

# Schedule 1 Respondents' views

## *Introduction*

## *Background*

- 1.1 Following National Grid Transco plc's (NGT's) announcement, in May 2003, that it would consider the sale of one or more of its DNs if it were to increase shareholder value, Ofgem initiated a programme of work to explore the potential costs and benefits that such a transaction may have for customers.
- 1.2 As part of this process, in September 2004 (the September document), Ofgem issued its initial analysis of the modifications to the relevant GT licences (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<sup>1</sup>.
- 1.3 This was followed, in November 2004, by a "Next Steps" document<sup>2</sup>, which set out respondents' views to Ofgem's September document, and Ofgem's revised proposals in the light of these views.
- 1.4 In February 2005, Ofgem issued a formal licence modification and transfer consultation document which was published on 14 February 2005 (the February document)<sup>3</sup> under section 23 and section 8AA of the Gas Act 1986 (Gas Act) on the proposed changes to Transco's GT licences required to ensure that the interests of customers continue to be protected in the event of any DN sales. This formal licence consultation represented the culmination of an extensive process of consultation, not only through the consideration of responses to the consultation documents outlined above, but also through discussions at regular open meetings of the Development and Implementation Steering Group (DISG).

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<sup>1</sup> 215/04 – National Grid Transco – potential sale of gas distribution network businesses - Initial thoughts on restructuring of Transco plc's Gas Transporters licence. Consultation document - September 2004.

<sup>2</sup> 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. November 2004.

<sup>3</sup> 45/05 - 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.

- 1.5 Following receipt by the Authority of a report from Transco updating the Authority on its progress regarding the remaining conditions precedent to consent, on 29 April 2005 the Authority issued an open letter<sup>4</sup> stating that having reviewed Transco's report and having due regard to its principal objective, it had concluded that the conditions precedent had been, or would be, fully satisfied by 1 May 2005 and that Transco could proceed to hive-down its four relevant DN businesses into its four relevant wholly owned subsidiary companies on 1 May 2005. Accordingly, a direction was issued which brought the licence modifications proposed as part of the section 23 and section 8AA consultation (with a few minor corrections) were made on 1 May 2005<sup>5</sup>
- 1.6 After the publication of this open letter, and prior to the completion of the sale of shares in the DNs, which Transco is proposing to sell to third party potential purchasers (potential purchasers), Ofgem conducted a further consultation on additional modifications to each of the six relevant GT licences which Ofgem considered may be necessary to protect the interests of customers in a divested industry structure. This section 23 licence consultation (referred to in this document as the April 2005 document) included modifications to introduce the interim incentive schemes for the NTS and the DN-GTs, as well as certain changes required as a consequence of respondents' views to the February document.

### ***Purpose of this Schedule***

- 1.7 This Schedule is structured as follows;
- ◆ Part A of this Schedule provides a summary of the high-level views expressed by respondents in relation to Ofgem's Final Proposals with respect to the interim incentives and Ofgem's response to these views; and
  - ◆ Part B of this Schedule provides a summary of the views expressed by respondents in relation to Ofgem's proposed licence drafting changes necessary to implement Ofgem's Final Proposals for interim incentives as

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<sup>4</sup> Ofgem open letter – Final approval for hive-down of NGTs Gas Transporter Network – 132/05.

<sup>5</sup> Implementation Direction made on 25 April 2005 under Section 23 of the Gas Act 1986 and Direction made under other specified provisions of two Gas Transporter licences held by Transco plc. Implementation Direction made on 25 April 2005 under Section 8AA of the Gas Act 1986 and Direction made under other specified provisions of two Gas Transporter licences held by Transco plc

well as further changes, as appropriate, to clarify the drafting directed on 25 April 2005 including Ofgem's proposals in light of these views.

- 1.8 In total Ofgem received six responses to the April 2005 document. Respondents included Transco (the licensee), all three potential purchasers, shippers/suppliers, and the Health and Safety Executive (HSE). None of these responses were confidential.
- 1.9 Each of these responses can be found in full on the Ofgem web-site ([www.ofgem.gov.uk](http://www.ofgem.gov.uk)).
- 1.10 It should be noted that nothing in this schedule shall fetter the discretion of the Authority in relation to future decision associated with licence interpretation and enforcement.

## ***Part A – Ofgem’s Final Proposals with respect to the Interim Incentives.***

### **Views expressed by NGT**

- 1.11 NGT<sup>6</sup> stated that, as detailed in responses to previous consultations, it was supportive of Ofgem’s general approach of retaining most aspects of the current exit incentive scheme. NGT stated that it was pleased that Ofgem had accepted some of the arguments made in response to the consultation and reflected them in the final incentive proposals.
- 1.12 NGT stated that it was disappointed that Ofgem had rejected its arguments relating to specific aspects of the NTS and DN interim incentives schemes. In particular, NGT stated that it was disappointed at the level of exposure that the NTS would face as a result of an unconstrained release of capacity (flat and flexible). However, NGT stated that, despite its disappointment, it was prepared to accept the NTS and DN interim incentive arrangements in order to enable the sale of the distribution businesses to proceed.

### **Views expressed by potential purchasers**

- 1.13 One potential purchaser stated that Ofgem’s approach of presenting the licence drafting proposed to implement the interim incentives was very useful in helping them to understand the detail of the DN scheme proposed and provided them with opportunities to comment at various stages. However, this potential purchaser stated that it was disappointed that Ofgem had not proposed an ex post adjustment mechanism to avoid a DN being “penalised” for genuine, unforeseen additional demand growth, including the impact of interruptible customers requesting to become firm, particularly given the expected reform of DN exit arrangements.
- 1.14 This potential purchaser was further disappointed that Ofgem was not expecting to modify the Regulatory Asset Values of the DNs at the next price control

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<sup>6</sup> NGT responded; on behalf of Transco, as the holder of two relevant Gas Transporter (GT) licences (NTS and RDN licences); on behalf of Blackwater SC A as the holder of the GT licence relating to Scotland; on behalf of Blackwater 2 as the holder of the GT licence relating to Wales and West; on behalf of Blackwater F as the holder of the GT licence relating to North of England; and on behalf of Blackwater G as the holder of the GT Licence relating to South of England.

review to take into account NTS offtake related investment as this potential purchaser considered that this would potentially undermine the intent of the incentive scheme, which is to encourage the DN to invest in its own system if it were more efficient to do so than to seek incremental NTS capacity. This potential purchaser urged Ofgem to revisit both of these conclusions in the review after the first year of the incentive scheme.

- 1.15 This potential purchaser also raised a concern regarding the targets, caps, collars and sharing factors set out in the April 2005 document. This potential purchaser stated that as these targets had been set against NGT's planning assumptions, they had not been within the control of the potential purchasers. The same potential purchaser stated that, in its view, this further underlined why a review of the scheme is required after one year. Furthermore, this potential purchaser stated that the introduction of DN exit reform should be preceded by a review of the DN incentive scheme to ensure that both are compatible.
- 1.16 This potential purchaser also stated that it was disappointed that Ofgem had proceeded with its proposals to introduce a single income adjusting event (IAE) threshold across all networks. This potential purchaser stated that this decision would in all likelihood exclude certain DNs from claiming such an IAE. However, this potential purchaser welcomed Ofgem's commitment to revisit the threshold in the context of the enduring offtake incentive scheme.

### **Views expressed by shippers/suppliers**

- 1.17 One shipper/supplier stated that it was broadly in agreement with the proposals in respect of the interim incentives, which are only intended to apply until 1 October 2008, in respect of the form, caps/collars and sharing factors. This shipper/supplier stated that it also supported the inclusion of parameters until September 2008 and believed that it would also be beneficial to extend Tables A3 and A4 (that define baseline levels of firm and interruptible NTS exit capacity rights from 2002/3 to 2006/7) to September 2008.

### **Ofgem's views**

- 1.18 Ofgem welcomes NGT's view that it is appropriate to retain most aspects of the current NGT exit incentive scheme in the interim incentive proposals. Ofgem notes that NGT is disappointed with the level of exposure borne by the NTS

under the incentive proposals, however given the nature of the interim offtake arrangements, Ofgem considers that the proposals represent a fair balance of risk and reward between customers and Transco shareholders. Ofgem therefore welcomes NGT's conclusion that the NTS and DN incentive proposals are acceptable for adoption for the interim period.

- 1.19 Ofgem welcomes the views of one potential purchaser that the Final Proposals for interim incentives were sufficiently detailed to enable this respondent to provide fully informed drafting comments. In response to the view of this respondent that an *ex post* volumetric adjustment should be adopted for DN incentives, Ofgem continues to consider that such a mechanism would not be appropriate. This is because Ofgem considers that, given DNs will have responsibility for managing the trade-off between requests for NTS offtake rights and demand management tools in the interim period, it is appropriate that DNs are the parties exposed to an appropriate extent of the risk that demand may differ from expected levels.
- 1.20 In relation to this potential purchaser comments, Ofgem notes that the potential purchaser does not agree with the view expressed in the Final Proposals document that Ofgem does not expect to modify RAVs of DNs at the time of the next price control review to take into account NTS offtake related investment. 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 maintains the expectation that the RAVs of the DNs will not be modified at the time of the next price control review to take account of NTS offtake related investment. Ofgem would reiterate, however, that the interaction between DN incentive schemes and the DN price controls will be considered further in the context of the development of the enduring DN incentive schemes.
- 1.21 Ofgem notes the view of this potential purchaser that the parameters of the DN incentive schemes have been developed on the basis of NGT's current planning assumptions. It considers that, at the present time, NGT's planning data represent the best data available on which to design the interim DN incentives. In addition, the parameters for interim DN incentive schemes have been subject to lengthy consultation, and if respondents had significant concerns regarding

the quality of the data on which the proposals have been designed, Ofgem considers that these would have been raised in the course of this consultation process. Ofgem therefore does not consider it appropriate at this time to commit to a review of the DN incentive schemes after a year.

- 1.22 In response to the concerns expressed by this respondent concerning the adoption of a single IAE threshold for all DNs, Ofgem notes the concern that a number of the smaller DNs will not be in a position to claim such an IAE. However, Ofgem continues to consider that this proposal is consistent with both the NTS scheme and the way in which IAEs are treated in the electricity transmission regime. Ofgem considers that the proposals provide the same level of absolute protection to all DNs. Given that the process of approving an IAE is not a costless exercise, Ofgem therefore considers that, for duration of the interim period, an approach in which the same level of absolute threshold is specified for all DNs is appropriate.
- 1.23 Ofgem welcomes the view of one shipper/supplier that stated it is broadly in agreement with the interim incentives proposals. Ofgem notes that this shipper/supplier considered that it would be beneficial to extend Tables A3 and A4 to the full duration of the interim period. However, given that the exit investment incentive (for which these baseline data are directly relevant) is capped at £1m, and the proposed implementation date of the enduring NTS offtake arrangements is 1 October 2008, Ofgem does not consider it essential to define baselines beyond 2006/7 at this stage.

## ***Part B - Ofgem's proposed licence drafting changes necessary to implement Ofgem's Final Proposals of interim incentives as well as further changes.***

### ***Respondents' views***

#### **NGT**

- 1.24 NGT<sup>7</sup> stated that it was generally supportive of the changes detailed in the consultation document. However, NGT did highlight that there was a minor typographical error within the drafting of Special Condition C14, within the NTS exit capacity buy-back and interruption reporting table. NGT stated that the term "ExBBC<sub>d,t</sub>" had the description "Entry capacity buy-back costs" instead of "Exit capacity buy-back costs". NGT stated its view that this correction would not represent a material change and should be corrected within the Section 23 Direction.

#### **Potential purchasers**

- 1.25 One potential purchaser stated that a number of the licence modification proposals contained within the April 2005 document reflected the outcome of discussions with Ofgem and that they had no further comments to make. This potential purchaser also stated that, to the extent that Ofgem is in a position to do so, an earlier direction, rather than 27 May 2005, would be welcomed in terms of share sale process given that Monday 30 May is a public holiday.
- 1.26 One potential purchaser acknowledged that a considerable effort from Ofgem was required to enable the April 2005 document to proceed ahead of timetable. This potential purchaser recognised the full and transparent process that had been undertaken with the industry prior to publishing the April 2005 document and the opportunity for all stakeholders to raise and discuss areas of concern with Ofgem, for example at DISG. This potential purchaser stated that it fully

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<sup>7</sup> NGT responded; on behalf of Transco, as the holder of two relevant Gas Transporter (GT) licences (NTS and RDN licences); on behalf of Blackwater SC A as the holder of the GT licence relating to Scotland; on behalf of Blackwater 2 as the holder of the GT licence relating to Wales and West; on behalf of Blackwater F as the holder of the GT licence relating to North of England; and on behalf of Blackwater G as the holder of the GT Licence relating to South of England.



supported the proposals within the April 2005 document but stated that there were some issues that it may wish to follow up post-sale.

- 1.27 This potential purchaser also stated that, to ensure that completion is able to take effect on 1 June 2005, it would be extremely helpful if these licence modifications could be directed for implementation as soon as possible after the consultation closes and, in any event, before the proposed date of 27 May 2005.
- 1.28 Another potential purchaser stated that the draft licence conditions had been subject to extensive consultation, with a number of discussions on individual conditions at various DISG meetings. This potential purchaser stated that it welcomed the changes to Standard Special Condition A38 (Credit Rating of the Licensee) and believed that the proposed changes dealt with its previous concerns.
- 1.29 This potential purchaser made specific comments in relation to Standard Special Condition A39 (Indebtedness). This potential purchaser stated that it did not believe that the definition of the businesses subject to the cross default obligations, provided in paragraph 5(iii), was appropriate as it excluded *de minimis* businesses. This respondent stated that, in practice, this would mean that subsidiaries would not be able to conduct such *de minimis* businesses as they would be excluded from the general cross-default obligations by virtue of this definition. This potential purchaser suggested that an appropriate cross reference in paragraph 5(iii) be made to *de minimis* activity.
- 1.30 This potential purchaser also stated that it would appreciate being given as much notice as possible of the final Authority decision to the transaction completing, assuming that such approval is forthcoming. This potential purchaser noted that the April 2005 document referenced the modifications being introduced on 27 May 2005. This respondent stated that it would be of great assistance if the Authority could announce earlier that it is or is not satisfied that all the conditions subsequent have been satisfied to allow a number of important steps in the completion process, such as the drawing down of finance and the putting in place of insurances, to commence.

## **Shippers/suppliers**

- 1.31 One shipper/supplier stated that, in relation to Standard Special Condition A15 (Agency), while the amendment to paragraph 3(iii) removed the potential confusion over the use of the term "user", that this change may leave some ambiguity. This respondent stated that its understanding was that the cost of the Agency would be met by relevant GTs until the end of the present price control period, given that an allowance had already been made for these costs within the present price control. This shipper/supplier stated that it was concerned that the proposed draft of Standard Special Condition A15 (Agency) does not make this clear, as it simply states that the costs of the Agency will be allocated on a transparent basis.
- 1.32 This shipper/supplier also commented on Standard Special Condition A33 (Restriction on Use of Certain Information and Independence of the Transportation Business) and Standard Special Condition A34 (Appointment of Compliance Officer). This shipper/supplier stated that it supported the majority of the changes proposed. However, this shipper/supplier stated that, where the Authority grants consent to the licensee to deviate from the provisions of the licence conditions, it would be appropriate to require the licensee to include a section within its annual report to the Authority outlining the detailed use made of such consents. This respondent also stated that it continues to believe that the licence should require that the annual report should be subject to an independent audit, and that the opinion of the auditor should be published along with the annual report.
- 1.33 Furthermore, this shipper/supplier also commented on Special Condition C4 (Prohibited Procurement Activities) and Standard Special Condition D4 (Prohibited Procurement Activities). This respondent stated that, while it does not object to the joint procurement of shrinkage gas until the end of the price control period, it believes that the use made of any consent granted by the Authority to permit this should also be included in the annual Compliance Officer's report to the Authority. Furthermore, in relation to Standard Special Condition D4, this shipper/supplier stated that such reporting would be of particular importance in the case of Scotia Gas Networks, as it noted from the

April 2005 document, that Scotia intends to apply for consent to allow joint procurement of shrinkage gas between its DN licensees and its affiliated shipper business.

- 1.34 This shipper/supplier also commented on Special Condition C20 (Separation of NTS and Distribution Network Businesses) and Special Condition C21 (Appointment and duties of the business separation compliance officer). This shipper/supplier stated that it continued to be concerned at the degree of separation of the managerial boards provided for under paragraph 5 of Special Condition C20 and the potential commonality of Directors between the NTS and RDN Boards, especially as the DN Board is expected to cover all four RDNs. In addition, this shipper/supplier stated that, as a minimum, it should be a requirement that the Boards are not identical. This shipper/supplier also stated that, as per its comment in relation to Standard Special Condition A34, the report submitted to the Authority under Special Condition C21 should be subject to an independent audit, and that the nature of the auditors' opinion should be published.
- 1.35 Finally, this shipper/supplier asked for clarification of paragraph 4.144 of the April 2005 document. This respondent stated that it was its understanding that NGT presently recovered the costs of supplying customers on independent networks as part of their revenue under the price control, and hence these costs are effectively passed through to customers. This respondent stated that paragraph 4.144 implies that this is not the case and requested clarification.

### **Health and Safety Executive**

- 1.36 The Health and Safety Executive (HSE) stated that the only modification made to the licence conditions applicable to the operation of the NTS and DN-GTs, and hence of specific interest to the HSE, related to a change to the wording of Standard Special Condition A8 (Emergency Services and Enquiry Service Obligations). The HSE stated that this change constituted a minor clarification which did not change the obligations set out in the condition. The HSE confirmed that it was content with the proposals outlined within the April 2005 document and that its views remained the same as those expressed in its response to the February document.

## ***Ofgem's views***

- 1.37 Ofgem welcomes the responses submitted by NGT, potential purchasers, shippers/suppliers and the HSE.
- 1.38 With regard to the change proposed by NGT, Ofgem agrees that the term "ExBBC<sub>d,t</sub> " should be described as "Exit capacity buy-back costs" instead of "Entry capacity buy-back costs". This minor clarification has been made as part of the accompanying direction (as set out in Schedule 2 and reflected in the licence drafting in Schedule 3).
- 1.39 Following consideration of the view expressed by a potential purchaser with respect to the definition of "cross-default obligation" within Standard Special Condition A39 (Indebtedness), Ofgem proposes to modify this definition such that sub-paragraph (iii) of the definition refers to paragraphs 1(a), 1(b), 1(c) **or 1(d)** of the definition of permitted purpose in Standard Special Condition A32 (Definition of Permitted Purpose). This revision introduces a reference to *de minimis* business in the description of the circumstances where entering into an agreement or arrangement does not create a cross-default obligation for the purposes of Standard Special Condition A39 (Indebtedness). Ofgem considers that this revision is appropriate, and has made this revision as part of the accompanying direction (as set out in Schedule 2 and reflected in the licence drafting in Schedule 3).
- 1.40 In considering the views expressed by a shipper/supplier in relation to the allocation of Agency costs pursuant to Standard Special Condition A15 (Agency), it is the current intention that Agency costs incurred will be allocated between the relevant GTs for the remainder of the current price control period. Ofgem is minded not to make any further amendments to the drafting of Standard Special Condition A15 (Agency) in order to retain the flexibility to changes in these arrangements beyond the current price control period.
- 1.41 Ofgem notes the comments by a shipper/supplier concerning Standard Special Conditions A33 and A34 and Special Conditions C20 and C21 such that the annual compliance report submitted to the Authority should be subject to an independent audit. However, Ofgem continues to believe that, its approach to be consistent across network licences and appropriate at this time.

- 1.42 In response to the comment raised by this shipper/supplier regarding the potential commonality of Directors between the NTS and RDN Boards, Ofgem continues to note that, had legal separation of the NTS and RDN businesses occurred, such a situation could also prevail under the terms of the Companies Act. As such, Ofgem does not believe that a modification is appropriate in this regard.
- 1.43 Ofgem notes the proposals made by this shipper/supplier that the use of consents, granted under Standard Special Condition A33, Special Condition C4, and Standard Special Condition D4, should be reported within the annual compliance report to the Authority. However, Ofgem would note that all consents issued by the Authority are available on the Public Register. In addition, detailed business information relating to compliance with consents issued by the Authority may not be appropriate for inclusion within a public domain report, due to potential confidentiality issues.
- 1.44 Furthermore, in relation to the shipper/supplier's comment regarding Standard Special Condition D4 and the need to report on the provisions made to ensure that all information is appropriately protected and the shrinkage accounts remain in the name of the DN licensees, Ofgem would note that all licensees are bound by the obligations of their licence. In particular, in this case, Ofgem would note the obligations of Standard Special Condition A33, Standard Special Condition A6 and Standard Special Condition A35 in this regard, in relation to sharing of information, conferring of unfair commercial advantage on affiliates and the prohibition of cross-subsidies. Furthermore, Ofgem would note that the conditions of the consent granted to the Scotia Gas Networks companies in this regard will be available on the Public Register.
- 1.45 In relation to the clarification requested by this shipper/supplier on paragraph 4.144 of the April 2005 document, Ofgem would note that the present price control was set so that the efficient costs of transporting gas to the independent systems were included within allowed revenue. However, this excluded the costs associated with the Bulk Price Differential (which is the excess cost of Liquefied Petroleum Gas (LPG) required as compared to methane), which instead, were treated by Transco as being a deduction from actual revenue (which would increase an under-recovery against allowed revenue) and

consequently paid for by consumers in each DN where there was an independent system supplied with LPG.

1.46 The alternative arrangements which are now in place have two financial implications, that:

- ◆ Transco will fund the payment of the Bulk Price Differential instead of consumers in each of the relevant DNs; and
- ◆ in instances where transportation charges in an independent system are higher than the GB average charge, Transco will pay to shippers the excess amount.

1.47 Within this price control period, both these payments will be made by Transco, but should be recoverable from GB consumers in general via the NTS price control as this price control will not be reset until April 2007, this is the first point at which such costs should be recoverable from GB consumers.

1.48 Finally, Ofgem welcomes the comments made by the HSE in relation to the April 2005 document.