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25 May 2005

Dear Sonia

RE Gas Distribution Network Sales – Open letter to NGT, Transco and the DN companies requesting report relating to the Authority's decision on conditions subsequent

Thank you for your open letter dated 20 May 2005 ("your letter") relating to the conditions subsequent to the consent of the Gas and Electricity Market Authority (the "Authority") to Transco plc ("Transco") to dispose of four of its gas distribution networks ("DNs") to four wholly owned Transco subsidiary companies (the "DN companies").

Transco now hereby seeks the Authority's unconditional written consent to dispose of each of the DN companies on 1 June 2005, such consent to permit Transco, without limitation:

- no longer to retain the legal and beneficial ownership of the share capital of the DN companies;
- to dispose of the share capital of the DN companies; and
- to relinquish all control over the DN companies.

In order to assist the Authority in considering whether to grant such unconditional written consent, I am pleased to provide a report that addresses the matters set out in your letter. The report forms Appendix 1 to this letter and answers in turn each of the questions you raise. The report responds on behalf of each of:

- National Grid Transco plc ("NGT") (as ultimate controller of Transco and as the ultimate controller of each of the DN companies);
 - Transco (as the holder of two relevant Gas Transporter ("GT") licences (i.e. the GT licence in respect of the National Transmission System ("NTS") business and the GT licence in respect of the retained DN ("RDN") business));
 - Blackwater SC A Limited (as the holder of the GT licence relating to the Scotland DN, and being one of the DN companies);
 - Blackwater 2 Limited (as the holder of the GT licence relating to the Wales & West DN, and being one of the DN companies);
 - Blackwater F Limited (as the holder of the GT licence relating to the North of England DN, and being one of the DN companies); and
 - Blackwater G Limited (as the holder of the GT licence relating to the South of England DN, and being one of the DN companies),
- (the "relevant NGT companies").

In your letter you asked the relevant NGT companies to acknowledge, and the relevant NGT companies do hereby acknowledge, that, in the event that the information provided in this letter (including Appendix 1) is misleading or inaccurate, whether intentionally or otherwise, the Authority may take enforcement action or other appropriate action, now or in the future (and regardless of share sale), against any or all of the relevant NGT companies in respect of any or all of the six licences as they will have been the ultimate controller and/or holders of the licences at the time this information is provided.

If you wish to discuss any of the issues raised in this letter (including the Appendix 1), please do not hesitate to contact me.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Chris Train', with a stylized flourish at the end.

Chris Train
Director – Network Sales.

APPENDIX 1

Below we set out Ofgem's questions (in italics) and provide the relevant NGT companies' answers in normal text after each question or sub-question.

Overall, the relevant NGT companies consider that the commercial and regulatory framework established and implemented to support network sales is now sufficiently robust and fit for purpose to support a divested industry structure. Furthermore, the relevant NGT companies consider that all the necessary system changes required to support this framework will be fully operational to allow the sales to proceed, thus enabling the benefits to consumers identified by Ofgem in their final impact assessment to be realised.

- 1. Are there any issues associated with the Uniform Network Code (UNC) or other aspects of the industry code arrangements (including without limitation any or all of the various 'short form' network codes, the joint governance arrangements agreement and/or the agency services agreement), which would (in order to ensure that each of the above companies' licence and wider statutory obligations and the Authority's principal objective and other statutory and public law duties are fulfilled) require:*
 - (a) changes to be made to the UNC, or other aspects of the industry code arrangements, prior to the completion of the share sale; and/or*
 - (b) modifications to be proposed under the UNC modification rules in order to resolve issues that were overlooked as a part of the UNC development process?*

In the event that you are aware of such issues, please provide details and a suggested way forward (including whether you propose to request urgent status in relation to any modification proposal and an assessment of materiality of the issues identified).

The relevant NGT companies remain of the opinion that the current UNC provides a robust commercial framework to support the divested industry structure, allowing all relevant GT licensees (Transco NTS, Transco RDN, and each IDN) to have in place transportation arrangements enabling them to facilitate the achievement of the relevant objectives set out in Standard Special Condition A11(1) of their respective GT licences. Furthermore, we consider the UNC to be consistent with all relevant Authority decisions associated with network sales.

The UNC has been the subject of considerable development, discussion and consultation with the industry. This has involved a long-running process of discussion on policy and business rules through Development and Implementation Steering Group (DISG), Commercial Interface Working Group (CIWG), the UNC Development Forum and the Exit Reform Forum during 2004 and early 2005, Transco's "Towards a new Industry Framework" consultation issued in December 2004, and numerous legal drafting sessions held during January and February 2005 which provided the opportunity for interested parties to input their views on the developing text of the UNC. Furthermore, the UNC was subject to Ofgem's two-stage consultation through March and April 2005, and was refined through this process in response to issues raised by industry participants. Accordingly, the relevant NGT companies formed the view that following this considerable development and consultation process, the UNC was sufficiently robust to support a divested industry structure and allow hive-down to proceed.

Following hive-down, the relevant NGT companies have undertaken a thorough review of the UNC, and remain confident that the UNC is robust and fit for purpose and does not require any further modification to support a divested industry structure following share sale. Furthermore, we believe that the DN purchasers consider the UNC fit for purpose, and they have not identified any issues to NGT that they consider need to be addressed prior to share sale.

The relevant NGT companies are not aware of any material issues that have arisen following the transition from Transco's Network Code to the UNC, or in relation to other aspects of the industry code arrangements (including the 'short-form' network codes, the joint governance arrangements agreement, and the agency services agreement), that would require changes to be made to the UNC or other aspects of industry code arrangements prior to the completion of the share sale.

Furthermore, a number of UNC Modification Panel meetings, committee meetings and Workstream meetings have been held since hive-down and the inception of the UNC. These meetings have provided industry participants every opportunity to raise issues associated with the operation of the UNC. The relevant NGT companies are not aware of any material issues raised by participants through these meetings associated with network sales and the operation of the UNC, and therefore consider that the industry is comfortable with the UNC in its current form and therefore is fit for share sale.

The relevant NGT companies can confirm that the Joint Office became operational from 1 May 2005, allowing the Gas Transporters to discharge their obligations as set out in Standard Special Condition A12 of their respective Gas Transporter Licences. The Joint Office website can be found at www.gasgovernance.com.

The first UNC Modification Panel was held at the Joint Office's new venue for such meetings, 10 Old Bailey, on 3 May 2005. All the business of the day was passed unanimously. This included the approval of; the Chairman's Guidelines, the Terms of Appointment and the Code of Conduct for Subject Matter Experts ("SMEs"), the list of individuals appointed as SMEs, the establishment of the Offtake Workstream and the change of names for the existing Workstreams, new modification and review proposal documentation, and the appointment of the SMEs for two current proposals (Modification Proposals 0007 and 0017, (UNC numbering)).

The second UNC Modification Panel was held on 19 May 2005. The Panel voted for Modification Proposal 0019 to proceed direct to consultation, appointing an SME in the process, and referred Review Proposal 0020 to the Governance Workstream.

On the basis that Modification Proposals (both Urgent and standard process) and a Review Proposal have been raised, that the Modification Panel is operating in its new "5:5" format, that the list of SMEs has been compiled, and that SMEs have been appointed to individual proposals, the relevant NGT companies are confident that the new UNC Modification Rules operate in practice as they were intended to and satisfy licence obligation SSC A11(7).

Whilst we do not consider that there are any material issues requiring modification to the UNC, in the unlikely event that an Urgent Proposal were to be raised prior to share sale, the relevant NGT companies are confident that the modification process would facilitate a report to the Authority within the required time-scale.

All the "Mods in Flight" have made the transition to the new modification process, in accordance with the transition rules, and been renumbered as UNC Modification Proposals.

Four new Modification Proposals have been raised since hive-down; these are:

- 0017** "Amendments to the provisions governing 'failure to obtain readings' (voted direct to consultation by Panel);
- 0018** "Transitional arrangements for the review and calculation of Annual Quantities for Gas Years 2005/6, 2006/7, 2007/8 and 2008/9" (Approved as Urgent on 12 May 2005);
- 0019** "Amendment of Network Entry Provisions at ConocoPhillips sub-terminal at Theddlethorpe to align with Transco's 10 Year Statement" (voted direct to consultation by Panel); and

0020 "Proposal to establish a review group to assess whether any changes are needed to UNC Governance in the light of the imminent introduction of the Appeals mechanism against Authority UNC modification decisions". This review proposal was raised in accordance with the transporters' obligation detailed in UNC-Transition Document (UNC-TD) Part IV paragraph 5 and referred to the Governance Workstream by the Panel.

None of these proposals have been raised as a result of issues arising through hive-down or in anticipation of share sale and the relevant NGT companies do not consider that these proposals are sufficiently material or relevant such that they need to be addressed prior to share sale.

Additionally, Workstream meetings for Transmission, Distribution, Offtake Arrangements and Governance have been held. Each of the Workstreams, which are held as open forums attended by shippers, transporters and other interested third parties, maintains an issues log which records matters arising at the Workstream requiring discussion and which may, or may not, result in a proposal.

On examining the Workstream issues logs, two of the issues recorded in the Transmission Workstream log have been raised as a result of hive-down and / or the implementation of the UNC. These are:

- a) The development work for the enduring exit capacity regime which has transferred from the Exit Regime Forum (ERF) to the Transmission Workstream and is ongoing, and
- b) Review of the operational procedures aligned to Transportation Principal Document (TPD) section O; Transco intend to make a presentation to the Workstream on this issue on 2 June.

The relevant NGT companies are confident that the new UNC governance procedures will permit both of these issues (along with other recorded issues not related to the introduction of the UNC) to be processed through to conclusion. Again, the relevant NGT companies do not consider that these issues are sufficiently material or relevant such that they need to be addressed prior to share sale.

In accordance with Transco's aim to correct minor errors in the UNC subsequent to hive-down, the following "Consents to Modify" the UNC have been submitted to Ofgem since 1 May 2005:

- **C001** - "Changes the to UNC to reflect the prior implementation of Modification Proposal 0730 in the Network Code"

This request to modify the UNC was raised as a result of the implementation of Modification Proposal 0730 on 1 April 2005, that is to say, after the UNC was "locked-down" for the second phase of the UNC consultation. Therefore, it was necessary to carry out this amendment to synchronise the UNC with the pre-hive-down Network Code.

This consent request was submitted to Ofgem on 6 May 2005 and approved on 19 May 2005.

- **C002** – "Proposed minor amendments to the UNC identified during the second phase of the draft UNC pre-hive-down consultation"

Transco advised Ofgem in its update letter¹ of 18 April 2005 that a number of minor drafting errors had been discovered during the second phase of the UNC consultation.

¹ _Transco update on process regarding conditions precedent of the Authority's consent direction, Letter from Chris Train to Sonia Brown, 18 April 2005.

These were documented in Appendix 4 of the letter and Transco advised Ofgem that it intended to correct the errors by way of seeking Ofgem's Consent to Modify.

This consent request was submitted to Ofgem on 6 May 2005 and approved on 20 May 2005.

- **C003** – "Correct allocation of obligations with respect to Transportation Revenue Information"

During the UNC drafting phase, the section of the UNC (TPD V5.12 and Annex V-3) that deals with the obligation to publish revenue information was mapped solely to Transco NTS. However, some of the information, as detailed in Table 1 within this Annex, relates to transportation revenue. Hence, the obligation should relate to "the Transporter" rather than "Transco NTS".

This consent request was submitted to Ofgem on 9 May 2005 and approved on 23 May 2005.

All these modifications have been implemented and will be reflected in the next issue of the UNC.

Overall, the relevant NGT companies consider that the UNC governance arrangements are fully operational and effective, providing the fullest opportunity for participants to raise issues and modification proposals to address any concerns they might have. There have been a number of industry meetings covering the scope of the UNC and, to date, no material issues have been identified through such meetings, supporting our view that the UNC provides a robust commercial framework to support a divested industry structure. If any commercial or operational issues associated with the UNC resulting from DN sales does arise in future, we will notify the Authority and seek to resolve any such issues in an economic, efficient and expeditious manner and, where appropriate, raise a modification proposal to rectify any issues identified.

2. *Whether you consider that UK-Link and all other relevant IT systems are fully operational to work in and support a divested industry structure post completion of share sale? The response should consider (without limitation):*
 - (a) *each of the systems of:*
 - *xoserve;*
 - *Transco NTS;*
 - *Transco RDNs;*
 - *IDNs;*
 - *independent gas transporters; and*
 - *shippers;*
 - (b) *any systems that are required to interface between one or more of the parties listed in (a) above; and*
 - (c) *the results of the industry's end-to-end system testing.*

In the event that you identify any operational issues, including (without limitation) data transfer issues, please provide details of the issue, as well as your view of the materiality of the issue and a suggested way forward.

In this respect, Ofgem also specifically requests that Transco report on whether potential buyers are fully satisfied that their own IT systems (and those of the DN companies which they propose to acquire) are fully operational to work in and support a divested industry structure post share sale having regard to the need to interface with a wide variety of interested parties, including without limitation, shippers, suppliers and independent gas transporters

xoserve and related systems

The relevant NGT companies consider that UK-Link and all other relevant IT systems are now fully operational to operate in and support a divested industry structure post completion of share sale.

With respect to **UK-Link** and its supporting systems, xoserve was established on 1 May 2005 as the Agency for all relevant GT networks, providing a common set of commercial systems and processes on behalf of relevant GTs, thus allowing these networks to discharge their obligations under GT licence condition SSC A15. The creation of xoserve has enabled a smooth transition to the new multi-transporter environment, ensuring that Users continue to face a single interface in respect of the provision of a wide range of commercial services provided by the relevant gas transporters (Transco NTS, Transco RDN and the IDNs).

The operation and management of the UK-Link suite of systems is a fundamental part of such services. With the exception of changes to the invoicing suite, all changes to UK-Link and supporting systems that were necessary to support a multi-transporter environment have been implemented, and became fully operational when hive-down occurred on 1 May 2005. The implementation of these changes has been completely seamlessly, without any disruption to services and service users. There have been no adverse impacts of these changes identified or reported by the shipper community, or any other party, and we have no reason to believe that there will be any such adverse impacts following the sale of the DN companies.

With respect to the **invoicing changes**, although there had been a late issue raised with three of the file formats, a resolution was agreed in April 2005 with the industry representatives of the UK-Link Committee, and communicated to all affected parties. Endorsement of the scheduled implementation date of 1 June 2005 has been given at the last two UK-Link Committee meetings (on 21 April 2005 and 19 May 2005). xoserve's changes to the invoicing suite have been successfully tested and are in the final stages of implementation, which are scheduled to be completed by the end of May 2005.

xoserve, on behalf of the relevant NGT companies, is continuing to provide support to shipper system testing activities, and is planning to provide a higher level of support for the first month after implementation, as is usual for a change of this scale. xoserve has proactively engaged the shipper community making all reasonable enquiries on its readiness to implement the invoicing changes at scheduled operational meetings as well during less formal interactions. From xoserve's discussions with operational contacts within shipper organisations, the relevant NGT companies remain confident that shippers' systems will be ready to operate in a multi-transporter environment, such that split invoicing will commence in June 2005 in respect of charges incurred during May 2005, with the first batch of invoices to be issued in respect on behalf of the separate relevant transporters on 1 June 2005, regardless of whether share sale proceeds.

In the unlikely event that any issues associated with the operation of xoserve in relation to network sales arise following the sale of the DN companies, the relevant NGT companies will

notify the Authority and work with xoserve, shippers and the IDN purchasers to resolve any such issues in an economic, efficient and expeditious manner.

Operational Control Systems (Transco NTS, Transco RDN, IDNs)

With respect to **Operational Control (SOMSA) Systems**, these remain unchanged for Network Sales. System Operation remains substantially the same post hive-down with the Gas Transportation Management System (GTMS) / Integrated Gas Managements System (iGMS) operational control systems requiring no functional changes to accommodate the new regime at hive-down and the same will be the case post share sale. These systems remain internal to Transco NTS which retains overall day to day system management control on behalf of the IDNs and the RDNs through managed service agreements. In terms of the impact of the interim Exit Capacity arrangements, minor enhancements were required and we can confirm these have been undertaken and implemented.

Front Office Systems (Transco NTS, Transco RDN, IDNs)

With respect to **Front Office (FOMSA) systems**, the relevant NGT companies can confirm that all the necessary application changes have been completed successfully. The scope of these changes included access control requirements for 30 applications, and the enablement of geographical access restrictions for nine applications.

The FOMSA provides the new companies with continuity of systems for period of at least 18 months, hence there is no risk associated with the sales. The necessary changes, to ensure access is restricted to commercially sensitive data for both IDNs and RDNs, took place over the hive-down weekend and there have been no reported issues. As part of the sales process, we have been working extensively with the IDN purchasers to assess and agree their plans for exiting the FOMSA systems. These plans have been agreed and we are confident that they will be able to transition from the Transco applications on to their own in a safe and effective manner and we are supporting the DN purchasers in migrating to their own front office applications in an efficient and seamless manner.

Back Office Systems (Transco NTS, Transco RDN, IDNs)

With respect to **Back Office systems**, as from 1 May 2005 new systems and processes were established that have allowed both the IDNs and xoserve to operate as separate companies with their own back office capability whilst still under the ownership of NGT. Both the system changes and data conversions associated with the company creation went to plan and there are no material issues associated with how these companies are currently operating.

There have been no major changes made to either the Transco RDN or Transco NTS back office systems and we confirm that these systems are fully operational and fully support the businesses in satisfying their statutory and licence obligations.

Plans are in place for the cutover to IDN purchasers' own back office systems and processes at share sale completion. The relevant NGT companies and the IDN purchasers have been working on the Back Office transition for well over eight months. Having made all reasonable enquiries and actively discussed progress with the IDN purchasers, the relevant NGT companies can confirm that the IDN purchasers are confident that their back office systems will be operational from 1 June 2005.

In August 2004, NGT, working closely with each of the IDN purchasers, required that each purchaser develop their own Back Office system implementation and data migration framework and plans. Several key milestones associated with confirming the respective purchaser's readiness to exit at share sale completion were built into the implementation programme:

Milestone A – The purchaser shall have successfully installed the target systems and completed data transformation so as to allow migration testing to commence.

Milestone B – Within 10 working days prior to the anticipated share sale completion date, the purchaser shall have completed migration testing and confirmed to Transco the purchaser's readiness for live cutover.

Milestone C – Within 24 hours after the share sale completion date, the purchaser shall have successfully achieved live cutover.

The purchasers were required to report progress against key (and supporting) milestones via weekly status reports on their respective target system implementation, data load and transform routines and also meet with NGT on a monthly basis to monitor progress to their agreed schedule and ensure NGT and purchaser plans remained aligned and issues and risks were actively managed by all parties.

During May 2005, all purchasers have formally confirmed to NGT that Milestone A has been achieved. NGT has subsequently provided purchaser-specific test data to enable migration testing to take place and recent feedback confirms the purchasers final migration testing has progressed well. With respect to Milestone B all purchasers have confirmed their readiness for live cut-over. All purchasers have now given formal notice to NGT that they are confident that both Milestone B and Milestone C will be achieved, based on the anticipation that share sale completion will occur on 1 June 2005.

Purchasers' confidence in being ready to implement their own Back Office systems on time has been re-affirmed during each of their respective May monthly progress meetings.

The relevant NGT companies can confirm that the potential buyers have indicated that no material issues remain with respect to their IT systems. Therefore we consider that all back office systems and contingencies will be in place to support the divested industry structure from the date of share sale.

Conclusion

Overall, the relevant NGT companies are confident that all the necessary system changes enabling the relevant gas transporters to fulfil their respective statutory and licence obligations under a divested industry structure will be in place and fully operational to allow the sales to proceed. In the unlikely event that any issues associated with such systems arise as a consequence of network sales, we will notify the Authority and work with the IDN purchasers and xoserve to resolve any such issues in an economic, efficient and expeditious manner.

3. *Whether, in respect of each of the six relevant GT licences, you are aware of any issues that need to be resolved prior to receiving all Health and Safety Executive (HSE) approvals required prior to completion of share sale. If there any such issues please identify them. In addition please indicate whether you have received all necessary HSE approvals. Please note that among other things, and without limitation, Ofgem expects to receive copies of all HSE approval letters before it gives unconditional consent to share sale.*

The Health and Safety Executive have completed their assessment of the four IDN version 5 Safety Cases. They have also completed the assessment of the Scottish Independent Undertakings Safety Case and the Transco Safety Case (RDNs + NTS).

The HSE have concluded that the Safety Cases as submitted meet all the requirements of the Gas Safety (Management) Regulations 1996 and make the necessary demonstrations against the particulars detailed in those regulations.

The HSE have sent letters confirming acceptance of the Safety Cases to each of the new duty holders in the four IDNs. These acceptances are unconditional, and the relevant NGT companies can confirm that there are no issues in relation to these acceptances that require resolution prior to completion of the share sale. The confirmation letters enable the independent networks owned by the new buyers to operate with effect from 1 June 2005. Copies of all these letters have been sent directly from the HSE to Ofgem.

4. *In respect of each of the six relevant GT licences:*

- (a) *Whether you are aware of any issues associated with the operation of the licences that give rise to a requirement to modify the licence(s) (in order to ensure that each of the above companies statutory obligations and the Authority's principal objective and other statutory and public law duties are fulfilled. If there are any such issues please report on whether the modifications need to occur before the completion of any sale of shares in the DN companies to third party purchasers;*

In answering this question it is perhaps helpful to briefly outline the extensive licence consultation process that has been conducted to date in the context of the DN sales process (the "Proposed Transaction")

The Modification and consultation process to date

As part of the Proposed Transaction, on 25 November 2004, the Authority published a notice pursuant to section 23 of the Act proposing modifications to each of the six licences held by Transco, together with an explanatory document.

This notice consulted on the Authority's proposal to separate the price controls in the Original Transco Licence to achieve revenue separation between the NTS and each of the DNs which are proposed to be disposed of by Transco (the "IDNs") and each of those DNs which are proposed to be retained by Transco (the "RDNs"). The explanatory document which was also consulted on informally asked for comments on the proposed restructuring of the licences as a whole to meet the regulatory needs of a divested industry.

The modifications required to achieve revenue separation were directed by the Authority on 1 February 2005.

After considering the responses to the informal consultation on the licence modifications required for a divested industry, and after extensive and detailed consultation concerning the drafting of individual licence conditions with industry participants through DISG, on 14 February 2005 the Authority published two notices proposing further modifications to each of six licences pursuant to section 23 and section 8AA of the Act, together with an explanatory document.

These notices stated that the effect of the proposed modifications would be to restructure each of the licences to support a divested industry structure with the intention of protecting the interests of customers in the event that the proposed transaction were to proceed.

On 25 April 2005 the Authority, having considered the responses to this consultation directed

- that each of the IDN Additional Licences be modified on 25 April 2005 but that such modifications would take effect by way of a separate direction. The Authority also consented to the transfer of the four IDN Additional Licences from Transco to

the four relevant wholly owned Transco subsidiary companies but that such transfers would take effect by way of a separate direction; and

- that the Original Transco Licence and the RDN Additional Licence be modified on 25 April 2005 but that such modifications would take effect by way of a separate direction.

On 1 May 2005, the modifications to restructure the six licences were brought into effect, and each of the IDN Additional Licences were transferred from Transco to respectively each of Blackwater G Limited, Blackwater F Limited, Blackwater 2 Limited and Blackwater SC A Limited together with the DN assets to which each of the IDN Additional Licences related.

Notwithstanding these modifications, at the time of hive-down of the IDNs from Transco to the four wholly owned Transco subsidiary companies, the Authority did not consider that the regulatory arrangements necessary to protect the interests of customers in a divested industry structure were fully in place. The Authority therefore considered that further modifications to each of the six licences would be required to ensure that customers' interests are protected.

As a result, on 26 April 2005, the Authority gave notice that it was proposing to modify further each of the six licences under section 23 of the Act. These modifications included

- general modifications to deal with respondents' views on the consultation conducted by the Authority in relation to the notice published in February 2005;
- modification proposals relating to the introduction of the interim incentive arrangements; and
- certain general modifications to the price control conditions to deal with respondents' views to the consultation conducted by the Authority in relation to the notice published in February 2005.

Following the consultations referred to above, the Authority carefully considered representations or objections made to it and not withdrawn in relation to its proposals to modify each of the six licences. The relevant NGT companies have considered the development of the licences through each of these consultations, as well as, in the case of Transco, taking part in the discussions at DISG. In this light, and having reviewed the public responses made to the Authority in relation to each of the consultations described above, the relevant NGT companies consider that each of the six licences have been the subject of a thorough and robust consultation process which has given all industry participants and other stakeholders sufficient opportunity to have their views heard in relation to the regulatory regime to be put in place after the proposed transaction has completed.

As stated above the relevant NGT companies have conducted an extensive review of each of the six relevant GT licences and are satisfied (subject to the points set out below) that they are not aware of any issues associated with the operation of the licences that give rise to a requirement to modify the licence(s) in order to ensure that each of the relevant NGT companies' statutory obligations and the Authority's principal objective and other statutory and public law duties are fulfilled. Accordingly, the relevant NGT companies believe that each of the six licences is drafted in such a way that its terms operate effectively and consistently with each of the relevant NGT companies' statutory obligations and the Authority's principal objective and other statutory and public law duties.

In particular the relevant NGT companies have thoroughly reviewed the price control conditions within the six relevant GT licences, taking into account the modifications which are the subject of the previous section 8AA and section 23 consultations issued on 14

Feb 2005 and the section 23 consultation issued on 26 April 2005. This thorough review has not raised any concerns as to the operation of any conditions which affect revenue flows and the relevant NGT companies continue to be satisfied that these provisions and that all associated revenue flows will operate appropriately within all six relevant GT licences and in accordance with the Authority's policy intent.

In giving this assurance the relevant NGT companies have made relevant enquiries of the purchasers of Blackwater SC A Limited, Blackwater 2 Limited, Blackwater F Limited and Blackwater G Limited and these purchasers have confirmed that they are not aware of any issues associated with the operation of the licence(s) that give rise to a requirement to modify the licence(s).

The relevant NGT companies have identified the following issues requiring modification to the licence(s):

- The modifications to the six relevant GT licence(s) which are currently the subject of the section 23 Notice dated 26 April 2005 subject to the following:
- In Special Condition C14 of the Original Transco Licence, the correction of the typographical error in the term "ExBBC_{d,t}" which is defined in the table in paragraph 1 so as to read "Exit capacity buy-back costs" rather than "Entry capacity buy-back costs";
- In Standard Special Condition A39 of each of the six relevant GT licences, the amendment of the definition of "cross default obligation" within paragraph 5 so as to refer, at sub-paragraph (iii), to "paragraphs 1(a), 1(b), 1(c) or 1(d) of the definition of permitted purpose set out in Standard Special Condition A32 (Definition of Permitted Purpose)".
- The further modification of Special Condition C19 in the Original Transco Licence and the insertion of a "mirror" provision as Special Condition E9 of the Additional Transco Licence relating to the RDN in order to address some residual concerns of the Authority in relation to business separation and to clarify the licensees' obligations in this regard. We understand that the Authority is likely to include these revised conditions in the relevant licences after having conducted a statutory consultation on the licence modifications in June 2005 and until such time as these modifications are introduced into the relevant licence the Authority requires an undertaking from NGT that it will procure that Transco plc will conduct its NTS and RDN businesses as if such modifications were already in effect. NGT has given such undertaking to the Authority and such undertaking will remain in force until such time as the licence modification in relation to C19 takes effect.

Save for the issues referred to above, the relevant NGT companies have not identified any further licence modifications that are required to the six relevant GT licences.

- (b) *Whether all necessary consents, clearances, permissions, authorisations or approvals required by Transco NTS, Transco RDN and each DN company on completion of share sale have been applied for and granted by the Authority to take effect on 1 June 2005. If any consents, clearances, permissions, authorisations or approvals remain outstanding at this time, please provide details. Your report should also indicate whether each of the DN purchasers agrees (or not as the case may be) with your assessment.*

The relevant NGT companies have conducted an extensive review of each of the relevant GT licences in order to identify the consents, clearances, permissions, authorisations and approvals required by Transco NTS, Transco RDN and each DN company for completion of share sale. Following such review Transco, as licensee for the NTS and the RDNs has applied for all consents, clearances, permissions, authorisations and approvals ("licence

related instruments" ("LRIs")) that it considers necessary for completion of share sale. Transco has seen the final draft versions of these LRIs and is satisfied that, subject to the Authority granting them to take effect on 1 June 2005, Transco will be in a position to comply in full with its NTS and RDN licences. Transco does not consider that there are any LRIs outstanding.

Following the review of each of the relevant GT licences in order to identify the consents, clearances, permissions, authorisations and approvals required by Transco NTS, Transco RDN and each DN company for completion of share sale, Blackwater 2 Ltd, Blackwater F Ltd, Blackwater G Ltd and Blackwater SC A Ltd also applied for all LRIs that they considered necessary for completion of share sale. Following such applications, NGT also asked the DN purchasers to confirm that the LRIs applied for by each Blackwater company constituted a full and final list of LRIs that each such company requires on completion of share sale. All DN purchasers have seen the relevant LRIs granted to each of the DN companies on 1 May 2005 and the final draft versions of those LRIs applied for by the DN companies for share sale completion. All DN purchasers have provided written confirmation to NGT that, subject to the Authority granting the LRIs applied for with effect from 1 June 2005, the relevant DN companies will have all necessary consents required for share sale, and that the DN purchasers do not consider that there are any LRIs outstanding.

- (c) *Whether, assuming share sale proceeds on 1 June 2005, Transco NTS and Transco RDN and each DN company will be in a position to comply in full with its licence obligations, including conditions imposed by consents, on that date.*

Transco is satisfied that, subject to the Authority granting the LRIs applied for to take effect on 1 June 2005, it will be in a position to comply in full with its NTS and RDN licence obligations, including conditions imposed by its consents.

NGT has also asked each IDN purchaser to confirm that the relevant DN company will be in a position to comply in full with its licence obligations, including those imposed by consents, after share sale completion. Each IDN purchaser has provided such confirmation in writing to NGT.

5. *In relation to both the business separation arrangements in place between the NTS and the RDNs and the undertaking provided in accordance with Special Condition C19, whether Transco NTS has entered into arrangements with Transco RDN business on terms which are effective from the date of completion of share sale or earlier, and which do not unduly differ from corresponding contractual arrangements entered into with the four relevant DN companies and which would be entered into as contractual arrangements if the Transco RDN business were not held within the same legal entity. For the avoidance of doubt, and without limitation to any other issue, the Authority would expect to have confirmation that the arrangements described above have been entered into.*

Business separation arrangements are in place between Transco NTS and Transco RDN that ensure compliance with the business separation licence conditions. In particular, a business separation compliance officer has been appointed for both Transco NTS and Transco RDN and has been allocated the tasks required by their licences. A compliance statement has been submitted and approved by Ofgem, and prior to this a review was conducted in order to establish the actions needed to ensure that Transco NTS and Transco RDN can each comply with their respective obligations. The required actions that were identified by the review have

been implemented to secure managerial independence of NTS from RDN, operational independence of NTS from RDN, and appropriate restrictions on access to NTS systems, accommodation and resources.

Effective at hive-down, Transco NTS put in place the ultimate controller undertaking required by Special Condition C19 and provided a copy to Ofgem. At that time, a further undertaking was given by NGT and Transco with the effect that wherever Transco NTS provides services to Transco RDN, the terms would not be unduly different to those that apply wherever the same services are provided by Transco NTS to IDNs, and that any such NTS/RDN arrangements would be set out in writing. Written arrangements that comply with Special Condition C19 and the further undertaking have been put in place in respect of services provided by Transco NTS to Transco RDN.

Ofgem is of the view that further clarification to Special Condition C19, as currently in force, is needed. Transco NTS and Transco RDN acknowledge that Ofgem has therefore signalled its intention to modify Special Condition C19 and to add an additional condition to the licence of Transco RDN, as soon as it is expedient to do so. The proposed C19 modification would have the effect of clarifying that written arrangements are needed wherever Transco NTS provides/procures services to/from Transco RDN and that such arrangements must be on arm's-length commercial terms not unduly different from the terms on which Transco NTS would provide/procure the same services to/from an IDN. The proposed new RDN licence condition would have the effect of clarifying that written arrangements are needed wherever Transco RDN provides/procures services to/from Transco NTS and that such arrangements must be on arm's-length commercial terms not unduly different from the terms on which an IDN would provide/procure the same services to/from Transco NTS.

NGT has undertaken that it will ensure that Transco NTS and Transco RDN will each conduct their activities from 1 June 2005 as if the further licence modifications described above had been made on that date, thereby removing the residual concerns of the Authority as to the lack of clarity of Special Condition C19 in the period immediately following share sale.

6. *Whether Transco NTS has entered into arrangements with both Transco RDN, and each of the four relevant DN companies, to ensure that customers do not bear any of the costs associated with the unconstrained incremental release of NTS offtake flexibility. Ofgem also requests that Transco report on whether these arrangements continue until such time as NTS offtake (flexibility) capacity is first released pursuant to the enduring offtake arrangements or such other date as the Authority may specify in writing*

For the avoidance of doubt, and without limitation to any other issue, the Authority would expect to have confirmation that the arrangements described above have been entered into.

Transco (as NTS licensee) has prepared, negotiated and completed identical agreements with each DN to ensure that customers do not bear any of the costs associated with the unconstrained incremental release of NTS offtake flexibility to those DNs. The arrangements will exist in respect of the time period before which any NTS offtake (flexibility) capacity first released pursuant to the enduring offtake arrangements becomes effective.

The agreements are consistent with Transco's statutory and NTS Licence obligations including the requirement to ensure no undue discrimination. Transco NTS has put in place identical arrangements with Transco RDN via an internal agreement. This arrangement has been confirmed between those responsible for Transco NTS and Transco RDN. Internal processes and procedures will ensure that the arrangements will be implemented in a way that is

consistent with application to the DN companies in accordance with the provisions of Special Condition C19 of the Transco NTS licence.

The agreements provide for the unconstrained release of incremental NTS offtake (flexibility) capacity consistent with DNs' needs to satisfy their statutory and licence obligations, together with the option for surrender of such capacity on a day-by-day basis where and to the extent that the NTS is physically constrained and provision of such capacity would compromise the safe operation of the NTS. Neither NGT nor Transco will seek any relief in the context of any of its price controls in respect of any of its licences for any costs incurred in exercising the options defined in the agreements.

The effect of the arrangements is to prevent customers from bearing any of the costs that might arise from the unconstrained incremental release of NTS offtake (flexibility) capacity at NTS/DN offtakes in respect of gas days from share sale until the point at which NTS offtake (flexibility) capacity released under the enduring offtake arrangements comes into effect or such other date as the Authority may specify in writing.

Each of the buyers has confirmed in writing their consent to these arrangements, and identical arrangements have now been signed between Transco NTS, Transco RDN, and each IDN.

7. *Whether the new contractual arrangements relating to independent networks are in place and whether, in particular, all relevant contracts have been novated to the relevant DN companies. In the event that you identify any contracts that are not in place, please provide details of the contract and a suggested way forward.*

Under the hive-down agreements, where a contract relates to an IDN business and the terms of that contract do not require third party consent in order to transfer the rights and obligations to the relevant DN company, the hive-down agreements operate to achieve the automatic transfer of those rights and obligations to the relevant DN company.

Where third party consent is required for the transfer of the rights and obligations under a contract, the hive-down agreements recognise that it may take time to obtain such consents from the relevant third party to allow transfer of such contracts to the relevant DN company, and accordingly allow the IDN companies to continue to operate under these contracts until the necessary third party consents are obtained.

The hive-down agreements have been designed to ensure that:

1. prior to gaining the necessary third party consents to the novation of such contracts, the IDNs will continue to have access to all the services they need under these contracts as necessary to manage their networks consistent with their licence and statutory obligations, thus ensuring that no operational issues arise where novation cannot be achieved; and
2. the relevant DN companies indemnify Transco in respect of any claims that might arise as a result of the relevant DN companies' operation of the contract prior to achieving such transfer. Accordingly, Transco is indemnified against any financial risk associated with delays to such transfers.

The IDNs will continue to have the benefit of all such contracts under the terms of the hive-down arrangements, and in effect, will make or receive payments in respect of the services they obtain or provide under all such contracts, albeit that Transco, as the contracting party, will act as a middleman, issuing and paying invoices and effectively administering payments between the contracting parties and the relevant IDNs. Overall, the hive-down arrangements allow all contracts which require novation, to operate as if they have been novated, thus serving to protect the interests of customers. Customers are held completely neutral and are in no way affected by the operation of any of these arrangements, as all payments for services will be properly allocated to the relevant IDN companies, and therefore there will be no cost impact on any customers as a result of contract novation, or lack thereof.

The relevant NGT companies are making steady progress in gaining the necessary consents from third parties as demonstrated in Transco's weekly reports to Ofgem required in accordance with the interim CDO consent granted under Standard Special Condition 39. However, a number of contracts remain outstanding as at today's date. The relevant NGT companies hope that many of these can be transferred over the next few weeks, and are in active discussion with the relevant counterparties in seeking their consent.

8. *Whether Transco (in respect of both its NTS and RDN licences) and each of the four relevant DN companies have consented to the licence modifications which are the subject of the current section 23 consultation.*²

The relevant NGT companies await Ofgem's request for consent to the licence modifications that are the subject of the current section 23 consultation; we will then respond accordingly. Subject to the proposed modification to Special Condition C14 (which the relevant NGT companies regard as a non-material change in order to amend a typographical error where the intention is clear) and to Standard Special Condition A39 identified in our response to paragraph 4(a) above and (in relation to Special Condition C14) in the relevant NGT companies' response to the current section 23 consultation, the relevant NGT companies are minded to provide their written consent to the proposed modifications to the six relevant GT licences, as identified in the formal section 23 consultation issued on 26 April 2005.

The relevant NGT companies have reviewed all the responses to Ofgem's section 23 consultation issued on 26 April 2005 and do not consider that any of these responses raise issues that require further changes to the NTS, RDN or IDN licences at this stage.

In particular, in respect of the price control licence conditions drafting consulted on as part of Ofgem's section 23 consultation issued on 26 April 2005, the relevant NGT companies continue to believe that this drafting is consistent with the intent of Ofgem's Final Proposals (taking into account the typographical error within Special Condition C14 referred to above).

9. *Whether there any other issues that you consider that the Authority should be aware of or take into account in reaching its decision on whether to allow share sale to proceed on 1 June 2005. In the event that there are further issues that the Authority should be aware of, please provide details of the issue, as well as your view of the materiality of the issue and a suggested way forward.*

The relevant NGT companies are not aware of any other issues that the Authority should be aware of in reaching their decision whether to allow the share sales to proceed on 1 June 2005. However, if any commercial, regulatory or operational issues resulting from DN sales arise in future, the relevant NGT companies will notify the Authority and seek to resolve any such issues in an economic, efficient and expeditious manner.

Ofgem have received a response to their open letter from the Chemical Industries Association regarding the enduring offtake arrangements. However, the Authority concluded as part of its January 2005 consent to network sales that enduring offtake arrangements are necessary to protect the interests of consumers under a divested industry structure. The relevant NGT companies do not consider that the issues raised in this response relate to share sale completion, and are not therefore relevant to the Authority's decision on whether to consent to allow the share sales to proceed on 1 June 2005.

² *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, Ofgem, April 2005. This consultation closed on 24 May 2005.*