the NTS on an unconstrained basis in the interim period without incurring any costs of buy-back.

³⁶ For the purposes of clarification, NTS connectees, in this context, mean all parties directly connected to the NTS, including without limitation directly connected customers (such as power stations) and the DNS.

3.9. Ofgem also proposed that the target for the 15 day interruption element of the incentive should be based upon current predictions of the costs associated with interrupting customers for more than 15 days per year (under their current interruptible contracts). The targets that were proposed for the buy-back and interruption incentive over the interim period are presented in Table 3.1 below:

Table 3.1 Targets for the buy-back and interruption incentive: initial proposals

	Year			
	2005/06	2006/07	2007/08	2008/09
Buy-back target (£m)	0	0	0	0
Greater than 15 day interruption target (£m)	1.59	1.68	1.73	1.68
Target total (£m)	1.59	1.68	1.73	1.68

3.10. In the Initial Proposals consultation document for interim incentives, Ofgem proposed two alternatives for cap, collar and sharing factors. These are outlined in Table 3.2 below:

Table 3.2 Parameters for buy-back and interruption incentive: initial proposals

Applicable to 2005/06 to 2008/09	Cap and Collar (£m)		Sharing factors	
	Cap	Collar	Upside	Downside
Option 1	As per target total ³⁷	-5	80%	75%
Option 2	As per target total	-7	75%	50%

3.11. These options were defined after Transco NTS stated that the buy-back costs for NTS connected supply points would, in the worst case, only be incurred were shippers to request to have firm exit capacity for a limited number of currently

³⁷ It was proposed that the cap be set equal to the target level of interruptible cost in each year of the incentive (hence the cap would differ for each year of the incentive, consistent with the "Target Total" data presented in Table 3.1).

interruptible supply points. Transco's analysis, which they shared with Ofgem, estimated that the maximum cost of buy-backs that could result from these customers becoming firm customers would be approximately £14 million per annum³⁸. Option 2 was therefore defined with a collar consistent with this "worst case" scenario.

- 3.12. Option 1 was presented as a potential alternative to Option 2, in which Transco would share more of the cost of buy-backs beneath the collar level, but face a relatively low collar.

Respondents' views

NGT

- 3.13. As noted previously, Transco submitted two responses to the Initial Proposals consultation, one with respect to its NTS business (Transco NTS) and one with respect to its retained Distribution Networks (Transco's RDNs). Transco NTS stated it found both proposed options for buy-back incentive parameters unattractive, given their opinion that all risk in the proposed incentive is downside. Instead, Transco NTS considered that any buy-backs necessary in the interim period should be treated as income adjusting events (IAEs). Transco NTS was concerned that the combination of the proposed cap and sharing factors in both Options 1 and 2 meant that the cap could never be attained. Transco NTS therefore favoured an upside sharing factor of 100%.
- 3.14. Transco NTS had stated that the NTS was unconstrained and could therefore be expected to meet all reasonable demands for incremental offtake capacity over the interim period on an economic and efficient basis. In subsequent conversations, Transco NTS has, however, recently identified that there could be costs associated with the unconstrained release of offtake flexibility.

Potential purchasers

- 3.15. Two potential purchasers stated that they explicitly supported the proposed inclusion of a buy-back element in the NTS incentive scheme. One potential buyer considered it interesting that (aside from a few specific instances) the NTS

³⁸ This figure was misreported in the Initial Proposals document as approximately £16m.

has sufficient spare capacity to accommodate all requests for firm NTS offtake rights. This respondent also considered that the target for the buy-back incentive should be set at zero.

- 3.16. One potential buyer requested more information on the amount of switching from interruptible to firm used in the analysis to calculate the proposed caps and collars, but on the basis of the initial proposals expressed a preference for Option 2.

Shippers/suppliers

- 3.17. Of the two shipper/supplier respondents to the document, one expressed a preference for the Option 2 set of parameters, considering that this would ensure Transco NTS is duly incentivised to minimise the level of NTS curtailment in the next few years.
- 3.18. One of these respondents agreed it was appropriate for an interruption incentive to be in place through the interim period, although stated that the extent to which Transco may interrupt a user may be reduced through the potential implementation of Modification Proposal 740³⁹ and a subsequent reduction in target may be appropriate.

Other

- 3.19. The Association of Electricity Producers (AEP) considered the Option 2 incentive parameters to be the most appropriate, on the grounds that this would minimise the incentive revenue gained by Transco in the event that no buy-backs or interruptions of NTS connectees for greater than 15 days were required in the interim period. This respondent also questioned the basis on which the target for cost of interruptions greater than 15 days had been calculated and favoured a target of zero.

Ofgem's final proposals

- 3.20. Having considered respondents' views, Ofgem believes that the scope and form of the buy-back and interruption incentive is appropriate for the interim NTS

³⁹ "Amendment to Transco rights to interrupt for supply /demand purposes".

incentive scheme. As noted in the initial proposals document, under both proposed options the buy-back element of the incentive is unusual as the target for cost of buy-back of NTS offtake rights is zero (and there is no possibility of improving upon the target) and reflects the unconstrained nature of the system that Transco NTS described to Ofgem prior to the publication of the Initial Proposals and was used to inform the Final IA. It is, however, consistent with providing Transco NTS with an incentive to use interruption contracts as efficiently as possible and minimise the costs of any necessary buy-backs.

- 3.21. In response to the request from a potential purchaser, Ofgem considers that it would not be appropriate to release details of the analysis undertaken to calculate the potential size of buy-back costs given it relates to assumptions, disclosed to Ofgem by Transco NTS in confidence, on individual offtake points' future offtake from the NTS. However, it is worth noting that the collar specified in Option 2 is set at a level that the analysis at the time indicated would only be reached if costs of buy-backs were to be at the high end of the range of expectations.
- 3.22. In response to the views of Transco NTS, Ofgem does not consider it appropriate for this incentive to have an upside sharing factor of 100%. The existing interruptions incentive on Transco NTS (although currently combined with the charges foregone incentive) is subject to a 50% upside sharing factor. Both options presented in the Initial Proposals consultation document contain upside sharing factors in excess of this. Ofgem also considers a sharing factor lower than 100% to be appropriate in this instance, given that this means risk and rewards of the incentive scheme will be shared by both customers and Transco shareholders.
- 3.23. Having regard to respondents' views, overall, Ofgem considers Option 2 of the parameters, presented in Table 3.2, to be most appropriate for inclusion in the Final Proposals for interim incentives. Ofgem considers that these parameters will deliver most protection for customers in the event that buy-back costs are at the high end of expectations, given that this option has the largest collar. This option also has the lowest upside sharing factor, hence gives customers the greatest share of benefits in the event that buy-backs and incidence of interruption greater than 15 days are at the low end of expectations. It should be noted that the target for Option 2 is set at the expected cost of interruption of

those interruptible NTS direct connect supply points for greater than 15 days for the duration of the interim period. The target for the final two years of the interim period was calculated by applying forecast growth rates in interruptible demand to the cost target specified for Transco's NTS business for 2006/07⁴⁰.

- 3.24. As with all of Ofgem's incentive schemes, were there to be instances where the cap and collar no longer provide a financial incentive for Transco NTS to operate efficiently, Ofgem would anticipate that Transco would continue to operate in adherence with its statutory and licence obligations, including without limitation the obligation to operate its system in an economic and efficient manner.
- 3.25. As noted above, the Final IA set out that Transco NTS had stated that, in the period prior to the introduction of the enduring offtake arrangements, to ensure that offtake rights would be allocated on a non-discriminatory basis there would be an unconstrained release of capacity, subject to its statutory and licence obligations. Therefore, any party that would be prepared to pay for the capacity would have the capacity allocated to that party and Transco NTS would have to 'buy-back' capacity from participants to manage any constraints on its system that might subsequently arise.
- 3.26. In developing these arrangements, Transco NTS had stated that it expected there to be no costs to customers associated with the introduction of the interim arrangements due to the unconstrained nature of its transmission system. Transco NTS has however recently identified that there could be costs associated with the unconstrained incremental release of offtake flexibility.
- 3.27. Having considered these issues, the Authority has decided to continue to proceed with an unconstrained approach; however, to protect the interests of customers, the Authority has imposed a requirement within the condition subsequent set out in paragraph 23(c) of its consent to Transco's applications to dispose of its relevant assets under Amended Standard Condition 29 of its original GT licence. The intent of this requirement is to ensure that, overall, customers should not bear any of the costs associated with the unconstrained incremental release of NTS offtake flexibility for the interim period. As noted,

⁴⁰ Note that the methodology used to calculate these targets was discussed at DISG 39 on 5 April 2005.

Transco must satisfy the Authority that suitable arrangements are in place to achieve this objective before the transaction may proceed to completion. The costs associated with any capacity buy-backs relating to NTS flat or NTS exit capacity will remain incentivised as set out above.

Constrained LNG incentive

Ofgem's initial proposals

- 3.28. In the March consultation document, Ofgem stated that a component of the interim incentives for the NTS would be necessary to give Transco an incentive to use LNG facilities efficiently. It was proposed that the scope and form of this incentive would reflect the current incentive scheme applicable to Transco NTS, with a target being set for the cost of using constrained LNG (CLNG) storage. Transco NTS would then be exposed to the difference between actual costs and this target.
- 3.29. As stated in the Initial Proposals, targets and incentive parameters for the CLNG incentive have already been defined for the duration of the current price control; hence new targets will need to be specified for 2007/08 and 2008/09.
- 3.30. The CLNG incentive targets proposed in the Initial Proposals document are set out in Table 3.3 below. Ofgem proposed that the targets for this incentive should be set at a level equal to the expected level of cost Transco NTS will incur in contracting for the use of LNG for constraint management purposes. At the time that the Initial Proposals were being developed, analysis to inform the choice of targets for the final two years of the interim period was still continuing. For this reason, Initial Proposals for targets for these two years were expressed as a range.

Table 3.3 Targets for CLNG incentive: initial proposals

	2005/06	2006/07	2007/08	2008/09
Target (£m)	6.6	6.6	1.57 – 2.6	1.03 – 2.1

- 3.31. Ofgem also proposed retaining the current parameters for the CLNG incentive, which are described in the following table.

Table 3.4 Parameters for CLNG incentive: initial proposals

	Cap and Collar (£m)		Sharing factors	
	Cap	Collar	Upside	Downside
Applicable 2005/06 to 2008/09	N/A	N/A	100%	100%

Respondents' views

NGT

- 3.32. Transco NTS stated that it was comfortable with the proposed form of the CLNG incentive. Transco NTS considered that, although it was likely that storage sites would be flowing at their maximum rate on the 1 in 20 day, it could not be guaranteed. Transco NTS therefore stated that it would need to undertake an amount of contracting to guarantee that these flows would be entering the system on the 1 in 20 day, and that a target at the upper bound of the proposed range would be the most appropriate option.

Potential purchasers

- 3.33. Two potential buyers commented on this incentive, both of whom supported the form of the proposed CLNG incentive. One stated that it would expect all storage sites to be delivering gas onto the network on the 1 in 20 day, (hence the potential purchaser considered that a target at the lower end of the range outlined in the Initial Proposals should be adopted).

Shippers/suppliers

- 3.34. Two shipper/supplier respondents stated that that they considered it appropriate to retain the current form of the constrained LNG incentive. Both proposed that the lower bound of the target range was most appropriate, given that they considered it rational to assume that all storage sites will be injecting gas onto the network on the peak day. One respondent stated that it would be appropriate to set the CLNG target to zero in 2008/09.

Other

3.35. The AEP agreed with Ofgem's sliding scale targets for use of constrained LNG, yet stated that on a peak 1 in 20 day, it would expect all storage facilities to be delivering gas onto the NTS at maximum rates. The AEP therefore favoured the lower bound estimates for the last two years of the incentives, and agreed with the 100% sharing factors proposed.

Ofgem's final proposals

3.36. Consistent with the views of the majority of respondents, Ofgem considers that the form and scope of the incentive presented in the Initial Proposals document is appropriate. On balance, Ofgem considers that the targets outlined in Table 3.5 below are appropriate for the interim period.

Table 3.5 Targets for constrained LNG: Final proposals

	2005/06	2006/07	2007/08	2008/09
Target (£ million)	6.6	6.6	2.6	2.1

3.37. Ofgem considers it appropriate for Transco NTS to move towards a more probabilistic assessment of contracting for constraint management requirements. However, in the interim period, Ofgem acknowledges that the higher band of cost target more closely reflects Transco NTS's current view of the cost of the volume of constraint management tools to satisfy the conditions its GT licence. Ofgem notes Transco NTS's significant outperformance of its existing targets in 2003/4 and 2004/5. Ofgem therefore considers that, compared to the level of CLNG targets already specified in the licence, the relatively low targets proposed for 2007/08 and 2008/09 represent a fairer share of risk and reward for customers and Transco's shareholders.

Charges foregone incentive and exit investment incentive

Ofgem's initial proposals

3.38. As described in the March consultation, a foregone charges and exit investment incentive currently applies to the NTS. The purpose of this incentive is twofold, namely:

- ◆ to give Transco NTS an incentive to reduce the charges foregone as a result of the interruptible "discount" applied to shippers agreeing to have interruptible sites interrupted by the NTS for up to 45 days per year; and
- ◆ to allow Transco NTS additional revenues associated with exceeding the baseline output measures set out within its GT licence.

3.39. In the Initial Proposals document, Ofgem proposed to extend the duration of the existing incentive to the end of the interim period. This approach would therefore require the definition of targets for 2007/08 and 2008/09 (i.e. the first two years of the next price control period).

3.40. Two alternatives for the specification of targets for these two years were proposed in the Initial Proposals consultation document, outlined in Table 3.6. These were:

- ◆ **Option 1**, the "rollover" of existing licence targets through to the end of the interim arrangements; and
- ◆ **Option 2**, a "revision" approach, which is a continuation of the current targets through to 2006/07, with an increase in targets for the remainder of the interim period reflecting the rise in NTS exit capacity charges of 8.9% planned for April 2005, and expected growth in interruptible demand.

Table 3.6 Targets for charges foregone incentive: initial proposals

	Year			
	05/06	06/07	07/08	08/09
Option 1 "Rollover" (£m)	37.2	37.9	37.9	37.9
Option 2 "Revision" (£m)	37.2	37.9	42.3	41.2

3.41. As with the current arrangements, it was proposed that any appropriate additional revenue accruing through the exit investment incentive revenue driver would be added to the charges foregone target.

3.42. Ofgem also proposed retaining the current, relatively limited, cap and collar parameters, presented in Table 3.7 below.

Table 3.7 Parameters for charges foregone and exit investment incentive: initial proposals

	Cap and Collar (£m)		Sharing factors	
	Cap	Collar	Upside	Downside
Applicable to 2005/06 to 2008/09	1	-1	50%	25%

Respondents' views

NGT

3.43. Transco NTS favoured Option 2, the "revision" option for targets for the charges foregone incentive. This respondent considered this to be the only feasible estimate of the likely level of charges foregone.

Potential purchasers

3.44. Two potential purchasers commented on this element of the interim NTS incentives. One favoured Option 2, on the basis that this most reflected commercial reality. This respondent also stated that, in the event that the forecast increase in charges varies regionally, then targets should also reflect this regional spread. Another potential buyer favoured the rollover of 2006/07

targets for the final two years of the interim period, on the basis that Transco has suggested there is spare capacity in the NTS.

Shippers/suppliers

- 3.45. Of the two shipper/supplier respondents to the document, both favoured the Option 2 “revision” approach. One respondent considered these parameters would take into account the latest views of interruptible loads going forward, and make the incentive more robust.

Other

- 3.46. The AEP favoured the Option 2 “revision” approach for the charges foregone incentive, since it considered it was appropriate to consider external issues which have caused changes to charges beyond the end of the current price control period. This respondent queried why the target falls in the final year of the interim period (though welcomed the fall).

Ofgem’s final proposals

- 3.47. In line with the majority of respondents’ views, Ofgem continues to consider that it is appropriate to specify parameters for this incentive scheme for the final two years of the interim period.
- 3.48. Ofgem considers that of the options presented in the Initial Proposals document, Option 2 should be adopted for the Final Proposals. This option most closely reflects current expectations of the commercial environment within which the NTS will be operating in the interim period. Ofgem would ask respondents to note that the fall in targets from 2007/08 to 2008/09 reflects a small fall in the level of forecast interruptible demand between these two years.
- 3.49. Final proposals for these targets are described in Table 3.8 below:

Table 3.8 Targets for charges foregone incentive

	2005/06	2006/07	2007/08	2008/09
Target (£ million)	37.2	37.9	42.3	41.2

3.50. For reasons of simplicity, Ofgem does not propose undertaking any *ex post* adjustment of the charges foregone incentive, either to reflect locational variations in NTS exit charges, or actual levels of charges, over the remainder of the interim period.

Duration of NTS incentive scheme

Ofgem's initial proposals

3.51. The NTS incentive scheme supporting the interim offtake arrangements will apply from the date at which the licence modifications proposed in Part B of this document are proposed to take effect (currently envisaged to be 1 June 2005) through to the end of the period for which the interim offtake arrangements apply (currently envisaged to be 30 September 2008). As noted in the Initial Proposals document, the parameters for the current incentive scheme have been specified until 2006/07.

3.52. Ofgem proposed that targets and parameters for the NTS incentive schemes should be specified for the entire interim period (i.e. through to 30 September 2008).

Respondents' views

NGT

3.53. Transco NTS did not consider it essential to specify parameters for NTS incentives for the final two years of the interim period, and although happy to work with Ofgem to define incentive parameters for these two years, did not believe this to be a requirement for DN sales to proceed.

Potential purchasers

- 3.54. One potential purchaser stated that it would seem appropriate to introduce targets and parameters up to October 2008. This respondent noted that this would mean that targets for 2008/09 would need to be pro-rated to apply to the first six months of that year.

Shippers/suppliers

- 3.55. One respondent stated that it generally agreed with Ofgem's proposals to retain the form and scope of the existing NTS exit incentives in the interim period.

Other

- 3.56. The AEP queried how the parameters for 2008/09 would be translated into the partial incentive year April 2008 to end-September 2008. This respondent considered that Transco NTS would not need to use constrained LNG or interruption in the summer months, hence stated that targets for year 2008/09 should be set to zero.

Ofgem's final proposals

- 3.57. Ofgem considers it is appropriate to define incentive parameters through to the end of the interim period, to provide a degree of certainty for the NTS and for customers through to the start of the enduring offtake arrangements.
- 3.58. In response to AEP's query, Ofgem notes that the proposed approach will require the definition of incentive targets for the partial incentive year April 2008 to end-September 2008. However, the enduring regime will also require the setting of similar partial year targets. Therefore, so long as the approach for both regimes is consistent, Ofgem considers that customers should continue to be protected. For this reason Ofgem considers that it remains appropriate for targets to be applied on a *pro rata* basis for this partial year, so long as enduring incentives (that on current plans will apply from 1 October 2008 for the remainder of partial year 2008/09) are defined on a similar pro-rating basis.

DN interim incentives

3.59. The Initial Proposals consultation document also outlined Ofgem's views on the proposed scope, form and duration of an appropriate incentive scheme for the DNs in the interim period. In particular, the document described proposals for:

- ◆ scope of the DN incentive;
- ◆ duration of the DN incentive;
- ◆ definition of cost performance measure and target for the DN incentive;
- ◆ level of DN targets; and
- ◆ level of caps, collars and sharing factors.

3.60. The following section sets out Ofgem's initial proposals, respondents' views to these proposals and Ofgem's final proposals.

Scope of the DN incentive

Ofgem's initial proposals

3.61. Ofgem stated in the Initial Proposals consultation that interim incentives for the DNs would be necessary to mitigate a tendency for DNs to overbook NTS offtake (flat) capacity and NTS offtake (flexibility) capacity in the interim period. This document also stated that the objective of the interim DN incentive scheme should be to enable DNs to meet their 1 in 20 obligation in the interim period at least cost, whether this occurred by the use of demand management tools, or the booking of additional NTS exit capacity and/or flexibility. It was therefore proposed that the incentive scheme should enable DNs to trade-off the cost of additional NTS exit capacity (and flexibility) with the cost of increased interruption / demand management of customers connected to the DNs.

3.62. Ofgem proposed that the interim DN incentive should be specified as a single mechanism for each DN. The scope of this single cost performance measure and target (for each DN) would therefore cover NTS offtake (flat) capacity, NTS offtake (flexibility) capacity and the cost of interruption of DN connectees for greater than 15 days.

Respondents' views

NGT

- 3.63. Transco NTS stated that it supports DN incentives which give the DNs incentives to not to overbook either NTS offtake (flat) capacity or NTS offtake (flexibility) capacity.
- 3.64. Transco's RDNs considered that the supply/demand balance of NTS exit capacity implied that there would be no benefit to a DN in requesting levels of flat capacity and flexibility that are in excess of their requirements. Also, Transco's RDNs argued for targets to be subject to a growth term to allow for unanticipated demand growth. This respondent also proposed an alternate DN incentive scheme, in which DNs would be able to request any level of exit capacity at an offtake up to the level that they have booked in the long-term auctions for the period commencing October 2008.

Potential purchasers

- 3.65. All of the potential purchasers considered the proposed DN incentive schemes to be appropriate. One of these respondents supported this view by stating that the proposed scheme is simple and reflects current practice. Another potential purchaser considered the proposed incentives to be appropriate on grounds of simplicity.
- 3.66. Another potential purchaser disagreed that there was a strong incentive for DNs to overbook NTS offtake rights, but supported the proposed scope of the incentive. This respondent stated that DNs should not be "penalised" for meeting unexpected increases in within-DN demand. This respondent therefore requested a mechanism to be defined through which an appropriate *ex post* adjustment could be made to targets (reflecting any differences between outturn demand and demand forecasts at the time the targets were set).

Shippers/suppliers

- 3.67. One respondent stated that it largely agreed with the scope and form of the proposed interim DN incentive scheme.

Other

- 3.68. The AEP stated that it agreed that a single incentive would be appropriate for the interim period.

Ofgem's final proposals

- 3.69. Ofgem proposes that the scope of the DN incentive scheme as outlined in Initial Proposals be retained for the Final Proposals.
- 3.70. In response to the potential purchaser that considered that a demand growth term should be included, Ofgem does not consider it is appropriate to remove the risk from the DNs that actual demand growth may differ from ex ante expectations. Given that securing an efficient combination of NTS offtake rights and demand management tools to meet expectations of demand will be a core role of the DNs in both the interim and enduring offtake arrangements, Ofgem continues to consider that it would not be appropriate to include an ex post demand forecasting error adjustment in DN incentive schemes.
- 3.71. In response to the comments made by Transco's RDN business, Ofgem does not consider that constraining DNs to request NTS offtake rights to the level booked in the long-term auctions is an appropriate alternative to the proposed incentive scheme. Ofgem considers that this approach has a number of practical limitations including that the interim regime is required to be operational from day 1, whereas the enduring regime will not be operational until September 2005.

Duration of DN incentive schemes

Ofgem's initial proposals

- 3.72. Consistent with the duration of the proposed NTS incentives scheme, the DN incentives schemes will apply from the date at which the licence modifications proposed in Part B of this document are proposed to take effect (currently envisaged to be 1 June 2005) through to the end of the period for which the interim offtake arrangements apply (currently envisaged to be 30 September 2008).

- 3.73. Ofgem initially proposed the DN incentive schemes should be specified for the same duration as the NTS incentive scheme.

Respondents' views

NGT

- 3.74. Transco's RDNs explicitly stated that it supported the proposed duration of the DN interim incentives schemes.

Potential purchasers

- 3.75. One potential purchaser stated that it supports the proposed duration of the DN interim incentives.

Shippers/suppliers

- 3.76. One respondent stated that it generally agreed with Ofgem's proposals to retain the form and scope of the existing NTS exit incentives in the interim period.

Other

- 3.77. The AEP stated that it supported the proposed duration of the DN interim incentives schemes.

Ofgem's final proposals

- 3.78. In line with the views of respondents and consistent with the duration of the NTS incentive scheme, Ofgem continues to consider it appropriate to define incentive parameters for DN incentives through to the end of the interim period, to provide a degree of certainty to the DN through to the start of the enduring offtake arrangements.

- 3.79. As with the NTS incentives, this approach will require defining incentive targets for 2008/09. Ofgem considers it is appropriate for targets to be applied on a *pro rata* basis for this partial year, with the enduring DN incentives defined on a consistent (*pro rata*) basis.

Form of cost performance measure and target for the DN incentive

Ofgem's initial proposals

- 3.80. In the Initial Proposals document, Ofgem proposed that the interim DN incentive schemes should be structured following a standard "sliding scale" form with a defined incentive cost target and a cap and collar. Deviations from this target level of incurred cost would then be shared between DNs and their customers, and be subject to defined sharing factors.
- 3.81. In terms of the appropriate definition of the cost performance targets, Ofgem proposed that these should be defined for NTS offtake (flat) capacity and NTS offtake (flexibility) capacity for each DN (over the period 2005/06 to 2008/09) as follows:
- ◆ base allocation of NTS offtake (flat) capacity and NTS offtake (flexibility) capacity in each year; multiplied by
 - ◆ an appropriate (outturn) reference price for each; plus
 - ◆ the expected cost of greater than 15 day interruption of DN connectees.
- 3.82. In the Initial Proposals document, reference prices were proposed for both NTS offtake (flat) capacity and NTS offtake (flexibility) elements of the cost performance target. For NTS offtake (flat) capacity, it was proposed that annual NTS exit charges should be used in calculation of the cost performance target.
- 3.83. For NTS offtake (flexibility) capacity, Ofgem proposed a number of different alternatives for the price component of the incentive (necessary given that, in the interim period, offtake flexibility will not be separately priced by the NTS). These alternatives were:
- ◆ NTS exit charges (Option 1);
 - ◆ Incremental price of providing an additional unit of flow flexibility (Option 2); or
 - ◆ Incremental price of providing storage in the DN network (Option 3).

- 3.84. Ofgem's initial view was that NTS offtake (flexibility) capacity should be priced at the same level as NTS offtake (flat) capacity on the basis that this was least likely to lead to undue discrimination between all users of the NTS.

Respondents' views

NGT

- 3.85. Transco NTS stated that the reference price for NTS offtake (flexibility) capacity should be the incremental price of providing an additional unit of flow flexibility. Transco NTS therefore favoured the Option 2 approach, as described in the consultation document. Transco NTS considered that this was the only approach that would give DNs an incentive not to request additional flow flexibility from the NTS if there was a cheaper alternative. In addition, Transco NTS stated that the use of NTS exit charges (i.e. the Option 1 approach) could lead to a perverse incentive on DNs to increase their use of flexibility where reference prices are low.
- 3.86. Transco's RDNs stated that the reference price for flexibility should be zero, given that the provision of flexibility to DNs by the NTS should be at zero cost.

Potential purchasers

- 3.87. All three potential purchasers commented on the most appropriate reference price to use for flexibility in the interim period. All favoured the approach of using the same reference price as that used for flat capacity (on grounds of simplicity). One of these respondents stated, however, that it would not be appropriate to continue to price flexibility in this way in the long run. One respondent requested that any incremental capacity released in the interim period should be added to DN base allocations.
- 3.88. One potential purchaser agreed with the proposal that is appropriate to base the flat capacity price element of the incentive on the prevailing outturn price of NTS exit capacity as set out in NGT's charging statement.

Shippers/suppliers

- 3.89. One respondent considered it would be appropriate to use a reference price for flexibility derived from the cost of incremental investment.

Other

- 3.90. The AEP stated that pricing flexibility at same level of flat capacity would not be cost reflective.

Ofgem's final proposals

- 3.91. Ofgem continues to consider outturn NTS exit charges to be the most appropriate reference price to use for NTS offtake (flat) capacity in the interim period. Ofgem believes that there should be no undue discrimination between different classes of NTS connectee (e.g. customers connected directly to the NTS and the DNs), and this proposal is consistent with this view.
- 3.92. Ofgem continues to consider that NTS offtake (flexibility) capacity should be priced at the same level as NTS offtake (flat) capacity, given that, in the interim period directly connected customers will only be able to access additional flexibility of offtake through purchasing additional NTS exit capacity. Again, Ofgem believes there should be no undue discrimination in arrangements for access to flexibility of offtake from the NTS by different classes of NTS connectee. This view is consistent with that outlined in the Initial Proposals document, and is also consistent with the majority of views of respondents.
- 3.93. Ofgem has considered respondents' views regarding the appropriate reference price to be used for NTS offtake (flexibility) capacity. Ofgem agrees with the views of the majority of respondents that it is preferable to have a reference price that is simple and transparent.
- 3.94. In response to the points on cost reflectivity, Ofgem would welcome enhancements to the level of cost reflectivity of charges to all users of the NTS.
- 3.95. In response to the view of one potential buyer, Ofgem has considered the possibility of revising base allocations on an annual basis, incorporating any incremental capacity released to DNs. Ofgem does not consider this to be appropriate, given that the DN incentive scheme is designed specifically so that DNs share the actual cost of incremental NTS offtake rights paid by DN shippers. Given that DN shippers will continue to pay for incremental NTS offtake rights requested by DNs beyond the first year in which they are allocated, Ofgem considers it appropriate that this ongoing cost should also be shared by DNs.

Level of DN targets

Ofgem's initial proposals

- 3.96. The Initial Proposals document presented indicative targets for interim DN incentives. In calculating these targets, it was necessary to make assumptions regarding the outcome of a number of issues on which the document invited respondents' views.
- 3.97. The Initial Proposals consultation for DN incentive scheme targets presented indicative targets, calculated on the basis of:
- ◆ a base allocation of NTS offtake rights (i.e. both flat and flexibility capacity) allocated to DNs;
 - ◆ interruption greater than 15 day targets derived from the application of interruptible growth forecasts to existing interruption cost targets; and
 - ◆ illustrative NTS exit charges.
- 3.98. It should be noted that Ofgem proposed that the level of actual annual targets should be adjusted each year in line with changes in actual NTS exit charges. These targets were presented in the Initial Proposals consultation document to give respondents an indication of the levels of actual incentive targets.

Respondents' views

NGT

- 3.99. Transco's RDNs stated that, given the proposed scheme excludes foregone charges, it will encourage DNs to seek more interruptible capacity. This respondent therefore proposed that all the costs of interruption should be included directly (i.e. including foregone charges), enabling a lower sharing factor to be chosen. This respondent also assumed that following planned reform of interruption arrangements in 2006, all costs of interruption should be included in the incentive scheme.

Potential purchasers

- 3.100. One respondent requested clarification of the way on which the proposed targets for cost of interruption related to the aggregate LDZ target, recently removed from the NTS incentive scheme. This respondent also requested more information on how DN targets were derived from the aggregate LDZ target.
- 3.101. Another potential purchaser noted that the targets for cost of interruption by DNs were based upon an assumption that requests for additional NTS exit capacity from NTS direct connects would not have a negative impact on both the frequency and cost of interruption of customers directly connected to the DNs.

Shippers/suppliers

- 3.102. One respondent questioned whether DNs would be able to enter into demand side contracts in the first year of the incentive scheme (given time constraints). This respondent also sought Ofgem's views on how DNs can be given an incentive not to interrupt customers unnecessarily, but instead to enter into demand side contracts.

Other

- 3.103. No other respondents commented on the level of DN targets.

Ofgem's final proposals

- 3.104. Ofgem notes the view of one respondent questioning whether DNs will be able to contract for demand management tools in the short term. Ofgem considers that DNs should be able to make such contracts where it is economic and efficient to do so and that it is appropriate for DNs to be encouraged to make an efficient trade-off between requests for NTS offtake rights and contracting for demand-side management tools in the interim period. Any such contracts must be consistent with DN licence obligations, its obligations under the Gas Act and its wider statutory obligations (including without limitation, competition law).
- 3.105. In response to one respondent's request for clarification on how the DN targets were derived, Ofgem notes that the targets for cost of greater than 15 day interruption included in the Initial Proposals for years 2005/06 and 2006/07 were derived from LDZ targets defined at the time of the last price control and

allocated across DNs according to volume of Network Sensitive Loads (NSLs) and Transco Nominated Interruptible (TNI) sites on each DN. Ofgem continues to consider this to be the most appropriate methodology to use to specify these targets.

3.106. The targets for cost of interruptions greater than 15 days to be included in the Final Proposals are presented in Table 3.9 below⁴¹.

Table 3.9 Targets for cost of interruptions greater than 15 days

DN	2005/06	2006/07	2007/08	2008/09
	Target for cost of interruption (£m)			
Scotland	0.12	0.13	0.13	0.13
North of England	0.22	0.23	0.23	0.24
North West	0.08	0.08	0.09	0.09
East of England	0.82	0.87	0.89	0.96
London	0.05	0.06	0.06	0.06
West Midlands	0.00	0.00	0.00	0.00
Wales and West	0.19	0.20	0.21	0.21
South of England	0.11	0.12	0.12	0.12
Total	1.59	1.68	1.73	1.82

3.107. Ofgem continues to consider it inappropriate to include a charges foregone term in interim DN incentive schemes. The DN incentive scheme as proposed has been designed as a simple mechanism, allowing DNs to compare the cost of incremental NTS offtake rights with the cost of securing demand management tools from DN connectees. Ofgem does not consider that the concept of charges foregone is an integral part of this trade-off, and that its inclusion is likely to reduce the transparency of the incentive scheme.

3.108. Since publication of the Initial Proposals, Transco has informed Ofgem that a number of base allocations of NTS offtake rights have been revised, as a result of the correction of a spreadsheet error, and a mistake in the planning process last summer (in respect of the NTS offtake flexibility requirements of one DN). Ofgem has presented these changes in base allocation volumes to the DISG, and

⁴¹ Note that these differ slightly from those in the Initial Proposals following correction of a rounding error.

considers it appropriate for these to be included in the Final Proposals. These allocations are included in Appendix 4 to this document.

Level of caps, collars and sharing factors

Ofgem's initial proposals

- 3.109. As noted above, Ofgem proposed in the Initial Proposals consultation that DN incentive schemes should be structured following a standard "sliding scale" form, and that a cap and collar for the scheme be defined. In addition, it was proposed that where the actual performance measure deviated from the defined incentive targets, then the resulting incentive costs / revenues would be shared between DNs and their customers according to defined (upside and downside) sharing factors.
- 3.110. Ofgem's initial view was that caps and collars for DN cost performance measures should be calculated as a fixed percentage of each DN's cost performance target (hence the absolute level of DN caps and collars would vary significantly across each network). Ofgem considered that this approach would reflect the locational nature of both exit charges and demand and would ensure that incentive schemes are accurately targeted across the network. Ofgem also proposed that these caps and collars should be symmetrical around defined targets.
- 3.111. Ofgem proposed that sharing factors for the incentive schemes should also be defined. Ofgem proposed that these should be relatively high, given that DNs will face the full cost of the use of demand management tools and/or any investment in their own networks (to the extent that this is possible in the interim period).
- 3.112. Ofgem proposed two alternative options for incentive parameters, applicable to each DN in the interim period. These are presented in Table 3.10.

Table 3.10 Parameters for DN incentive schemes: initial proposals

	Cap and Collar (% of each DN target)		Sharing factors	
	Cap	Collar	Upside	Downside
Option 1	7.5%	-7.5%	100%	100%
Option 2	10%	-10%	75%	75%

3.113. Ofgem considered that both of these options would give an appropriate balance of risk and reward for the DNs and their customers.

Respondents' views

NGT

3.114. Transco's RDNs suggested it would be sensible for the caps and collars for DN incentive scheme to be set such that they are set at the extremities of the likely range of the out-turn of the cost performance measure. This respondent stated that the costs of interruption together with any investment costs incurred should be included directly in the incentive, and considered that if this approach was followed, then a low sharing factor (of the order of 5%) would be sufficient to overcome the weak incentive to overbook NTS offtake rights.

Potential purchasers

3.115. One potential buyer considered the caps and collars presented in the options to be too broad, exceeded the levels necessary to purchase the required volumes of offtake rights and instead favoured caps and collars of 2%. This respondent agreed, however that incentive scheme parameters should be symmetrical.

3.116. Another potential buyer stated that it was indifferent between the two options proposed, though marginally favoured Option 1 given that this had the highest sharing factor (hence was more consistent with Ofgem's Initial Thoughts on enduring incentive schemes).

3.117. One potential buyer stated explicitly that it was appropriate to define caps and collars as a percentage of targets. This potential purchaser favoured the Option 2 combination of cap, collar and sharing factors on the basis that a high cap and

collar combined with a positive sharing factor would, to a degree, protect shippers from any significant underperformance by DNs. A balanced sharing factor would also give limited protection to inexperienced DNs.

Shippers/suppliers

- 3.118. One of these respondents stated a preference for Option 1, on the basis that this alternative has the highest sharing factor (hence would ensure DNs are fully exposed to the benefits and losses associated with the trade-off between purchasing additional NTS offtake rights and demand management tools).

Other

- 3.119. The AEP considered that Option 1 for the parameters for the DN incentive scheme would be most appropriate.

Ofgem's final proposals

- 3.120. Ofgem continues to consider that a 100% sharing factor is most appropriate for the DNs. Ofgem favours this approach as it considers that this will give DNs a strong incentive to trade-off efficiently the cost of incremental NTS offtake rights for the cost of substitutable demand management tools (assuming that the cap or collar of each DN's incentive is not breached).
- 3.121. Ofgem also notes that the Option 1 combination of parameters and sharing factors was favoured by a number of respondents. Ofgem also considers it appropriate to define DN caps and collars as a percentage of cost performance targets, as this will reflect the locational nature of both exit charges and demand and will ensure that incentive schemes are accurately targeted across the network.
- 3.122. On balance, Ofgem therefore considers the Option 1 combination of caps, collars and sharing factors most appropriate for inclusion in Final Proposals (as described in Table 3.10).
- 3.123. It should be noted that, given the relatively short duration of the interim incentive scheme, the possibility of a reopener after one year and the interaction between a new incentive scheme and the existing DN price controls, Ofgem does not expect to modify the Regulatory Asset Values (RAVs) of the DNs at the

time of the next price control review to take account of NTS offtake related investment⁴². Ofgem will consider the interaction between the new incentive scheme and the DN price controls in the ongoing discussion on enduring incentive schemes.

Income adjusting events

- 3.124. Under the current NTS price control, the NTS can apply for an event to be designated an IAE if it meets certain criteria. These provisions are to be extended to DNs.
- 3.125. In the NTS provisions, the scheme is specific in scope. It applies only to the NTS SO, and not to the TO. It may arise from revenue lost or gained because of *force majeure*, a network gas supply emergency, the termination of a shipper, or any other event which, in the opinion of the Authority, is an IAE. In all cases except supply emergency or shipper termination, the event must first have an impact on NTS SO costs above a certain threshold in order to be considered.
- 3.126. The circumstances through which an IAE may be applied for are defined in the licence drafting. However, Ofgem considers that the only DN costs in the interim arrangements that are comparable to those included in the NTS provisions are the costs of exit capacity, flow flexibility and interruptions. Consistent with the NTS scheme, if an event causes a change in these costs of more than some threshold amount, then the licensee will be able to apply for an income adjustment for this event, which may then be considered by the Authority.
- 3.127. In the NTS scheme, the threshold is set at £2 million and Ofgem does not propose to make any changes to this as part of this review.
- 3.128. Ofgem proposes also to set the threshold for each DN at £2 million for the interim arrangements. This has implications for the smaller DNs, as their relevant costs are expected to be such that their exposure to any event is likely lower than this threshold. In fact, for two of the DNs, this threshold is larger than their total expected costs of exit capacity, flow flexibility, and interruptions. However the

⁴² For the purposes of this document, NTS offtake related investment is defined as being those DN investments that are substitutable for NTS exit capacity rights or NTS exit flow flexibility rights.

administration involved in the Authority approving an IAE is not costless (hence the reason for a threshold in the first place). A threshold of £2 million is reasonable for the initial period and consistent with the NTS scheme. A single threshold across all licensees is also consistent with how IAEs are treated in the electricity transmission regime.

3.129. The proposals on IAE were discussed at DISG 40⁴³, and comments on the appropriate IAE threshold were received informally from two potential purchasers. One potential purchaser stated that the IAE provision should apply for a local gas supply emergency as well as a network gas supply emergency. However, a network gas supply emergency inherently has more impact than a local gas supply emergency. Given that a local gas supply emergency still has impact on the NTS, if it were appropriate to include it in the IAE provisions, the NTS provisions would simply have been for a 'gas supply emergency' rather than the more restrictive 'network gas supply emergency'.

3.130. Both of these potential purchasers also stated that the threshold should be related to DN cost targets in some way, to allow for the differences between DNs. Ofgem have considered this, but believe that for the interim arrangements, it is appropriate to keep consistency with the NTS scheme. The threshold will be revisited in the context of the enduring offtake incentive scheme.

⁴³ Held on 19 April 2005.

4. Part B – Licence consultation – Proposals with respect to 1 May licence conditions

Overview

- 4.1. In this chapter we provide explanatory text for the formal licence consultation under section 23 of the Gas Act (the Notice for which is contained in Appendix 6 to this document). This formal licence modification consultation concerns the following issues:
- ◆ Ofgem’s final proposals for interim incentives as outlined in Part A of this document;
 - ◆ where appropriate, licence modifications designed to address views raised by respondents, both in formal responses to the February document, and in informal responses received from industry participants; or
 - ◆ provide clarification / corrections which are deemed to be in customers’ interests following an internal review of the drafting within Ofgem.
- 4.2. Schedule 1 of the section 8AA and section 23 directions, published on 25 April 2005 (“the Schedule”), considered the views raised in responses to the February document. The Schedule stated that Ofgem proposed to address a number of the issues raised within responses in this formal section 23 consultation (referred to as the April section 23 consultation in the Schedule).
- 4.3. In this chapter only those views expressed in responses to the February document that were highlighted in the Schedule as being issues that should be addressed in this consultation are repeated. These are supplemented, as appropriate, by issues raised by industry participants on an informal basis, either in response to the February document, or during, or in response to, discussions at DISG meetings.
- 4.4. This chapter therefore includes, with respect to each condition for which changes are proposed:

- ◆ a brief description of the licence condition;
 - ◆ a summary of the background to the development of the modification proposals, including any responses received to the February document that have informed development of the proposed modifications; and
 - ◆ Ofgem’s views and associated proposals for modification.
- 4.5. In each case, Ofgem invites respondents’ views on all of the proposed modifications.
- 4.6. The information in this document is not binding on the Authority. Nothing in this document 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 document.

Existing licence conditions – Part A

Standard Special Condition A3 – Definitions and Interpretation

Description

- 4.7. This condition explains and defines the key terms used in Parts A, B, C, D and E of the licence unless the context otherwise requires.

Background & respondents’ views

- 4.8. A potential purchaser commented informally that a number of definitions would benefit from clarification. This potential purchaser was concerned that the lack of grammatical instruments in certain sentences could result in the definitions to which the sentences relate being misconstrued. For example, the definition of “transportation business”, following the changes introduced pursuant to the section 8AA direction would read:

“the activities of the licensee connected with the development, administration, maintenance, and operation of the transportation system and with the supply of transportation services but excluding the metering business other than in relation to the following conditions.... [a number of conditions are listed].”

- 4.9. The potential purchaser was concerned that in this definition it was not clear whether the “other than” related to the exclusion of the metering business and the meter reading business or the applicability of the entire definition. The same comment applied in respect of the definitions of “licensee”, “relevant shipper”, “relevant supplier” and “supply of transportation services”.
- 4.10. Furthermore, following a review by Ofgem of the consistency of licence definitions with those proposed in the Uniform Network Code (UNC) and discussions with NGT, it was proposed that it would be appropriate to amend the definition of “constraint management” such that it no longer referred to the network code, as neither “constraint management” nor the “management of capacity rights” are defined terms in the network code.
- 4.11. Finally, following consideration of the financial structures of the potential purchasers and which entities would be captured by the definition of “affiliate” directed as part of the section 8AA/section 23 changes in the February document, Ofgem has decided that the definition of “affiliate” should be subject to modification in advance of share sale in order to ensure that all appropriate affiliates and related undertakings fall within the scope of the relevant licence conditions.
- 4.12. Proposed amended drafting for this condition was circulated for comment following DISG 40. Minutes of this meeting are provided in Appendix 2.

Ofgem’s proposals

- 4.13. Ofgem notes the comments raised by a potential purchaser, and proposes to reword the definitions of “licensee”, “relevant shipper”, “relevant supplier” “transportation business” and “supply of transportation services” to make it clear that the definition in its entirety is subject to the alternative definitions in the listed conditions. To achieve this the following new sentence has been introduced into the conditions:
- “This definition will apply other than in relation to....[the listed conditions]”.
- 4.14. Furthermore, as stated above, Ofgem proposes to modify the definition of “constraint management” such that the phrase “as defined in the network code” is deleted.

- 4.15. As stated above, following further consideration of the definition of “affiliate”, Ofgem has decided that the definition of “affiliate” following share sale should be broader in scope. As such, Ofgem proposes to reinstate the definition of “affiliate” as previously stated in Amended Standard Condition 1 of Transco’s licences. Ofgem would note that this revised definition would apply to all NTS and DN-GTs. However, if the broader definition causes difficulties with respect to specific conditions, Ofgem would be willing to consider applications for consent to be exempted in part from the condition.
- 4.16. Ofgem invites respondents’ views on its proposals for Standard Special Condition A3, the detailed drafting of which are set out in full in Appendix 7A. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Standard Special Condition A4 – Charging – General

Description

- 4.17. This licence condition requires the licensee to provide the Authority with charging statements. This condition also requires that the licensee shall use all reasonable endeavours to provide at least 150 days’ notice to the Authority in the event of a proposed change to its transportation charges.

Background & respondents’ views

- 4.18. In its response to the February document, one shipper/supplier noted that it may be clearer to reword paragraph 2(d) so that it reads “give the Authority notice of any proposals to change the charges or reserve charges mentioned in paragraph 1 which it is considering...”.
- 4.19. Proposed amended drafting for this condition was circulated for comment following DISG 40. Minutes of this meeting are provided in Appendix 2.

Ofgem’s proposals

- 4.20. Ofgem notes the comments from a shipper/supplier and proposes to clarify the drafting of paragraph 2(d) by introducing a comma after the word “considering” in the first line of this sub-paragraph.

- 4.21. Ofgem invites respondents' views on its proposals for Standard Special Condition A4, which are shown in Appendix 7A. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Standard Special Condition A5 – Obligations as Regard Charging Methodology

Description

- 4.22. This licence condition describes the objectives of a charging methodology, sets out that the licensee shall not make a modification of the charging methodology unless certain conditions are met and states that the licensee shall keep the charging methodology at all times under review.

Background & respondents' views

- 4.23. In its response to the February document, one shipper/supplier noted that the third relevant objective set out in sub-paragraph 5(b) should be applicable as far as it is consistent with the first two relevant objectives (set out in sub-paragraphs (a) and (b)) and not just the first objective as currently drafted.
- 4.24. This shipper/supplier also stated that it would be helpful to provide an end date in each year by which the report required under paragraph 3 should be furnished to the Authority.
- 4.25. Proposed amended drafting for this condition was circulated for comment following DISG 40. Minutes of this meeting are provided in Appendix 2.

Ofgem's proposals

- 4.26. Ofgem agrees with the comment made by a shipper/supplier, and proposes to change sub-paragraph 5(c) such that it applies as far as is consistent with sub-paragraphs 5(a) and 5(b).
- 4.27. Furthermore, in relation to the shipper/supplier's comments on the end date by which the report required under paragraph 3 should be furnished to the Authority, Ofgem would note that this report covers the 12 month period preceding 1 October in each formula year and that, as such, licensees would

have a six month window with which to comply with their licence. However, Ofgem would note that the previous drafting of Transco's licences related to the calendar year and, as such, the implicit deadline was 31 December. In order to maintain consistency, Ofgem therefore proposes to insert the words "by 31 December in that formula year".

- 4.28. Ofgem invites respondents' views on its proposals for Standard Special Condition A5, which are shown in Appendix 7A. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Standard Special Condition A8 – Emergency Services and Enquiry Service Obligations

Description

- 4.29. This licence condition sets out a number of obligations on the licensee with respect to emergency services. These include:
- ◆ **telephone service.** A requirement to establish, or procure the establishment of, and operate and maintain a single free of charge, efficiently run, well publicised, continuously manned emergency telephone number, including arrangements for the deaf and blind;
 - ◆ **domestic supplies and minor repairs.** A requirement to prevent gas escapes in such a way as to maintain, as far as reasonably practicable, the supply to domestic premises for heating and cooking; and
 - ◆ **requirements on personnel.** A requirement for work to be completed by trained persons able to recognise leakage of carbon monoxide who will inform the owner or the occupier of the relevant premises about the carbon monoxide risks.

Background & respondents' views

- 4.30. One shipper/supplier stated, as part of their response to the February document, that paragraphs 12 and 13 referred to "arrangements" without stating that these arrangements were those referred to in paragraph 8 and, as such, there was a lack of clarity.

- 4.31. Proposed amended drafting for this condition was circulated for comment following DISG 40. Minutes of this meeting are provided in Appendix 2.

Ofgem's proposals

- 4.32. Ofgem notes the comments from a shipper/supplier and proposes to clarify the drafting of paragraphs 12 and 13 by inserting the phrase "referred to in paragraph 8" after "arrangements" in these paragraphs.
- 4.33. Ofgem invites respondents' views on its proposals for Standard Special Condition A8, which are shown in Appendix 7A. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Standard Special Condition A11 – Network Code and Uniform Network Code

Description

- 4.34. This licence condition obliges the licensee to establish a network code and, together with other NTS and DN-GTs, a uniform network code (UNC).
- 4.35. The network code and UNC must be established to facilitate the achievement of one of a number of specified "relevant objectives", including, but not limited to, the following:
- ◆ the efficient and economic operation of its pipe-line system;
 - ◆ so far as is consistent with the above, the coordinated, efficient and economical operation of (i) the combined pipe-line system, and/ or (ii) the pipe-line system of one or more other relevant GTs;
 - ◆ so far as is consistent with the above, the efficient discharge of the licensee's obligations under this licence; and
 - ◆ so far as is consistent with the above, the securing of effective competition:
 - ◆ between relevant shippers;

- ◆ between relevant suppliers; and/or
- ◆ between DN operators (who have entered into transportation arrangements with other relevant GTs) and relevant shippers; and
- ◆ so far as is consistent with the above, the promotion of efficiency in the implementation and administration of the network code and/or the UNC.

4.36. This licence condition also requires that the UNC includes network code modification procedures which set out the procedures for reviewing the UNC and the network code (unless the Authority otherwise consents) and the conduct of proposals.

Background & respondents' views

4.37. One potential purchaser stated, in its response to the February document, that in order to be consistent with sub-paragraph 1(a), the reference to "economical" in paragraph 1(b) (which sets out the relevant objective relating to the coordinated, efficient and economical operation of (i) the combined pipe-line system, and/ or (ii) the pipe-line system of one or more other relevant GTs) should be changed to "economic".

4.38. One shipper/supplier stated, in its response to the February document, that the drafting of paragraph 19(1) may be ambiguous as it seemed to imply that there was a question as to whether the UNC would be implemented.

4.39. Proposed amended drafting for this condition was circulated for comment following DISG 40. Minutes of this meeting are provided in Appendix 2.

Ofgem's proposals

4.40. Ofgem notes the change proposed by the potential purchaser, and proposes to make this change to achieve the desired consistency.

4.41. Furthermore, to address the concerns raised by a shipper/supplier, Ofgem proposes to replace the word "it" in the final line of paragraph 19(a) with the words "such a proposal".

4.42. Ofgem invites respondents' views on its proposals for Standard Special Condition A11, which are shown in Appendix 7A. Nothing in this consultation

document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Standard Special Condition A12 – Joint Office Governance Arrangements

Description

- 4.43. This licence condition requires the licensee, together with all other relevant GTs, to establish, operate and develop arrangements (joint governance arrangements) for:
- ◆ the administration of the network code and UNC modification procedures;
 - ◆ administering the coordination of the modification of the licensee's and other relevant GTs' respective charges, reserve prices or charging methodologies;
 - ◆ the administration of such matters as are provided for in the UNC, consistent with the provisions of Standard Special Condition A15 (Agency);
 - ◆ the promotion of efficiency in the implementation and administration of the network code and/or UNC; and
 - ◆ such other matters as they may decide, subject to their licence and statutory obligations.

Background & respondents' views

- 4.44. Paragraph 1(a) of Standard Special Condition A12 obliges the licensee to establish, operate and develop arrangements (Joint Governance Arrangements) to carry out specified administrative functions. In its response to stage 1 of the consultation on network code arrangements, Gemserv noted that in paragraph 1(a), the use of the phrase "establish, operate and develop" may be restrictive and that it may be more efficient and economic if transporters were required to "establish, develop, operate or procure the operation of" the arrangements.

- 4.45. Proposed amended drafting for this condition was circulated for comment following DISG 40. Minutes of this meeting are provided in Appendix 2.

Ofgem's proposals

- 4.46. In relation to Gemserv's proposal that the drafting of paragraph 1(a) should require the licence to "procure the operation of" as well as "establish, develop and operate", Ofgem agrees that this change would be beneficial in affording maximum flexibility of options to DN and NTS-GT licensees and therefore proposes this change as part of this consultation.
- 4.47. Ofgem invites respondents' views on its proposals for Standard Special Condition A12, which are shown in Appendix 7A. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Standard Special Condition A15 – Agency

Description

- 4.48. This licence condition requires the licensee, together with all other relevant GTs, to enter into an agency services agreement with the other relevant GTs providing for the common provision of services and systems, the scope of which shall be set out in the UNC.

Background & respondents' views

- 4.49. One shipper/supplier noted in their response to the February document that sub paragraph 3(iii) states "the costs of the agency shall be allocated between the users of the agency on a transparent basis". This shipper/supplier pointed out that the term "users" was not defined and had a specific meaning in the network code, which may cause confusion. This shipper/supplier suggested that, given the intention is that GTs should meet the costs of the agency throughout the remainder of the current price control period, "users" should either be defined to be "gas transporters" or replaced with "gas transporters".
- 4.50. Proposed amended drafting for this condition was circulated for comment following DISG 40. Minutes of this meeting are provided in Appendix 2.

Ofgem's proposals

- 4.51. Ofgem has considered the comments raised by a shipper/supplier. Ofgem notes that the use of the term "users" without being defined may cause confusion. As such, Ofgem proposes to remove the phrase "between the users of the agency" from the drafting of Standard Special Condition A15 such that the detail of the cost allocation process is managed outside the licence, and can adapt to future changes in arrangements as appropriate.
- 4.52. Ofgem invites respondents' views on its proposals for Standard Special Condition A15, which are shown in Appendix 7A. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Standard Special Condition A29 – Change of Financial Year

Description

- 4.53. This licence condition states that where the licensee changes its financial year in relation to its statutory accounts, it must provide notice to the Authority, specifying the new dates for the current and subsequent financial years which will continue in force unless revoked by the licensee by a further notice.

Background & respondents' views

- 4.54. In the February document, Ofgem noted that to the extent to which any inconsistencies remained between the electricity Distribution Network Operator (DNO) and GT licences with respect to this condition, they may be corrected as part of a further section 23 process subsequent to hive-down (i.e. this section 23 process).
- 4.55. Since modification of the DNO licence conditions, Ofgem has performed a review of those financial conditions in the DNO licences that have equivalent conditions in the licences of relevant GTs. This review has flagged a number of minor modifications necessary to bring the text in these conditions into line (insofar as the text is not GT or DNO specific).

- 4.56. Proposed amended drafting for this condition was circulated for comment following DISG 40. Minutes of this meeting are provided in Appendix 2.

Ofgem's proposals

- 4.57. Following a comparison of the drafting for Standard Special Condition A29 as published in the February document to the drafting for the equivalent DNO licence condition, which came into effect on 1 April, Ofgem does not consider it necessary to make any substantive changes to the condition.
- 4.58. Ofgem does however propose to make one minor typographical modification, which is the removal of "sub-" from paragraph 4.
- 4.59. Ofgem invites respondents' views on its proposals for Standard Special Condition A29, which are shown in Appendix 7A. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Standard Special Condition A30 – Regulatory Accounts

Description

- 4.60. This licence condition sets out the obligations of the licence holder in respect of its regulatory accounts. It includes (without limitation) the duty to produce annual regulatory accounts in respect of each of its separate businesses (unless the Authority otherwise consents in writing) and to provide copies of these to the Authority.

Background & respondents' views

- 4.61. In the February document, Ofgem noted that to the extent to which any inconsistencies remained between the DNO and GT licences with respect to this condition, they may be corrected as part of a further section 23 process subsequent to hive-down (i.e. this section 23 process).
- 4.62. Since modification of the DNO licence conditions, Ofgem has performed a review of those financial conditions in the DNO licences that have equivalent conditions in the licences of relevant GTs. This review has flagged a number of

minor modifications necessary to bring the text in these conditions into line (insofar as the text is not GT or DNO specific).

- 4.63. Proposed amended drafting for this condition was circulated for comment following DISG 40. Minutes of this meeting are provided in Appendix 2.

Ofgem's proposals

- 4.64. Following a comparison of the drafting for Standard Special Condition A30, as published in the February document against the drafting for the equivalent DNO licence condition, which came into effect on 1 April, Ofgem proposes the following minor modifications:

- ◆ deletion of the comma after "other records" in the third line of paragraph 1;
- ◆ deletion of "sub-" in paragraphs 4, 6 and 8(a);
- ◆ deletion of the comma after "company" in paragraph 7(a)(i) and the change of the semi-colon to a comma at the end of this sub-paragraph;
- ◆ deletion of the comma after "substituted" in paragraph 13; and
- ◆ replacement of "describing" with "which describes" in paragraph 17 (b).

- 4.65. Ofgem invites respondents' views on its proposals for Standard Special Condition A30, which are shown in Appendix 7A. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Standard Special Condition A33 – Restriction on Use of Certain Information and Independence of the Transportation Business

Description

- 4.66. This licence condition restricts the flow of confidential information between the transportation business, the trading business, any relevant supplier, relevant

shipper and pursuant to the changes brought about through the RGMA process, the licensee's meter-related services business and meter reading business.

- 4.67. The condition requires the licensee to have in place managerial and operational systems to prevent specified persons from having access to confidential information except in specified circumstances.
- 4.68. It also requires the licensee to manage and operate its transportation business to ensure that it doesn't restrict, prevent or distort competition in the supply of electricity or gas, the shipping of electricity or gas, the generation of electricity, any trading business or in supply of metering relating services or meter reading.
- 4.69. The licensee must also have in place a statement, approved by the Authority, describing the practices, procedures and systems it has adopted to secure compliance with the requirements of this condition and must use best endeavours to comply with this statement.

Background & respondents' views

- 4.70. NGT stated informally that it could accept the licence condition as it is, provided that there is provision for the Authority, by written consent, to relieve licensees of their obligations under paragraph 2 (which Ofgem had suggested in the February licence consultation that it may consider removing). NGT also stated that the Authority must be able, by written consent, to relieve licensees of their obligations under paragraph 6(b) so that separate branding for the regulated meter service was not required. NGT also commented generally that the business separation conditions already go further than is required in several aspects when the total transparency of any potential wrongdoing and the degree and impact of any risk is fully understood and considered.
- 4.71. One potential purchaser noted, on an informal basis, that paragraph 3 (the requirement on the licensee to manage and operate its transportation business to ensure that it doesn't restrict, prevent or distort competition in activities including meter reading) would make more sense if "or meter reading" at the end of this paragraph was changed such that it read "or of meter reading services".
- 4.72. One shipper/supplier stated, in their response to the February document, that they did not believe that the current drafting of Standard Special Condition A33

was sufficiently broad to cover prevention of access to confidential information by any related generation businesses in the same group of companies. This shipper/supplier noted that this principle would need to flow throughout the condition via a number of paragraphs, for example 6(c) and associated subparagraphs.

- 4.73. Proposed amended drafting for this condition was circulated for comment following DISG 40. Minutes of this meeting are provided in Appendix 2.

Ofgem's proposal

- 4.74. Ofgem notes the comments made by NGT and proposes to retain the consent provision in paragraph 2. Furthermore, following informal discussions with NGT about the difficulties they face in ensuring separate branding of their transportation business and their meter provider of last resort business, Ofgem proposes to introduce a consent provision into paragraph 6 to allow the Authority to consider applications for limited exclusions to the provisions of paragraph 6, in particular in relation to metering rebranding. However, should evidence arise that indicates conduct in relation to branding is giving rise to anti-competitive concerns Ofgem will consider whether any action is required under either Standard Special Condition A33, or under other statutory powers available to it including those contained in the Competition Act 1998 or the Enterprise Act 2002.
- 4.75. Ofgem notes the comment made by a potential purchaser and proposes to implement the modification suggested as part of this consultation.
- 4.76. Furthermore, in relation to the comment made by a shipper/supplier, Ofgem believes that it is necessary to amend this licence condition to ensure that this licence condition achieves the necessary separation between the competitive and monopoly businesses. As stated above, the concern that has been raised relates to whether the licence condition fully addresses the competitive and monopoly separation in relation to those licence holders who also hold an interest in a generation business.
- 4.77. As such, the following modifications are proposed:

- ◆ introduce a definition of a “relevant generator”, which is defined to be the holder of an electricity generation licence which is an affiliate or related undertaking of the licensee; and
- ◆ introduce the term “relevant generator” to the list of businesses from which separation is required into paragraphs 2 and 6 as appropriate; and
- ◆ insert “electricity generator” in paragraph 2(a), such that the licensee can make confidential information available to electricity generators to the extent that the information is being made available on an equal basis to all other electricity generators.

4.78. In the process of reviewing the drafting of Standard Special Condition A33, Ofgem has also determined that it is appropriate to expand the definition of “trading business” so that it captures activities connected with the acquisition, disposal and consumption of electricity as well as gas.

4.79. Ofgem also proposes to clarify the exclusions to the definition of “trading business” as follows:

- ◆ a number of exclusions to the definition of trading business are set out in the definition. As previously drafted, it appeared that these exclusions only applied to a sub-section of the definition. Ofgem intends to clarify the definition so that it is clear that the exclusions to the definition relate to the whole definition to the extent that they are applicable, rather than just to sub-paragraph (c);
- ◆ to replace the reference to “the efficient operation of the pipe-line system to which this licence relates or the replacement of gas lost from that system” with the defined term “supply of transportation services” in order to ensure greater consistency throughout the licence; and
- ◆ to clarify which of the exclusions to the definition are specific to the trading business of the licensee and which relate to trading businesses more generally.

4.80. Furthermore, Ofgem considers that it would be clearer if the consent provision (in sub-paragraph 2(c)) came at the beginning of paragraph 2 instead of as a sub-paragraph and is therefore proposing to make this change.

- 4.81. Ofgem invites respondents' views on its proposals for Standard Special Condition A33, which are shown in Appendix 7A. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Standard Special Condition A36 – Restriction on Activity and Financial Ring Fencing

Description

- 4.82. This condition prohibits the licensee from holding or acquiring shares or investments of any kind unless they comply with specified exceptions, or the Authority has granted its consent. This condition also enables the Authority to grant its consent to the licensee conducting certain businesses, and specifies a definition of de minimis business and a cap, which the level of de minimis business must not exceed.

Background & respondents' views

- 4.83. In the February document, Ofgem noted that to the extent to which any inconsistencies remained between the DNO and GT licences with respect to this condition, they may be corrected as part of a further section 23 process subsequent to hive-down (i.e. this section 23 process).
- 4.84. Since modification of the DNO licence conditions, Ofgem has performed a review of those financial conditions in the DNO licences that have equivalent conditions in the licences of relevant GTs.
- 4.85. Proposed amended drafting for this condition was circulated for comment following DISG 40. Minutes of this meeting are provided in Appendix 2.

Ofgem's proposals

- 4.86. Following a comparison of the drafting for Standard Special Condition A36 as published in the February document to the drafting for the equivalent DNO licence condition which came into effect on 1 April, Ofgem proposes only one minor typographical modification, which is the replacement of "its most recent

audited regulatory accounts” with “the most recent audited regulatory accounts” in paragraph 4b(i) of this condition.

- 4.87. Ofgem invites respondents’ views on its proposals for Standard Special Condition A36, which are shown in Appendix 7A. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Standard Special Condition A37 – Availability of Resources

Description

- 4.88. This licence condition states that the licensee shall ensure that it has sufficient resources to carry on its transportation business properly and efficiently and to comply with all of its relevant obligations. The licensee is also obliged to submit to the Authority, each year, a Board approved certificate relating to the adequacy of its resources to carry on the activities authorised by the licence.
- 4.89. This condition also includes a requirement for a specific certificate before any dividend or distribution may be paid or made or any share capital of the licensee is redeemed or repurchased and prohibits such dividends or distributions if the requisite certificate is not provided.

Background & respondents’ views

- 4.90. In the February document, Ofgem noted that to the extent to which any inconsistencies remained between the DNO and GT licences with respect to this condition, they may be corrected as part of a further section 23 process subsequent to hive-down (i.e. this section 23 process).
- 4.91. Since modification of the DNO licence conditions, Ofgem has performed a review of those financial conditions in the DNO licences that have equivalent conditions in the licences of relevant GTs. This review has flagged a number of minor modifications necessary to bring the text in these conditions into line (insofar as the text is not GT or DNO specific).
- 4.92. Proposed amended drafting for this condition was circulated for comment following DISG 40. Minutes of this meeting are provided in Appendix 2.

Ofgem's proposals

- 4.93. Following a comparison of the drafting for Standard Special Condition A37 as published in the February document to the drafting for the equivalent DNO licence condition which came into effect on 1 April, Ofgem proposes only two minor modifications:
- ◆ removal of the commas after “certificate” and “paragraph 2” in paragraph 6; and
 - ◆ replacement of “nor shall the licensee” with “and the licensee shall not” and change of the remaining “nor” to “or” in the opening phrase of paragraph 7.
- 4.94. Ofgem invites respondents' views on its proposals for Standard Special Condition A37, which are shown in Appendix 7A. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Standard Special Condition A38 – Credit Rating of the Licensee

Description

- 4.95. This licence condition obliges the licensee to take all appropriate steps to maintain an investment grade issuer credit rating at all times.

Background & respondents' views

- 4.96. In its response to the February document, MGN Gas Networks (UK) Limited (MGN) noted that they had been advised by Ofgem that a Moody's senior implied rating would be acceptable. However, they questioned why, if this is the case, such a rating should be excluded on the face of the licence condition. MGN stated that it would be better to make the acceptability of such a credit rating explicit in the licence drafting rather than issuing an exemption or derogation letter in this regard. MGN also stated that it would be helpful for the condition to leave some flexibility for any future rating category that is issued and that would satisfy Ofgem's requirements.

- 4.97. Proposed amended drafting for this condition was circulated for comment following DISG 40. Minutes of this meeting are provided in Appendix 2.

Ofgem's proposals

- 4.98. Ofgem notes that, in the case of whole-of-business securitisation structures (but not necessarily in any other case), a Moody's "senior implied" credit rating can be considered to be equivalent to an "issuer" rating and that, accordingly, Ofgem would be prepared to accept holding of such a rating of requisite grade as consistent with the requirements of Standard Special Condition A38.
- 4.99. However, because the judgement made by Ofgem in this instance is relevant to a particular type of financing structure, Ofgem does not consider it appropriate to modify network owner licences to admit such ratings as eligible in all cases. Ofgem wishes to retain the discretion to rule such ratings ineligible in any case where they would be inappropriate i.e. where, because of the structure, they were not considered to be equivalent to an "issuer" rating. The same applies to any other rating category that might, in some circumstances but not in others, satisfy Ofgem's requirements.
- 4.100. As a result, Ofgem proposes licence modifications to Standard Special Condition A38 (Credit Rating of the Licensee) as part of this consultation such that the concerns expressed by MGN are addressed while retaining flexibility for Ofgem to assess the merits of each new case individually.
- 4.101. The modifications proposed therefore amend sub-paragraph (d) of the definition of "issuer credit rating" and sub-paragraph (a)(iv) of the definition of "investment grade" in paragraph 2, such that the Authority can notify the licensee, in writing, of a rating (issued by Standard & Poor's Ratings Group, Moody's Investors Service Inc. or Fitch Ratings Ltd) which is, in its opinion, equivalent to those stated on the face of the licence as being acceptable. Once this provision is in place, the Authority presently expects to issue such an opinion to MGN, stating that a Moody's senior implied rating is, in the case of this licensee, acceptable for the purposes of Standard Special Condition A38. This expectation is held on the basis of the information currently available to the Authority relating to, inter alia, MGN's proposed financing structure and the published ratings of Moody's Investor Services and may be revised in the light of further information.

- 4.102. Furthermore, Ofgem proposes to modify the equivalent condition of the DNO licences (Standard Condition 46) as part of a future licence consultation such that it is consistent with the changes proposed as part of this consultation.
- 4.103. Ofgem invites respondents' views on its proposals for Standard Special Condition A38, which are shown in Appendix 7A. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Standard Special Condition A39 – Indebtedness

Description

- 4.104. This licence condition prevents the licensee from incurring, without the prior consent of the Authority, inappropriate indebtedness or giving any form of security or guarantee unless it is on an arm's length basis, on normal commercial terms and for a permitted purpose and, where relevant, in accordance with Standard Special Condition A27 (Disposal of Assets).
- 4.105. This licence condition requires the prior written consent of the Authority for transfers, leases etc, of any asset, right, sum or benefit etc. to any affiliate or related undertaking subject to certain exceptions.

Background & respondents' views

- 4.106. In the February document, Ofgem noted that to the extent to which any inconsistencies remained between the DNO and GT licences with respect to this condition, they may be corrected as part of a further section 23 process subsequent to hive-down (i.e. this section 23 process).
- 4.107. Since modification of the DNO licence conditions, Ofgem has performed a review of those financial conditions in the DNO licences that have equivalent conditions in the licences of relevant GTs. This review has flagged a number of minor modifications necessary to bring the text in these conditions into line (insofar as the text is not GT or DNO specific).

Ofgem's proposals

- 4.108. Following a comparison of the drafting for Standard Special Condition A39, as published in the February document, against the drafting for the equivalent DNO licence condition, which came into effect on 1 April, Ofgem proposes only three minor modifications:
- ◆ to realign the final phrase of paragraph 1(b), insert a comma after “however”, and replace the full stop after “therein” at the end of this phrase with a semi-colon;
 - ◆ insert a comma after “however” in the final phrase of paragraph 1; and
 - ◆ insert “of” after “arising, “ in the definition of “cross-default obligation” in paragraph 5.
- 4.109. Furthermore, following further review, Ofgem has established that sub-paragraph (iii) of the definition of “cross-default obligation” in paragraph 5 requires amendment to capture sub-paragraphs (b) and (c) within the definition of “permitted purpose” in Standard Special Condition A32 as well as sub-paragraph (a), i.e. to capture the metering business and meter reading business as well as the transportation business.
- 4.110. Ofgem invites respondents' views on its proposals for Standard Special Condition A39, which are shown in Appendix 7A. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Standard Special Condition A40 - Price Control Review Information

Description

- 4.111. This licence condition relates to the provision of price control review information. From the date specified in a notice by the Authority, the licensee must ensure that it maintains accounting records necessary to enable the licensee to prepare price control review information, establish a common set of rules, which are to apply to the collection and preparation of price control review information, and to facilitate a price control review.

Background & respondents' views

- 4.112. In the February document, Ofgem noted that to the extent to which any inconsistencies remained between the DNO and GT licences with respect to financial licence conditions, they may be corrected as part of a further section 23 process subsequent to hive-down (i.e. this section 23 process).
- 4.113. Since modification of the DNO licence conditions, Ofgem has performed a review of those financial conditions in the DNO licences that have equivalent conditions in the licences of relevant GTs. This review has flagged a number of minor modifications necessary to bring the text in these conditions into line (insofar as the text is not GT or DNO specific).
- 4.114. Proposed amended drafting for this condition was circulated for comment following DISG 40. Minutes of this meeting are provided in Appendix 2.

Ofgem's proposals

- 4.115. Following a comparison of the drafting for Standard Special Condition A40, as published in the February document, against the drafting for the equivalent DNO licence condition, which came into effect on 1 April, Ofgem proposes a number of minor modifications. These are:
- ◆ the insertion of a comma after "review" in the third line of paragraph 5;
 - ◆ the deletion of the comma after "condition" in the third line of paragraph 6(b);
 - ◆ the replacement of "reviewer" in the third line of paragraph 7 with "reviewer's";
 - ◆ replacing the comma at the end of paragraph 9(b) with a semi-colon;
 - ◆ replacing the semi-colon at the end of paragraph 10(b) with a comma;
 - ◆ inserting "the" before "price control review information" in the opening phrase of paragraph 11; and
 - ◆ replacing the semi-colon at the end of paragraph 15(b) with a comma.

- 4.116. Ofgem invites respondents' views on its proposals for Standard Special Condition A40, which are shown in Appendix 7A. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Standard Special Condition A50 – System Development Obligations

Description

- 4.117. This licence condition requires that a licensee applying for an extension of its licence under section 7(4) of the Gas Act must give notice to the Health and Safety Executive (HSE) and (if required) in accordance with Standard Special Condition A51 (Information to be provided to a Designated Registrar of Pipes) the appropriate designated registrar of pipes.

Background & respondents' views

- 4.118. A potential purchaser noted, on an informal basis, that, in order to achieve consistency with the rest of the licence, the words "licensee's pipe-line system" should be changed to "pipe-line system to which this licence relates".
- 4.119. Proposed amended drafting for this condition was circulated for comment following DISG 40. Minutes of this meeting are provided in Appendix 2.

Ofgem's proposals

- 4.120. Following consideration of respondents' views, Ofgem proposes to change "licensee's pipe-line system" to "pipe-line system to which this licence relates" in paragraph 8(a) in order to ensure that this condition is consistent with other conditions in the licence.
- 4.121. Ofgem invites respondents' views on its proposals for Standard Special Condition A50, which are shown in Appendix 7A. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Existing licence conditions – Part C

Special Condition C4 – Prohibited Procurement Activities

Description

- 4.122. This licence condition requires that the licensee, any affiliate or related undertaking or business operated by the licence holder, its affiliates or related undertakings under a separate GT licence shall not enter into or otherwise acquire capacity rights, gas or gas derivatives with the intention of selling, assigning or disposing of such assets to third parties without the consent of the Authority.
- 4.123. The prohibition does not apply where the purchase or acquisition occurs for the purposes of facilitating balancing management and constraint management, so long as the transaction is conducted on economic and efficient terms and facilitates the economic and efficient operation of the transportation system.

Background & respondents' views

- 4.124. In its response to the February document, NGT stated that it continued to have concerns regarding the treatment of shrinkage. NGT's main contentions, which were raised with Ofgem in correspondence, were that prohibiting joint transactional purchase of shrinkage:
- ◆ is unrelated to network sales;
 - ◆ does not carry any risk of undue discrimination and if it is not resolved, would seem to place NGT at a disadvantage compared to IDNs and compared to its pre-network sales position; and
 - ◆ was not necessary to protect consumers.
- 4.125. Proposed amended drafting for this condition was circulated for comment following DISG 40. Minutes of this meeting are provided in Appendix 2.

Ofgem's proposals

- 4.126. Ofgem has further considered the issue of shrinkage procurement raised by NGT. Ofgem remains of the view that the joint procurement of shrinkage gas by the NTS and RDN businesses should not be allowed on the face of the licence given the potential for issues in relation to price control separation. As such, Ofgem proposes to tighten the drafting of Special Condition C4 and Standard Special Condition D4 such that it is clear that joint procurement is not allowed between parties other than DN operators, unless consent is otherwise granted.
- 4.127. Ofgem notes that it has received an application for consent from NGT such that the NTS and RDN businesses can jointly procure shrinkage gas. Ofgem also expects to receive an application for consent from Scotia Gas Networks plc to allow joint procurement between its DN licensees and its affiliated shipper business⁴⁴.
- 4.128. Ofgem therefore proposes to modify paragraph 2 such that the provision that allows "any affiliate or related undertaking, including, for the avoidance of doubt, any other business operated by the holder of this licence or its affiliates or related undertakings under a separate gas transporter licence for a relevant gas transporter" to acquire the specified commodities on the account of the licensee, is removed such that the licensee (the NTS) must procure such commodities on its own behalf, unless it has the prior written consent of the Authority or such procurement is in accordance with its functions under its network code.
- 4.129. Following informal discussions with potential purchasers, Ofgem also proposes to modify the drafting of Standard Special Condition D4 (the equivalent condition for the DNs) such that any affiliate or related undertaking of the licensee that is licensed to undertake such activities by the Authority is not subject to the prohibitions of Standard Special Condition D4. So for example, any actions undertaken by a licensed shipper, which is an affiliate or related undertaking of the licensee, shall be allowed as long as such activities are consistent with their shipper licence. The same modification is proposed to Special Condition C4, as shown in paragraph 2(a).

⁴⁴ It is Ofgem's current intention to grant such consents (to NGT prior to hive down, and to Scotia after hive down but prior to share sale) until 31 March 2007 (during which time prices to customers are fixed), for further review in 2007 when the consents expire.

- 4.130. Ofgem also proposes to clarify the drafting of paragraph 1 such that it is clear that the licensee shall procure that affiliates or related undertakings shall not undertake transactions on their own account, on behalf of the licensee, or on behalf of each other.
- 4.131. Following further consideration, Ofgem has also reached the conclusion that the terms “transportation commodities” and “balancing trade” are not required within Special Condition C4 as the reference to the acquisition or disposal of “capacity rights, gas or gas derivatives” would cover such trades within the general paragraph 1 prohibition. Furthermore, the reference to “balancing management” in the paragraph 2 exclusions should exclude such balancing trades from the general prohibition as appropriate.
- 4.132. Other minor modifications are proposed to clarify the drafting of this condition. These include (without limitation):
- ◆ changing “balancing management **and** constraint management” to “balancing management **and/or** constraint management” in paragraph 2 (d);
 - ◆ restructuring paragraphs 1 and 2 such that all exclusions / exceptions to the general prohibition are addressed in paragraph 2; and
 - ◆ replacing “so long as” with “provided that” in paragraph 2.
- 4.133. Ofgem invites respondents’ views on its proposals for Special Condition C4, which are shown in Appendix 7C. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Special Condition C8A – Revenue restriction definitions in respect of the NTS transportation owner activity and NTS system operation activity

Description

- 4.134. This condition defines a number of terms in the revenue restrictions.

Background & respondents' views

- 4.135. In response to the February document, one shipper/supplier noted that the word “that” in the definition of “firm entry capacity” was not needed and could be removed.
- 4.136. In addition, one potential purchaser made a number of comments on the drafting of Special Condition E2A, which is the equivalent licence condition for the DNs. These comments are discussed in greater detail in Schedule 1 of the section 8AA / section 23 direction published on 25 April 2005. However, as discussed later in this chapter under Special Condition E2A, a review of these comments led Ofgem to consider that it would be appropriate to clarify the applicability of the definitions in Special Conditions E2A and C8A with respect to other conditions in the licence.
- 4.137. As well as providing clarifications to the existing licence drafting and reflecting respondents' views to the February document as appropriate, changes to this licence condition are proposed to define new terms required in respect of the proposed interim incentives. In the February document, Ofgem noted that Special Condition C8A would be subject to further changes as part of a further section 23 process subsequent to hive-down to reflect the proposed incentive regimes and arrangements for offtake.
- 4.138. Proposed drafting for this condition has been circulated at, or following, DISG 38, DISG 39 and DISG 40. Minutes of these meetings are provided in Appendix 2.

Ofgem's proposals

- 4.139. Following consideration of respondents' views to the February document, Ofgem proposes to introduce the following modifications to Special Condition C8A:
- ◆ to remove the word “that” in the definition of “firm entry capacity”;
 - ◆ to include wording such that the definitions set out in paragraph 1 of this condition will apply to Special Condition C8B as well as to Special Condition C8A;

- ◆ to include a new defined term (“interruption”) in paragraph 1, consistent with the proposed licence drafting for interim incentives in Special Condition C8B; and
- ◆ to include definitions for “DM connected system exit point” and “NDM connected system exit point”, as these terms are not defined in either the licence or the UNC, and to include the terms “DM supply meter point” and “NDM supply meter point” in Special Condition C8A.

4.140. Ofgem invites respondents’ views on its proposals for Special Condition C8A, which are shown in Appendix 7C. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Special Condition C8B – Restriction of revenue in respect of the NTS transportation owner activity and NTS system operation activity

Description

4.141. This condition defines the price controls and incentives applicable in respect of the NTS transportation owner activity and the NTS system operation activity.

Background & respondents’ views

4.142. In the February document, Ofgem noted that further changes to the price control conditions may be required through this subsequent section 23 notice consultation to implement changes to incorporate:

- ◆ the interim incentive arrangements, including amongst other things, consideration of an incentive regime upon the DNs to address the removal of the > 15 day curtailment rights incentive as part of the 1 February section 23 modification, the introduction of Income Adjusting Event provisions in the DN licences to accompany the suite of incentives introduced, and further modifications as necessary to address revenue flows between the NTS and DN operators;

- ◆ changes required to reflect the outcome of Transco's pricing consultations, for example if the TO or SO commodity charges are to be passed through the DNs; and
- ◆ any changes required to ensure that charging and revenue recovery is consistent with the DTI's proposed alternative arrangements for independent systems.

4.143. Since publication of the February document, Transco has concluded that any formal pricing consultation should be run in parallel with the consultation on the enduring regime. In this period, Transco has issued informal pricing discussion documents to initiate the debate.

4.144. Furthermore, following discussions with NGT and the DTI, it is proposed that the DTI's proposed alternative arrangements for independent systems will be implemented through a series of legally enforceable undertakings on the part of Transco and the IDNs. These undertakings will ensure that customers are charged in accordance with the DTI determinations (as annexed to the DTI Statement of Reasons⁴⁵), and that the associated costs are incurred by NGT and shall not be recoverable from customers until the 1 April 2007 price control review at the earliest.

4.145. As a result, the focus of the modifications proposed to Special Condition C8B as part of this consultation is the implementation of the final proposals for the interim incentives as outlined in detail in Part A of this document.

4.146. Proposed drafting for this condition has been circulated at, or following, DISG 38, DISG 39 and DISG 40. Minutes of these meetings are provided in Appendix 2.

4.147. In response to the licence drafting circulated following DISG 40, one shipper/supplier stated that modifications in relation to embedded entry points and shrinkage in terms of payments from the DNs to the NTS should explain in greater detail the calculations performed rather than relying on the network code to provide this detail, as the network code is a modifiable document.

⁴⁵ http://www.dti.gov.uk/energy/publications/policy/sale_gas_dist_networks_reasons.pdf

Ofgem's proposals

4.148. As a result of Ofgem's final proposals on interim incentives for the NTS, Ofgem is proposing to make a number of licence modifications to Special Condition C8B, and to Special Conditions C8A and C14.

4.149. As outlined in Part A of this document, Ofgem is proposing the following incentives:

- ◆ a buy-back and greater than fifteen day interruption incentive (to give the NTS an incentive both to interrupt NTS connectees and buy back firm capacity rights as efficiently as possible) through a single (combined) mechanism;
- ◆ a constrained LNG incentive (in order to give Transco an incentive to use LNG facilities efficiently); and
- ◆ a charges foregone incentive and exit incentive target (to give Transco NTS an incentive to reduce the charges foregone as a result of the interruptible "discount" applied to shippers agreeing to have designated sites interrupted by the NTS for up to 45 days per year and also to allow Transco NTS to receive additional revenues associated with exceeding the baseline output measures set out in its GT licence).

4.150. As stated in Part A, it is proposed that the incentive schemes supporting the interim offtake arrangements will relate to the period 1 June 2005 (the date on which it is anticipated that these conditions will become effective) to 30 September 2008. The parameters for the current incentive schemes have been specified until 2006/07, however, it is Ofgem's proposal that the incentive schemes and parameters described above should be specified for the entire interim period (i.e. through to 30 September 2008).

Buy-back and interruption incentive

4.151. As stated in Part A, Ofgem proposes that this incentive should take a standard "sliding scale" form, with deviations from a specified target level of incurred cost shared between Transco NTS and customers, subject to a defined sharing factor, a cap and a collar. Ofgem's final proposals in relation to the appropriate levels

of the targets, sharing factor, caps and collars are detailed in Part A of this paper and not repeated here.

4.152. In order to introduce this incentive, the following modifications are proposed:

- ◆ the introduction of the term $ExCBBIIIR_t$, representing the NTS exit capacity buy-back and interruptions incentive revenue, into the NTS system operator incentive revenue formula in paragraph 14(2); and
- ◆ the introduction of the term $ExCBBICP_t$, representing the NTS exit capacity buy-back and interruptions costs incurred by the licensee, into the NTS system operation costs formula in paragraph 14(3).

4.153. The proposed licence drafting associated with these two terms is provided in 14(12) "NTS exit capacity buy-back and interruption incentive revenue".

4.154. In this section the NTS exit capacity buy-back and interruptions incentive revenue ($ExCBBIIIR_t$) is defined to be zero for all days until 1 June 2005 (or such later date as the Authority otherwise directs in writing). After such a date, this term is defined such that:

- ◆ if the NTS exit capacity buy-back and interruption incentive target ($ExCBBIIIT_t$) exceeds (or is equal to) the NTS exit capacity buy-back and interruption performance measure ($ExCBBICP_t$), then this excess amount is subject to an upside sharing factor ($ExCBBIUSF_t$), which is capped at a specified amount ($ExCBBICAP_t$); and
- ◆ otherwise the deficit is subject to a downside sharing factor ($ExCBBIDSF_t$), which is subject to a specified collar ($ExCBBICOL_t$).

4.155. Both the NTS exit capacity buy-back and interruption incentive target ($ExCBBIIIT_t$) and the NTS exit capacity buy-back and interruption performance measure ($ExCBBICP_t$) are defined to be zero for all days until 1 June 2005 (or such later date as the Authority otherwise directs in writing). Furthermore, from 1 October 2008 (or such later date as the Authority otherwise directs in writing), these terms shall have a value of zero.

4.156. The NTS exit capacity buy-back and interruption incentive target ($ExCBBIIIT_t$) is defined to be the sum of:

- ◆ the target for NTS exit capacity buy-back ($ExCBBIT_t$); and
- ◆ the incentive target with respect to payments made by the licensee in respect of the curtailment of rights to offtake gas from the NTS on greater than 15 curtailment days ($ExNTSIIT_t$).

4.157. New targets for 2007/08 and 2008/09 have been specified for $ExNTSIIT_t$ and in combination with this, this incentive target has been removed from the charges foregone incentive target ($ExNTSIT_t$) from 1 June 2005 (or such later date as the Authority otherwise directs in writing).

4.158. The NTS exit capacity buy-back and interruption performance measure ($ExCBBICP_t$) is defined to be the sum of:

- ◆ the costs incurred by the licensee in respect of NTS exit capacity constraint management ($ExCCMC_t$); and
- ◆ the costs incurred by the licensee in respect of the curtailment of rights to offtake gas from the NTS on greater than 15 curtailment days ($ExNTSIIC_t$).

4.159. In combination with this, $ExNTSIIC_t$ has been removed from the charges foregone cost term ($ExNTSIC_t$) from 1 June 2005 (or such later date as the Authority otherwise directs in writing).

Constrained LNG incentive

4.160. As stated in Part A, Ofgem proposes that the scope and form of this incentive should reflect the current incentive scheme applicable to Transco, with a target being set for the cost of using constrained LNG (CLNG) storage, and with Transco being exposed to the difference between actual costs and this target.

4.161. As targets and incentive parameters for the CLNG incentive have already been defined for the duration of the current price control period, it has only been necessary to specify new targets for 2007/08 and 2008/09. Ofgem's final proposals in relation to the appropriate levels of these targets are detailed in Part A of this paper and not repeated here.

4.162. As such, modifications with respect to the proposed CLNG incentive are limited to the insertion of new incentive targets for costs incurred by the licensee in respect of its use of constrained storage facilities to avoid transportation

constraints for the years $t = 6$ and $t = 7$ i.e. 2007/8 and 2008/9, consistent with Ofgem's final proposals in this regard.

Charges foregone incentive

- 4.163. As stated in Part A, Ofgem proposes that the scope and form of this incentive should reflect the current incentive scheme applicable to Transco.
- 4.164. As targets and incentive parameters for this incentive have already been defined for the duration of the current price control period, it has only been necessary to specify new targets for 2007/08 and 2008/09. Ofgem's final proposals in relation to the appropriate levels of these targets are detailed in Part A of this paper and not repeated here.
- 4.165. In order to implement Ofgem's final proposals with respect to these incentives, both the incentive target ($ExNTSIT_t$) and the total accrued value ($ExNTSIC_t$) for payments made by the licensee or charges foregone by the licensee in respect of NTS exit capacity curtailment rights have been modified such that:
- ◆ from 1 June 2005, these parameters shall only relate to charges foregone. As discussed above, both the incentive target ($ExNTSIT_t$) and cost term ($ExNTSIC_t$) with respect to payments made by the licensee in respect of the curtailment of rights to offtake gas from the NTS on greater than 15 curtailment days cease to be included in this incentive and now form part of the buy-back and greater than fifteen day interruption incentive from this date;
 - ◆ from 1 October 2008 i.e. the end of the interim period (or such date as the Authority otherwise directs in writing) these terms shall be zero; and
 - ◆ new incentive targets with respect to charges foregone ($ExNTSSIT_t$) have been inserted for the years $t = 6$ and $t = 7$ i.e. 2007/8 and 2008/9, consistent with Ofgem's final proposals in this regard.

Other modifications

- 4.166. In addition, Ofgem proposes amendments to reflect payments made by the DNs to the NTS, namely to amend the definition of:

- ◆ $BBC_{d,t}$ to reflect payments made by the DNs to the NTS with respect to buy-back costs for embedded entry points in 14(7)(b); and
- ◆ GC_t to reflect payments by the DNs to the NTS with respect to CV shrinkage incurred by the NTS as a result of actions by the DNs in 14(8)(g).

4.167. In the definition of $UDQI_{t-2,q,d}$ in paragraph 14(8)(e), the main beach terminals are explicitly named in order to allow the correct weighting to be applied to the forward prices. In view of the Isle of Grain's change of status, and Milford Haven coming on stream, Ofgem proposes an amendment to the definition of $UDQI_{t-2,q,d}$ in 14(8)(e) such that Isle of Grain and Milford Haven are introduced to the text.

4.168. Ofgem also proposes correction of a number of typographical or formatting errors that were present in the existing licence drafting as part of this consultation. These include (without limitation):

- ◆ the insertion of spaces between words or phrases where they had previously been lacking;
- ◆ reformatting of formulae as appropriate to ensure consistency throughout the condition, for example, the reformatting of the formula for SOK_t ; and
- ◆ correction of cross-references as required, for example, the deletion of the reference to sub-paragraph (a) of 14(6)(d)(iii) in the definition of $ExNTSSIT_t$ in 14(6)(d)(i).

4.169. In addition, Ofgem proposes a number of minor clarifications of existing licence drafting to ensure that the meaning is clear and correct and/or that the drafting flows. Examples include (without limitation):

- ◆ the insertion of the word "of" in the definition of $SOROC_t$;
- ◆ the insertion of the word "the" in 14(5)(i)(iii);
- ◆ changing the headings for key sections of the licence drafting, for example, (14(6), 14(7), 14(8), 14(9) and 14(10)) so that the titles use consistent wording, and so that the price control parameter to which the section relates is provided in brackets;

- ◆ clarification of the drafting in paragraph 14(6)(i)(bb) in the “statement of actual interruption” section; and
- ◆ clarification of definitions of the use of the sigma term (Σ) such that the term being defined is balanced and consistent with the definition provided as exemplified by the correction to the definition of (Σ all z) shown in 14(6)(d)(iii).

4.170. Ofgem has considered the view of the respondent who stated that the calculations of payments from the DNs to the NTS should be explained in greater detail, and considers that as things stand, such payments are clearly auditable, and that no change is necessary at this time.

4.171. Ofgem invites respondents’ views on its proposals for Special Condition C8B, which are shown in Appendix 7C. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Special Condition C10 – Supplementary provisions of the revenue restrictions in respect of the NTS transportation owner activity and NTS system operation activity

Description

4.172. This licence condition sets out the activities that can be treated as excluded services and defines the charges or proportions of charges which can be treated as excluded revenue. These include last resort payment claims, supplemental charges, emergency service charges, charges relating to gas illegally taken or the execution of works at connection points.

Background & respondents’ views

4.173. In its response to the February document, one shipper/supplier noted that paragraph 3 of Special Condition C10 could be clarified, for example by changing “derive” to “derived”.

4.174. Proposed drafting for this condition has been circulated at, or following, DISG 38, DISG 39 and DISG 40. Minutes of these meetings are provided in Appendix 2.

Ofgem's proposals

- 4.175. Ofgem agrees with the shipper/supplier's comments that additional changes need to be made to this licence condition in order address the clarity issues raised. Ofgem proposes to amend this licence condition so that at paragraph 3, (b) and (d) "derive" is changed to "derived". In addition, Ofgem proposes to amend paragraph 3 (c) so that "represent" is changed to "representing".
- 4.176. Ofgem invites respondents' views on its proposals for Special Condition C10, which are shown in Appendix 7C. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Special Condition C14 – 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

Description

4.177. This licence condition requires the licensee to provide information statements to the Authority in connection with its transportation system revenue restriction.

Background & respondents' views

4.178. In response to the Initial Section 23 consultation⁴⁶, one shipper/supplier noted that there may be a requirement for a general review of reporting requirements under Special Condition 33. In the direction that followed this consultation⁴⁷, Ofgem stated that reporting requirements would be considered as part of one (or

⁴⁶ 263/04 *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*, Ofgem, November 2004

⁴⁷ 24/05 [Section 23 Direction: Modification of the price control conditions in each of Transco plc's six gas transporters licences, 1 February 2005](#)

more) of the section 23 consultations planned to follow the section 8AA consultation.

- 4.179. The February document confirmed this position, noting that Special Condition C14 (and Special Condition E6) would be subject to further change as part of a further section 23 process subsequent to hive-down. It set out that this change would be necessary to reflect the proposed incentive arrangements for offtake, and that, during that process, it proposed to conduct a full review of the information reporting requirements in this condition to ensure that information in respect of all appropriate price control terms is provided.
- 4.180. Following publication of the February document, Ofgem initiated a review of the provisions of Special Condition C14 and Special Condition E6 to establish whether terms in these conditions were included on a consistent basis and if additional price control terms should be introduced to provide a foundation for the further changes that would be necessary to support the interim incentives licence drafting.
- 4.181. As a result of this review, Ofgem proposes to introduce a number of terms, already included in Special Conditions C8B and E2B, into Special Conditions C14 and E6 respectively. These modifications will clarify certain aspects of Ofgem's information requirements.
- 4.182. On completion of this review, proposed changes to Special Condition C14 and Special Condition E6 were circulated for comment at DISG 37. Once relevant drafting for the interim incentives had been included in Special Condition C8B and Special Condition E2B, further changes to Special Condition C14 and Special Condition E6 respectively were made to reflect the key variables introduced by the proposed interim incentives regime. This revised drafting was circulated for comment at DISG 37, DISG 38, DISG 39 and DISG 40. Minutes of these meetings are provided in Appendix 2.

Ofgem's proposals

- 4.183. As stated above, Ofgem performed a review of the terms included in Special Condition C14 to ensure consistency with respect to the granularity of reporting and nature of variables reported.

- 4.184. In performing this review, and subsequent modifications to Special Condition C14, Ofgem has sought to ensure that the following data items are reported:
- ◆ all basic data that are not pre-specified inputs or freely available in the public domain, such that it is clear on the face of the licence that Ofgem will automatically receive sufficient data to generate all regulatory parameters specified in Special Condition C8B; and
 - ◆ additional selected parameters, which are themselves the outcome of higher level calculations, such that it is clear on the face of the licence that Ofgem will be able to perform appropriate cross-checks of key parameters.
- 4.185. As a result of this review, Ofgem proposes to introduce a number of pre-existing regulatory parameters into Special Condition C14. Without limitation, examples include $TORCOM_t$ (which is one of the three parameters in the principal formula for NTS transportation owner actual revenue and does not have any component parameters) and $TOMR_t$ (which is the maximum NTS transportation owner revenue and is therefore viewed to be a key parameter that should be requested on the face of the licence).
- 4.186. Building upon the principles outlined above Ofgem also proposes, as part of this consultation, to introduce a number of the parameters in the interim incentives licence drafting proposed for Special Condition C8B into the new “Exit capacity investment incentive information” table of Special Condition C14.
- 4.187. Furthermore, given the clarification proposed to Special Condition C8A, which will make it clear that the definitions in Special Condition C8A apply to Special Condition C8B as well as to Special Condition C8A, Ofgem proposes to clarify that the terms used in Special Condition C14 shall have the meaning given to those terms in Special Condition C8A and/or Special Condition C8B.
- 4.188. Ofgem invites respondents’ views on its proposals for Special Condition C14, which are shown in Appendix 7C. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Special Condition C15 – Licensee’s methodology for determining incremental entry capacity volumes

Description

- 4.189. This licence condition requires the licensee to prepare and submit each year an audited incremental entry capacity release methodology statement setting out the methodology by which it will determine whether to make incremental entry capacity available for sale to gas shippers.

Background & respondents’ views

- 4.190. As discussed later in this chapter, consistent with Ofgem’s proposals for interim and enduring offtake arrangements, Ofgem proposes to introduce a new licence condition (Special Condition C18), which will specify provisions in relation to the determination by the licensee of its methodology for determining incremental exit capacity volumes. It is Ofgem’s view that this new licence condition should be drafted on a consistent basis to the equivalent entry provisions in Special Condition C15. As part of the process of adapting Special Condition C15 to create this new licence condition, the drafting of Special Condition C15 was reviewed, and it was decided that the drafting of this condition would benefit from a number of clarifications.
- 4.191. Proposed drafting for this condition has been circulated at, or following, DISG 38, DISG 39 and DISG 40. Minutes of these meetings are provided in Appendix 2.

Ofgem’s proposals

- 4.192. As a result of the review described above, Ofgem proposes to implement clarifications as part of this consultation. These clarifications are:
- ◆ the replacement of “longer period” in paragraph 2 with “later date in each formula year”;
 - ◆ the expansion of paragraph 4 to make it clear what the 2 month period previously specified related to; and

- ◆ clarification of the interaction of paragraphs 5, 6 and 7 such that it is clear that paragraph 5 does not apply if paragraph 7 applies, and that paragraph 6 is linked to the provisions of paragraph 5.

4.193. Ofgem invites respondents' views on its proposals for Special Condition C15, which are shown in Appendix 7C. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Special Condition C20 – Separation of NTS and Distribution Network Businesses

Description

4.194. This licence condition requires the NTS-GT licensee to have in place, and at all times maintain, managerial and operational systems that are necessary to ensure that the licensee complies with obligations in Standard Special Condition A6 (Conduct of Transportation Business) and Standard Special Condition A35 (Prohibition of Cross-Subsidies). Furthermore, the licensee shall have a statement in place describing the practices, procedures and systems it has adopted to meet the obligations set out above by 1 May 2005, unless otherwise directed by the Authority.

Background & respondents' views

4.195. NGT has highlighted, on an informal basis, that further clarification is needed in paragraph 4(b)(ii) of this licence condition. NGT has suggested that inserting the words "have access to" at the end of this sub-paragraph would provide such clarification.

4.196. Proposed amended drafting for this condition was circulated for comment following DISG 40. Minutes of this meeting are provided in Appendix 2.

Ofgem's proposals

4.197. Ofgem notes the comment raised by NGT on an informal basis. Following consideration of the drafting, Ofgem believes that "have access" should be inserted at the end of sub-paragraph 4(b)(ii), and this change is proposed as part

of this consultation. Ofgem would note that the word “to” does not need to be inserted given the use of the phrase “to which” earlier in this sub-paragraph.

- 4.198. Ofgem invites respondents’ views on its proposals for Special Condition C20, which are shown in Appendix 7C. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Existing licence conditions – Part D

Standard Special Condition D4 – Prohibited Procurement Activities

Description

- 4.199. This licence condition requires that the licensee, any affiliate or related undertaking or business operated by the licence holder, its affiliates or related undertakings under a separate GT licence shall not enter into or otherwise acquire capacity rights, gas or gas derivatives with the intention of subsequently selling, assigning or otherwise disposing of such assets to third parties without the prior written consent of the Authority.
- 4.200. The prohibition does not apply where the purchase or acquisition occurs for the purposes of facilitating balancing management and constraint management, so long as the transaction is conducted on economic and efficient terms and facilitates the economic and efficient operation of the transportation system.

Background & respondents’ views

- 4.201. In its response to the February document, NGT raised concerns regarding the treatment of shrinkage. NGT’s key contentions (raised informally) were that prohibiting joint transactional purchase of shrinkage:
- ◆ is unrelated to network sales;
 - ◆ is not necessary as joint transactional purchase of shrinkage does not carry any risk of undue discrimination; and,

- ◆ if not resolved, would seem to place NGT at a disadvantage compared to IDNs and compared to its pre-network sales position. NGT argued that such a prohibition was not necessary to protect consumers.

4.202. Proposed amended drafting for this condition was circulated for comment following DISG 40. Minutes of this meeting are provided in Appendix 2.

Ofgem's proposals

4.203. As discussed in relation to Special Condition C4, Ofgem has further considered the issue of shrinkage procurement raised by NGT. Ofgem remains of the view that the joint procurement of shrinkage gas by the NTS and RDN businesses, or indeed by a DN and a competitive affiliate, should not be allowed on the face of the licence given the potential for issues in relation to price control separation of monopoly businesses and separation of competitive and monopoly businesses. As such, Ofgem proposes to tighten the drafting of Standard Special Condition D4 such that it is clear that joint procurement is only allowed between affiliated DN operators, unless consent is otherwise granted.

4.204. As such, Ofgem proposes to modify paragraph 2 such that the provision that allows "any affiliate or related undertaking, including, for the avoidance of doubt, any other business operated by the holder of this licence or its affiliates or related undertakings under a separate gas transporter licence for a relevant gas transporter" to acquire the specified commodities on the account of the licensee, is removed such that the licensee (a DN operator) must procure such commodities on its own behalf unless:

- ◆ the licensee has the prior written consent of the Authority;
- ◆ such procurement is in accordance with its functions under the network code;
- ◆ they are undertaken for the purpose of facilitating shrinkage procurement and/or constraint management provided that such transactions are conducted on economic and efficient terms, facilitate the economic and efficient operation of the transportation system, and are undertaken by:
 - ◆ a DN operator that is an affiliate of the licensee on behalf of the licensee;

- ◆ the licensee on behalf of such a DN operator affiliate; or
- ◆ the licensee and any DN operator that is an affiliate of the licensee on a joint basis.

4.205. Ofgem would note that it has received an application for consent from NGT such that the NTS and RDN businesses can jointly procure shrinkage gas. Ofgem also expects to receive an application for consent from Scotia Gas Networks plc to allow joint procurement between its DN licensees and its affiliated shipper business⁴⁸.

4.206. Following informal discussions with potential purchasers, Ofgem also proposes to modify the drafting of Standard Special Condition D4 such that any affiliate or related undertaking of the licensee that is licensed to undertake such activities by the Authority is not subject to the prohibitions of Standard Special Condition D4. So for example, any actions undertaken by a licensed shipper, which is an affiliate or related undertaking of the licensee, shall be allowed as long as such activities are consistent with their shipper licence.

4.207. Ofgem also proposes to clarify the drafting of paragraph 1 such that it is clear that the licensee shall procure that affiliates or related undertakings shall not undertake transactions on their own account, on behalf of the licensee, or on behalf of each other.

4.208. Other minor modifications are proposed to clarify the drafting of this condition. These include:

- ◆ changing “shrinkage procurement **and** constraint management” to “shrinkage procurement **and/or** constraint management” in paragraph 2;
- ◆ restructuring paragraphs 1 and 2 such that all exclusions / exceptions to the general prohibition are addressed in paragraph 2;
- ◆ inserting “of the licensee” after “affiliate” in the definition of “shrinkage procurement” in paragraph 3; and

⁴⁸ It is Ofgem’s current intention to grant such consents (to NGT prior to hive down, and to Scotia after hive down but prior to share sale) until 31 March 2007 (during which time prices to customers are fixed), for further review in 2007 when the consents expire.

- ◆ replacing “so long as” with “provided that” in paragraph 2.
- 4.209. Ofgem invites respondents’ views on its proposals for Standard Special Condition D4, which are shown in Appendix 7D. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Existing licence conditions – Part E

Special Condition E2A – Revenue restriction definitions in respect of the Distribution Network

Description

- 4.210. This condition defines a number of terms in the revenue restrictions in respect of the DNs.

Background & respondents’ views

- 4.211. In response to the February document, one shipper/supplier noted that the word “that” in the definition of “firm entry capacity” was not needed and could be removed.
- 4.212. In addition, one potential purchaser made a number of comments on the drafting of Special Condition E2A. These were as follows:
- ◆ that a definition of “distribution network capacity” is required since it is referred to in Part 2 Paragraph 14(6)(i);
 - ◆ that a definition of “curtailment day” is required for the DN definitions since it is referred to in Special Condition E6 under “Exit Information Reporting”; and
 - ◆ that the definition of “formula year” states that $t = 1$ means the year starting 1 April 2004, but that for clarity it may be helpful to add the words “except in relation to Special Condition E5 where $t = 1$ means year commencing 1 April 2002 at 06:00hrs”.

- 4.213. A review of the points raised by this potential purchaser led Ofgem to consider that it would be appropriate to clarify the applicability of the definitions in Special Conditions E2A and C8A with respect to other conditions in the licence.
- 4.214. As well as providing clarifications to the existing licence drafting and reflecting respondents' views to the February document as appropriate, changes to this licence condition are proposed to define new terms introduced to reflect the proposed interim incentives. In the February document, Ofgem noted that Special Condition E2A would be subject to further change as part of a further section 23 process subsequent to hive-down to reflect the proposed incentive regimes and arrangements for offtake.
- 4.215. Proposed drafting for this condition has been circulated at, or following, DISG 38, DISG 39 and DISG 40. Minutes of these meetings are provided in Appendix 2.
- 4.216. In response to the licence drafting circulated following DISG 40, one potential purchaser noted that the definition of "NTS (TO) Exit capacity charge" should refer to p/peak day kWh/day consistent with the NTS charging statement. A shipper/supplier also made this point, and noted that a change in this definition could have implications for the definitions of other related terms.

Ofgem's proposals

- 4.217. Following consideration of respondents' views to the February document, Ofgem proposes the following modifications to Special Condition E2A:
- ◆ removing the word "that" from the definition of "firm entry capacity";
 - ◆ clarifying paragraph 1 so that it is clear that the definitions in Special Condition E2A apply to Special Condition E2B as well as to Special Condition E2A – in Ofgem's view, this modification should address the comment made in relation to the definition of "formula year";
 - ◆ including a definition of "Distribution Network capacity" to mean "LDZ capacity (having the meaning given to that term in the network code) within the relevant Distribution Network", the definition of LDZ capacity has been removed and references elsewhere to "LDZ capacity" have been changed to "Distribution Network capacity"; and

- ◆ introducing a definition of “curtailment day” along with definitions of “connected system exit point” and “storage connection point” which are terms currently used within this definition, and not defined.

4.218. Furthermore, a number of new terms have been defined consistent with the proposed licence drafting for interim incentives in Special Condition E2B. New terms introduced in this regard include: “deemed cost”, “Distribution Network exit zone”, “initial volume allocation”, “maximum actual allocation”, “NTS gas transportation statement”, “NTS (TO) Exit capacity charge”, and “plus 15 curtailment day”.

4.219. Consistent with responses received, Ofgem has ensured that the definition of “NTS (TO) Exit capacity charge” (and related terms where applicable) is consistent with the NTS charging statement.

4.220. Ofgem invites respondents’ views on its proposals for Special Condition E2A, which are shown in Appendix 7E. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Special Condition E2B – Restriction of revenue in respect of the Distribution Network transportation activity

Description

4.221. This condition defines the price controls and incentives applicable to the DN operators.

Background & respondents’ views

4.222. In the February document, Ofgem noted that further changes to the price control conditions would be required in May 2005 to implement:

- ◆ changes to incorporate the interim incentive arrangements, including amongst other things, consideration of an incentive regime upon the DNs to address the removal of the greater than 15 day curtailment rights incentive as part of the 1 February section 23 modification, the introduction of Income Adjusting Event provisions in the DN licences to accompany the suite of incentives introduced, and further modifications

as necessary to address revenue flows between the NTS and DN operators;

- ◆ changes required to reflect the outcome of Transco's pricing consultations, for example if the TO or SO commodity charges are to be passed through the DNs; and
- ◆ changes that may be required to ensure that charging and revenue recovery is consistent with the DTI's proposed alternative arrangements for independent systems.

4.223. Since publication of the February document, Transco has concluded that any formal pricing consultation should be run in parallel with the consultation on the enduring regime. In the meantime, Transco has issued informal pricing discussion documents to initiate the debate.

4.224. Furthermore, following discussions with NGT and the DTI, it is anticipated that the DTI's proposed alternative arrangements for independent systems will be implemented through a series of legally enforceable undertakings on the part of Transco and the IDNs. These undertakings will ensure that customers are charged in accordance with the DTI determinations (as annexed to the DTI "statement of reasons"⁴⁹), and that the associated costs are incurred by NGT and shall not be recovered from customers until the 1 April 2007 price control review at the earliest.

4.225. As a result, the focus of the modifications proposed in relation to Special Condition E2B as part of this consultation is the implementation of the final proposals for the interim incentives as outlined in detail in Part A of this document.

4.226. One shipper/supplier noted, in their response to the February document, that the cross-reference in paragraph 10(4) to "Part I b" should be to "Part 1 b".

4.227. Draft proposals for licence drafting were circulated for comment at DISG 38, DISG 39 and DISG 40. Minutes of these meetings are provided in Appendix 2. Comments on these drafts were received from industry participants on an

⁴⁹ http://www.dti.gov.uk/energy/publications/policy/sale_gas_dist_networks_reasons.pdf

informal basis. One potential purchaser provided comments on the initial drafting proposals, and noted that it would be more appropriate to refer in the drafting to “DN exit zones” rather than “LDZ exit zones”, consistent with the transportation charging statement. This potential purchaser also noted mistakes in the calculation of capacity and flow flexibility numbers for Scotland and the South of England.

- 4.228. This potential purchaser also commented upon the incentive relating to the curtailment of rights to offtake gas from the DN on greater than fifteen curtailment days. The potential purchaser noted that the fact that the target is set to zero if there are no greater than fifteen day interruption costs could generate a perverse incentive on a DN so that, rather than having no interruption costs and getting no incentive payment, they may rather make sure that someone was interrupted in order for an incentive payment to be made.
- 4.229. In comments provided after DISG 40, this potential purchaser also noted that the term $NTSRExCH_{v,t,d}$ should make reference to p/peak day kWh/day. A shipper/supplier also made this point, and also noted that a change in this definition could also have implications for the definitions of other related terms. The shipper/supplier also stated that it would be helpful to clearly state where a term was in £million rather than in £ as the rest of the condition is, and that the word “and” in the definition of $DNExIC_{z,d}$ should be replaced by the word “or”.

Ofgem’s proposals

- 4.230. As a result of Ofgem’s final proposals on interim incentives for the DNs, Ofgem is proposing to make a number of licence modifications to Special Condition E2B, and to Special Conditions E2A and E6.
- 4.231. As part of introducing the proposed incentive arrangements, Ofgem proposes to modify the maximum DN transportation activity revenue formula in paragraph 8(1) such that:
- ◆ the term $DNExC_t$, representing the actual payments made by the licensee in respect of NTS exit capacity and NTS exit flow flexibility (to represent the pass-through of these money flows as part of the “Option 2A” approach associated with the enduring arrangements), is removed and

replaced by the term $DNEx_t$, which represents DN exit capacity costs and incentive revenue, and has $DNExC_t$ as one of its components; and

- ◆ to insert the term $DNIAE_t$ representing any allowance in respect of approved income adjusting events (whether positive or negative).

4.232. The proposed licence drafting is discussed for each of these terms in turn below.

DN exit capacity costs and incentive revenue ($DNEx_t$)

- 4.233. As outlined in Part A of this document, Ofgem is proposing a single incentive mechanism for each DN to enable them to trade-off the cost of additional NTS exit capacity and flexibility with the cost of increased interruption of DN connectees. As such, the scope of this incentive covers NTS offtake (flat) capacity, NTS offtake (flexibility) capacity⁵⁰ and the cost of interruption.
- 4.234. As stated in Part A, it is proposed that the incentive schemes supporting the interim offtake arrangements will relate to the period 1 June 2005 (the date on which it is anticipated that these conditions will become effective) to 30 September 2008. It is Ofgem's proposal that the DN incentive scheme should be specified for the entire interim period (i.e. through to 30 September 2008). However, it may be appropriate to review the incentive arrangements applying to the DNs in light of the reform of the interruption arrangements, planned for implementation in April 2006.
- 4.235. As stated in Part A, Ofgem proposes that this incentive should take a standard "sliding scale" form, with deviations from a specified target level of incurred cost shared between DNs and customers, subject to a defined sharing factor, and a cap and a collar. Ofgem's final proposals in relation to the appropriate levels of the targets, sharing factor, and caps and collars are detailed in Part A of this paper and not repeated here.
- 4.236. DN exit capacity costs and incentive revenue ($DNEx_t$) is defined to be the sum of:
- ◆ the DN exit capacity incentive revenue ($DNExCIR_t$);

⁵⁰ In the licence drafting attached in Appendix 7, NTS offtake (flat) capacity is referred to as NTS exit

- ◆ the costs incurred by the licensee in respect of the total payments made by the licensee to the relevant NTS operator (consistent with section K(4) of the UNC – Offtake Arrangements Document) in respect of the curtailment of rights to offtake gas from the DN on greater than 15 curtailment days ($DNExIIC_t$), to allow recovery of these costs; and
- ◆ the actual payments made by the licensee in respect of NTS exit capacity and NTS exit flow flexibility ($DNExC_t$), as discussed above.

4.237. The DN exit capacity incentive revenue ($DNExCIR_t$) is defined in 8(5). This term is defined to be zero for all days until 1 June 2005 (or such later date as the Authority otherwise directs in writing). After such a date, this term is defined such that:

- ◆ if the DN exit incentive target ($DNExIT_t$) exceeds (or is equal to) the DN performance measure ($DNExCP_t$), then this excess amount is subject to an upside sharing factor ($DNExUSF_t$), which is capped at a specified amount ($DNExCAP_t$); and
- ◆ otherwise the deficit is subject to a downside sharing factor ($DNExDSF_t$), which is subject to a specified collar ($DNExCOL_t$).

4.238. Both the DN exit incentive target ($DNExIT_t$) and the DN performance measure ($DNExCP_t$) are defined to be zero for all days until 1 June 2005 (or such later date as the Authority otherwise directs in writing).

4.239. The DN exit incentive target ($DNExIT_t$) is defined to be the sum of:

- ◆ the target cost of the initial volume of NTS exit capacity in respect of the relevant DN ($DNExCTC_t$);
- ◆ the target cost of the initial volume allocation of NTS exit flow flexibility in respect of the relevant DN ($DNExFFTC_t$); and
- ◆ the incentive target in respect of the curtailment of rights to offtake gas from the DN on greater than 15 curtailment days ($DNExIIT_t$).

capacity and NTS offtake (flexibility) capacity is referred to as NTS exit flow flexibility. These terms are used in the rest of this chapter.

- 4.240. The target cost of the initial volume of NTS exit capacity ($DNExCTC_t$) shall be the sum of the product of the relevant NTS (TO) exit capacity charge as set out in the NTS gas transportation statement ($NTSRExCh_{v,t,d}$) and the initial volume allocation of NTS exit capacity as specified in the licence ($NTSBAExC_{v,t}$) for each DN exit zone within the DN.
- 4.241. The target cost of the initial volume allocation of NTS exit flow flexibility ($DNExFFTC_t$) shall be the sum of the product of the relevant NTS (TO) exit capacity charge as set out in the NTS gas transportation statement ($NTSRExCh_{v,t,d}$) and the initial volume allocation of NTS exit flow flexibility as specified in the licence ($NTSBAExFF_{v,t}$) for each DN exit zone within the DN.
- 4.242. The incentive target in respect of the curtailment of rights to offtake gas from the DN on greater than 15 curtailment days ($DNExIIT_t$) is specified within the licence, consistent with Ofgem's final proposals in this regard. The provisions relating to this incentive that were deleted as part of the 1 February 2005 direction (specifying circumstances under which $DNExIIT_t$ would be equal to zero, and the reasonable endeavours obligation with regards to the level of the weighted average unit charge payable) have been reinstated. However, the definition of $DNSIC_t$ has been modified to remove the reference to "payments made by the licensee in respect of capacity curtailment rights". This correction has been made such that the numerator and denominator in the equation for $ADNExIIC_t$ are balanced and consistent and to reflect the fact that requirements for universal firm have been removed from the licence.
- 4.243. $DNExCTC_t$, $DNExFFTC_t$, and $DNExIIT_t$ are defined to have a value of zero from 1 October 2008 (or such date that the Authority otherwise directs in writing).
- 4.244. The DN exit performance measure ($DNExCP_t$) is defined to be the sum of:
- ◆ the deemed costs incurred by the licensee for NTS exit capacity in respect of all NTS offtakes within the relevant DN ($DNExCDC_t$);
 - ◆ the deemed costs incurred by the licensee for NTS flow flexibility in respect of all NTS offtakes within the relevant DN ($DNExFFDC_t$); and
 - ◆ the costs incurred by the licensee in respect of the total payments made to the relevant NTS operator in respect of the curtailment of rights to offtake gas from the DN on greater than 15 curtailment days ($DNExIIC_t$).

- 4.245. The deemed costs incurred by the licensee for NTS exit capacity ($DNExCDC_t$) shall be the sum of the product of the relevant NTS (TO) exit capacity charge as set out in the NTS gas transportation statement ($NTSRExCh_{v,t,d}$) and the maximum actual allocation of NTS exit capacity ($NTSMAExC_{v,t}$) for each DN exit zone within the DN.
- 4.246. The deemed costs incurred by the licensee for NTS flow flexibility ($DNExFFDC_t$) shall be the sum of the product of the relevant NTS (TO) exit capacity charge as set out in the NTS gas transportation statement ($NTSRExCh_{v,t,d}$) and the maximum actual allocation of NTS exit flow flexibility ($NTSMAExFF_{v,t}$) for each DN exit zone within the DN.
- 4.247. The costs incurred by the licensee in respect of the total payments made to the relevant NTS operator in respect of the curtailment of rights to offtake gas from the DN on greater than 15 curtailment days ($DNExIIC_t$) is derived by summing such payments across all supply points, connected system exit points and storage connection points and all days in the relevant formula year.
- 4.248. $DNExCDC_t$, $DNExFFDC_t$ and $DNExIIC_t$ are defined to have a value of zero from 1 October 2008 (or such date that the Authority otherwise directs in writing).
- 4.249. The statement of actual interruption section, which was previously 14(6)(i) of Part 2 has been moved into paragraph 8(5)(d), and minor modifications have been made in paragraph (i)(bb) to clarify the drafting.
- 4.250. In formulating the incentives licence drafting, the comments outlined above, that were raised by a potential purchaser have been fully considered, and addressed as appropriate. In relation to the comments raised by the potential purchaser in respect of the incentive that relates to the curtailment of rights to offtake gas from the DN on greater than fifteen curtailment days, Ofgem would note that licensees are subject to a licence obligation to be economic and efficient with respect to the operation of their pipe-line system, and, without fettering the Authority's discretion, to act as this potential purchaser suggests would be in conflict with this obligation.

Income adjusting event provisions (DNIAE_t)

- 4.251. As stated above, an additional term ($DNIAE_t$) has been introduced into the maximum DN transportation activity revenue formula in paragraph 8(1). This

term represents the value of the income adjusting event (positive or negative) as determined by the provisions in paragraph 8(6). The drafting of these income adjusting event provisions mirrors that in the NTS licence in relation to the NTS SO. As discussed in Part A, income adjusting events have been defined in relation to the costs of exit capacity, flow flexibility and interruptions (DNExCP) and the £2m threshold applicable to the NTS SO has been retained.

Other modifications

- 4.252. Ofgem also proposes to clarify the fact that DNExC_t (which reflects the “Option 2A” payment flows associated with the enduring arrangements) shall have a value of zero before 1 October 2008 (or such date that the Authority shall otherwise direct in writing).
- 4.253. Ofgem also proposes correction of a number of typographical or formatting errors that were present in the existing licence drafting as part of this consultation. These include (without limitation):
- ◆ the removal of an unnecessary sub-paragraph (i) in the definition of DNZ_t in 8(1); and
 - ◆ changing “Part I b” to “Part 1 b” in 10(4), reflecting the comment raised by a shipper/supplier in their response to the February document.
- 4.254. In addition, Ofgem proposes a number of minor clarifications of existing licence drafting to ensure that the meaning is clear and correct and/or that the drafting flows. Examples include (without limitation):
- ◆ the insertion of the phrase “an amount equal to” in 8(1);
 - ◆ clarification that the units of the term J_t are in millions of pounds; and
 - ◆ deletion of superfluous text in the definition of I_t which feeds into the formula for DNK_t. This text specifies details regarding the applicability of the formula for I_t for t=1, which is unnecessary given that a value for DNK_t is specified for the formula year commencing on 1 April 2004, which is t=1.
- 4.255. Consistent with responses received, Ofgem has ensured that the definition of “NTS (TO) Exit capacity charge” (and related terms where applicable) is

consistent with the NTS charging statement, that terms in £million are clearly identified as being so, and that the definition of DNExIIC_{z,d} is correct.

- 4.256. Ofgem invites respondents' views on its proposals for Special Condition E2B, which are shown in Appendix 7E. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Special Condition E3 – Allocation of revenues and costs for calculations under the price control in respect of the Distribution Network

Description

- 4.257. This licence condition sets out the licensee's obligations regarding the allocation or attribution of revenues, costs, assets and liabilities by the licensee in order to calculate values referred to in Special Condition E2B.

Background & respondents' views

- 4.258. One potential purchaser noted, on an informal basis, that an amendment is needed to this licence condition for the IDN licensees only. This potential purchaser noted that paragraph 1(b)(ii)(bb) states "any other business held by Transco plc or its affiliates or related undertakings under a separate licence", which would not be applicable to the IDNs following share sale.
- 4.259. Proposed drafting for this condition has been circulated at, or following, DISG 38, DISG 39 and DISG 40. Minutes of these meetings are provided in Appendix 2.

Ofgem's proposals

- 4.260. Ofgem notes the comments raised by a potential purchaser, and would agree that, whilst appropriate for the period between hive-down and share sale, the wording of paragraph 1(b)(ii)(bb) requires modification on or before share sale. As such, as part of this consultation, Ofgem proposes to change "Transco plc" to "the licensee".

4.261. Ofgem invites respondents' views on its proposals for Special Condition E3, which are shown in Appendix 7E. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Special Condition E4 – Supplementary provisions of the revenue restrictions in respect of the Distribution Network.

Description

4.262. This licence condition sets out activities that can be treated as excluded services and defines charges or proportions of charges which can be treated as excluded revenue. These include last resort payment claims, supplemental charges, emergency service charges, charges relating to gas illegally taken or the execution of works at connection points.

Background & respondents' views

4.263. In their response to the February document, one shipper/supplier noted that paragraph 3 of Special Condition C10 may need rewording as the drafting did not appear to flow.

4.264. Proposed drafting for this condition has been circulated at, or following, DISG 38, DISG 39 and DISG 40. Minutes of these meetings are provided in Appendix 2.

Ofgem's proposals

4.265. Ofgem agrees with the shipper/supplier's comments that additional changes need to be made to this licence condition in order address the clarity issues raised. Ofgem proposes to amend this licence condition so that at paragraph 3, (b) and (d) "derive" is changed to "derived". In addition Ofgem proposes to amend paragraph 3 (c) so that "represent" is changed to "representing".

4.266. Ofgem invites respondents' views on its proposals for Special Condition E4, which are shown in Appendix 7E. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

Special Condition E6 – Information to be provided to the Authority in connection with the transportation system revenue restriction in respect of the Distribution Network

Description

4.267. This licence condition requires the licensee to provide information statements to the Authority in connection with its transportation system revenue restriction.

Background & respondents' views

4.268. In response to the Initial Section 23 consultation⁵¹, one shipper/supplier noted that there may be a requirement for a general review of reporting requirements under Special Condition 33. In the direction that followed this consultation⁵², Ofgem stated that reporting requirements would be considered as part of one (or more) of the section 23 consultations planned to follow the section 8AA consultation.

4.269. The February document confirmed this position, noting that Special Condition E6 (and Special Condition C14) would be subject to further change as part of a further section 23 process subsequent to hive-down to reflect the proposed incentive arrangements for offtake, and that, during that process, it proposed to conduct a full review of the information reporting requirements in this condition to ensure that information in respect of all appropriate price control terms is provided.

4.270. Following publication of the February document, Ofgem initiated a review of the provisions of Special Condition E6 and Special Condition C14 to establish whether terms in these conditions were included on a consistent basis, and whether additional price control terms should be introduced to provide a foundation for the further changes that would be necessary to support the interim incentives licence drafting.

⁵¹ 263/04 *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*, Ofgem, November 2004

⁵² 24/05 [Section 23 Direction: Modification of the price control conditions in each of Transco plc's six gas transporters licences](#), Ofgem, 1 February 2005

- 4.271. As a result of this review, Ofgem proposes to introduce a number of terms, already within Special Conditions E2B and C8B, into Special Conditions E6 and C14 respectively. These modifications will clarify certain aspects of Ofgem's information requirements.
- 4.272. Following this review, proposed changes to Special Condition E6 and Special Condition C14 were circulated for comment at DISG 37. Following drafting of the interim incentives in Special Condition E2B and Special Condition C8B, further changes to Special Condition E6 and Special Condition C14 respectively were made to reflect the key variables introduced by the proposed interim incentives regime, and circulated for comment at (or after) DISG 37, DISG 38, DISG 39 and DISG 40. Minutes of these meetings are provided in Appendix 2.
- 4.273. Ofgem would also note that NGT has commented, on an informal basis, that whilst NTS information is provided throughout the year, DN information is only required at year end, and therefore that amendments may be required to remove references to within year information.

Ofgem's proposals

- 4.274. As stated above, Ofgem performed a review of the terms included in Special Condition E6 to ensure consistency in terms of the granularity of reporting and nature of variables reported.
- 4.275. In performing this review, and while making subsequent modifications to Special Condition E6, Ofgem sought to ensure that the following data items are reported:
- ◆ all basic data items that are not pre-specified inputs or freely available in the public domain, such that it is clear on the face of the licence that Ofgem will automatically receive sufficient data to generate all regulatory parameters specified in Special Condition E2B; and
 - ◆ additional selected parameters, which are themselves the outcome of higher level calculations, such that it is clear on the face of the licence that Ofgem will be able to perform appropriate cross-checks of key parameters.
- 4.276. As a result of this review, Ofgem proposes to introduce a number of pre-existing regulatory parameters into Special Condition E6. Without limitation, examples

include DN prescribed rates (which does not have any component parameters and feeds into DNF_t which in turn feeds into the maximum revenue principal formula) and $DNMRA_t$ (which is the mains replacement expenditure adjustment and one of the parameters that feeds directly into the maximum revenue principal formula and is therefore viewed to be a key parameter that should be requested on the face of the licence).

- 4.277. Building upon the principles outlined above, Ofgem also proposes, as part of this consultation, to introduce a number of the parameters in the interim incentives licence drafting proposed for Special Condition E2B into the "Exit information reporting" table of Special Condition E6.
- 4.278. Following consideration of the point raised informally by NGT, Ofgem would note that the provisions in Special Condition E6 that relate to within year information will lie dormant if not applicable. As a result, Ofgem does not believe that any material modifications in this respect are required, however, Ofgem proposes to insert the words "where applicable" at the beginning of paragraph 3 in order to clarify this point.
- 4.279. Furthermore, given the clarification proposed to Special Condition E2A, which will make it clear that the definitions in Special Condition E2A apply to Special Condition E2B as well as to Special Condition E2A, Ofgem proposes to clarify that the terms used in Special Condition E6 shall have the meaning given to those terms in Special Condition E2A and/or Special Condition E2B.
- 4.280. Ofgem invites respondents' views on its proposals for Special Condition E6, which are shown in Appendix 7E. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

New licence conditions

Special Condition C18 – Licensee’s methodology for determining incremental exit capacity volumes

Description

- 4.281. This licence condition would require the licensee to prepare and submit each year an audited incremental exit capacity release methodology statement setting out the methodology by which it will determine whether to make incremental exit capacity available for sale to gas shippers or DN operators.

Background & respondents’ views

- 4.282. Consistent with Ofgem’s proposals for interim and enduring offtake arrangements, Ofgem proposes to introduce a new licence condition (Special Condition C18), which will specify provisions in relation to the determination by the licensee of its methodology for determining incremental exit capacity volumes. It is Ofgem’s view that this new licence condition should be drafted on a consistent basis to the equivalent entry provisions in Special Condition C15.
- 4.283. As discussed earlier in this chapter, Ofgem has reviewed the drafting of Special Condition C15 and proposes to make certain clarifications.
- 4.284. The drafting of Special Condition C15 has been further modified to be appropriate for exit. These proposed modifications have been circulated at, or following, DISG 38, DISG 39 and DISG 40. Minutes of these meetings are provided in Appendix 2.

Ofgem’s proposals

- 4.285. As discussed above, Ofgem proposes to modify its proposals for Special Condition C15 (Licensee’s methodology for determining incremental entry capacity volumes) to reflect the exit specific drafting required for Special Condition C18. Without limitation, the exit specific modifications made include the following:

- ◆ references to incremental exit capacity instead of incremental entry capacity;
- ◆ a definition for “incremental exit capacity” has been introduced such that it is defined to mean “capacity that is in excess of the initial volume allocation”, where the “types of capacity that are included in references to incremental exit capacity include NTS exit capacity and NTS exit flow flexibility”;
- ◆ a definition for “initial volume allocation” which means “for an NTS exit point (having the meaning given to that term in the network code), either the aggregate quantity of NTS exit capacity that gas shippers are registered as holding pursuant to the network code on 1 May 2005 (or such later date as the Authority otherwise directs in writing) or the aggregate quantity of NTS exit capacity or the aggregate quantity of NTS exit flow flexibility as set out in the Offtake Capacity Statements (having the meaning given to that term in the network code) as at 1 May 2005 (or such later date as the Authority otherwise directs in writing)”;
- ◆ insertion, in paragraph 2, of 1 June 2005 (the date on which this new licence condition is intended to take effect) as the date before which the licensee shall prepare, and submit for approval by the Authority, an incremental exit capacity release methodology;
- ◆ insertion of “DN operators” as well as gas shippers in paragraphs 2, 4, 5(ii), 7(a), and 7(b)(iv) to reflect the fact that incremental exit capacity could be released for sale to DN operators as well as gas shippers;
- ◆ insertion of a provision in paragraph 3, which relates to the requirement for an *ex ante* audit, such that this obligation does not need to be complied with if the Authority so consents in writing; and
- ◆ insertion of a new sub-paragraph 7(b)(ii) such that an obligation to introduce an *ex post* audit is introduced such that appropriate auditors are asked to issue a statement giving their opinion as to the extent to which the licensee has complied with the statement prepared pursuant to paragraph 2.

4.286. With respect to Ofgem's proposed amendments of paragraphs 3 and 7(b)(ii) in relation to audit requirements, Ofgem would note that:

- ◆ Ofgem does not believe that it is appropriate for the NTS operator to comply with the *ex ante* audit provisions in paragraph 3 in respect of the interim arrangements. As a result, Ofgem has introduced the scope for the Authority to consent to the licensee not having to comply with paragraph 3, and intends to grant such consent for the interim arrangements; however
- ◆ As the *ex ante* audit will not apply to the interim arrangements, Ofgem considers that it is appropriate to introduce an *ex post* audit, as shown in paragraph 7(b)(ii). Ofgem considers it appropriate for such arrangements to apply to the enduring as well as the interim arrangements.

4.287. Ofgem invites respondents' views on its proposals for Special Condition C18, which are shown in Appendix 7C. Nothing in this consultation document shall fetter the discretion of the Authority with respect to enforcement of the conditions.

5. Way forward

- 5.1. This chapter sets out the way forward with respect to the proposed DN sales transaction, with a particular focus upon incentives proposals and the licence modification process.

Hive-down process

- 5.2. As stated earlier, the Authority directed the licence modifications proposed as part of the section 23 and section 8AA consultations (with a few minor corrections) be made on 25 April 2005. These modifications shall come into effect on 1 May 2005 or such later date as the Authority may direct subject to the Authority receiving a report from Transco updating the Authority on its progress against the remaining conditions precedent to consent and the Authority being fully satisfied that all of the conditions precedent have been met. The modifications will come into effect by way of an implementation direction likely to take effect on 1 May, although it is possible that the direction could take effect at a later date. This consultation proposes modifications to the licence modifications made on 25 April.

Section 23 consultation

- 5.3. As described previously, this document attaches a formal section 23 Notice under the Gas Act proposing the modification of the six GT licences that relate to Transco's NTS and RDN businesses and the four DN businesses proposed to be sold.
- 5.4. **While it is the consent of the holders of these licences which is required for these modifications to be directed (as described in chapter 2), Ofgem welcomes respondents' views, including the views of potential DN purchasers and other interested parties, on the section 23 Notice to be received by close of business on 24 May 2005.**⁵³

⁵³ It is noted that in August 2004 Ofgem wrote to the proposed purchasers of the DN businesses encouraging them to respond and comment upon the proposed licence modifications. This letter can be found on Ofgem's website at www.ofgem.gov.uk. Ofgem has to this point received valuable input from potential purchasers as part of previous licence consultations and would encourage purchasers to comment on the modification proposals attached to this document.

- 5.5. However, subject to respondents views, assuming that hive down has occurred and the relevant licence holders give consent to the licence modification proposals, it is envisaged that the licence modifications will be directed for implementation on 27 May 2005 such that they take effect on 1 June 2005, the scheduled date for share sale, subject to Transco meeting all of the relevant conditions subsequent to the Authority's consent, which was granted on 20 January 2005. It should be noted, however, that the Authority does reserve its discretion to revise this date.

Process following hive-down and transfer

- 5.6. It is important to note that, as part of the Authority's conditions to consent as granted on 20 January 2005, Transco would not be able to sell the shares in the four relevant wholly owned subsidiary companies without the Authority's prior consent.
- 5.7. In addition, the Authority's conditions to consent also provide that Transco and each of the four relevant wholly owned subsidiary companies shall consent to any licence modifications and implement any other regulatory, commercial or operational changes following hive-down that the Authority considers are necessary in order to ensure that the proposed sales transactions are implemented in a manner that ensures that the interests of customers are protected. Until these conditions are met the Authority will not provide its consent to the share sale proceeding.
- 5.8. As such, and having considered respondents' views to this licence consultation, Ofgem would not be in a position to consent to the share sale until such time as Transco and each of the four relevant wholly owned subsidiary companies have provided their consent to the proposed licence modifications. Once these consents are forthcoming the Authority would subsequently direct the licence modifications.
- 5.9. Provided that the Authority is satisfied that the regulatory, commercial and operational arrangements are sufficient to protect the interests of customers, within a divested industry structure, (consistent with the conditions subsequent to the Authority's Consent Directions attached to the Authority's February decision document) and that no further changes to these arrangements are

necessary at that time, the Authority would then proceed to provide its consent to the share sale, thereby allowing the sales transaction to complete. It should be noted that the Authority could, if necessary to protect the interests of customers, attach conditions to any such consent.

Process following completion

- 5.10. As part of the section 8AA and section 23 modifications, which were directed on 25 April 2005, to take effect from 1 May 2005 (or such later date as the Authority may direct), the Authority has introduced licence conditions on Transco and each DN requiring them to use best endeavours to implement the enduring offtake arrangements by 1 September 2005.⁵⁴ It is expected that these arrangements would be introduced via modifications to the UNC.
- 5.11. As part of this process, Ofgem also intends to bring forward licence modifications to each of the six relevant GT licences in July 2005 to introduce, amongst other things and without limitation to, enduring incentive arrangements on Transco's NTS and RDN businesses as well as the IDNs for implementation by September 2005. These incentive arrangements are intended to support the introduction of the enduring offtake arrangements and will be consulted upon through the formal licence modification process set out in section 23 of the Gas Act.

⁵⁴ The enduring offtake arrangements are described in chapter 5 of Ofgem's Final Impact Assessment on DN sales, namely, *National Grid Transco, Potential sale of gas distribution network businesses, Final Impact Assessment*, Ofgem, November 2004.