



Shippers, National Grid Transco
and other interested parties

25 May 2005

Dear Colleague,

Gas Distribution Network Sales – Final consent to sale of four of National Grid Transco’s gas distribution networks

The Gas and Electricity Market Authority (the Authority) has today granted its unconditional consent to allow National Grid Transco (NGT) to dispose of the shares in its four relevant distribution network (DN) companies¹ to third party purchasers². The Authority has reached this decision having regard to its principal objective under the Gas Act 1986 (the Act) as well as its other statutory and wider public law duties and the statutory and licence obligations of gas transporters (GTs). In this letter we set out the background and reasons for the Authority’s decision.

Background

The Authority’s final consent to share sale is the culmination of an inclusive regulatory process lasting nearly two years. This section briefly describes the process associated with DN sales and then considers in more detail the Authority’s decisions in relation to DN sales that were made in January and April 2005.

Process associated with DN sales

The regulatory process was initiated in May 2003, when 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 Amended Standard Condition 29 (ASC 29) of Transco’s original Gas Transporter (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).

Following NGT’s announcement, Ofgem undertook a substantial programme of work and consultation to investigate the potential costs and benefits that such a transaction could deliver

¹ The DN companies are Blackwater F Ltd, Blackwater SC A Ltd, Blackwater 2 Ltd and Blackwater G Ltd.

² The third party purchasers are MGN Gas Networks (Senior Finance) Limited, Gas Networks Limited and Scotia Gas Networks Limited. Scotia has entered into agreements with Transco to purchase two DNs.

for customers.³ This process included the establishment of a number of industry workgroups, including the Development and Implementation Steering Group (DISG)⁴, which have been open to all interested parties to attend. In addition, Ofgem 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 sale of DNs was to proceed.

The completion of the RIAs and associated conclusions documents culminated in the publication of a Final Impact Assessment (Final IA) in November 2004.⁵ As part of this Final IA, Ofgem undertook an examination of the potential costs and benefits associated with the proposed overall regulatory, commercial and operational 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 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.⁶

Previous Authority decisions on DN sales

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.⁷ These applications for consent were considered at a duly convened meeting of the Authority on 20 January 2005.

At its 20 January 2005 meeting, the Authority granted its conditional consent to Transco under ASC 29 of Transco's original GT licence on the terms described in Transco's four applications for consent, and 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 2005.⁸

The conditional consents were granted at a time when the details of the regulatory, commercial and operational arrangements necessary to protect the interests of customers in a divested industry structure were still being consulted upon and developed. The Authority therefore attached a number of conditions to its consent to ensure that it would be satisfied that the arrangements developed and implemented over the following months would protect the interests of customers and would be consistent with the Authority's principal objective and statutory and other public law duties.

³ A full list of documents published by Ofgem in respect of DN sales can be found at Ofgem's website, www.ofgem.gov.uk.

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

⁶ The net benefits were calculated in net present value terms over the period between 2005/6 and 2022/23. This figure is net of the costs associated with the proposed transaction, which were estimated to be approximately £102 million.

⁷ Transco also applied for consents under Paragraph 3 of Schedule 3 to the Gas Act 1986 to permit it to dispose of land (relating to the four relevant gas networks) that it has acquired compulsorily, to the four DN companies. The Authority consented to these applications at its meeting on 20 January 2005.

⁸ *National Grid Transco – Sale of gas distribution networks: Transco plc applications to dispose of four gas distribution networks Authority decision*, 1 February 2005, 21/05.

The conditions to consent fell into two broad categories; conditions precedent,⁹ which must be satisfied before the proposed hive-down can occur, and conditions subsequent,¹⁰ which must be satisfied after hive-down occurs but before the proposed sale of the shares in the four DN companies to third party purchasers can occur.

The conditions precedent were the subject of the Authority's April 2005 decision on DN sales. The Authority issued an open letter on 25 April 2005 giving Transco permission to take steps towards implementing hive-down of the four relevant DN businesses to the four DN companies.¹¹ That letter set out that final consent to undertake hive-down would not be given until the Authority had issued a further notice setting out that the conditions precedent had been satisfied in full. The Authority issued this further notice on 29 April 2005 and attached the Implementation Directions necessary for hive-down to take place.¹² The hive-down of the four relevant DN businesses to the four DN companies subsequently occurred on 1 May 2005.

The conditions subsequent prohibit Transco from selling the shares in the four DN companies without the Authority's prior consent. The conditions subsequent also require Transco and each DN company to consent to any licence modifications or other regulatory, commercial or operational changes following hive-down that the Authority considers are necessary in order to ensure that the proposed transaction is implemented in a manner that ensures that the interests of customers are protected.

The conditions subsequent were necessary because certain aspects of the licensing arrangements including, among other things, the interim incentive arrangements, were not finalised at the date of hive-down.¹³ Further, it was necessary for the Authority to retain a consent over the share sale given that other issues could have arisen through the detailed development of the regulatory, commercial and operational arrangements that were not anticipated at the time of the Authority's January decision.

Prior to permitting Transco to hive-down, the Authority determined that an additional requirement regarding the incremental release of NTS flow flexibility rights should be introduced under the conditions subsequent to ensure that customers' interests can be protected in a divested industry structure.

In summary, this requirement provided that Transco should enter into arrangements with the four DNs it is proposing to retain (the RDNs) and each of the four relevant DN companies to ensure that customers do not bear the costs associated with the unconstrained incremental release of National Transmission System (NTS) offtake flexibility rights for the period leading up to the release of capacity under the proposed enduring offtake arrangements on 1 October 2008. This requirement is set out in the Authority's open letter giving final approval for hive-down of Transco's gas distribution networks issued on 29 April 2005.¹⁴

⁹ The Authority's conditions precedent are set out in paragraph 21 of the Authority's January Consent Directions. Those directions are annexed to the Authority's February 2005 decision document, "National Grid Transco – Sale of gas distribution networks – Transco plc applications to dispose of four gas distribution networks – Authority decision, February 2005.

¹⁰ The Authority's conditions subsequent are set out in paragraph 23 of the Authority's January Consent Directions.

¹¹ *Ofgem approves next stage of NGT's sale of four of its gas distribution networks*, Ofgem 25 April 2005.

¹² *Ofgem – Final approval for hive-down of NGT's gas distribution networks*, Ofgem 29 April 2005.

¹³ *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*, Ofgem April 2005 129/05.

¹⁴ *Ofgem – Final approval for hive-down of NGT's gas distribution networks*, Ofgem, 29 April 2005.

The conditions subsequent were considered at today's Authority's meeting. The remainder of this letter describes the outcome of this meeting.

Issues considered by the Authority

In forming a view as to whether Transco has satisfied the conditions subsequent set out in the Authority's January Consent Directions and the 29 April 2005 open letter,¹⁵ the Authority has had regard to its statutory duties with respect to a broad range of issues. Some, but not all, of these issues were addressed in a Transco report to Ofgem.

Issues considered in Transco's report to Ofgem

On 20 May 2005, Ofgem issued an open letter¹⁶ that asked Transco to provide a report addressing nine issues relevant to the Authority's consideration of whether the conditions subsequent have been satisfied.¹⁷ Transco provided this report on 25 May 2005.¹⁸ In addition, Ofgem received one response from another interested party. This section sets out the issues raised in Ofgem's open letter, Transco's view and the Authority's view, having regard to the Authority's statutory duties on each issue. The issues raised by the other interested party are discussed under point 9 below.

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).

Transco's views

Transco considered that the current form of the UNC and associated industry codes provides a robust commercial framework to support a divested industry structure. Transco was of the opinion that the provisions contained within the UNC would also serve to facilitate achievement of the UNC relevant objectives by each GT, as contained in Standard Special Condition A11 of the six relevant GT licences, and further, that the UNC was consistent with all relevant Authority decisions associated with network sales.

¹⁵ Ofgem – Final approval for hive-down of NGT's gas distribution networks, Ofgem 29 April 2005.

¹⁶ Gas Distribution Network Sales – Open letter to NGT, Transco and the DN companies requesting report relating to the Authority's decision on conditions subsequent, Ofgem open letter, 20 May 2005.

¹⁷ Transco was asked to provide the report on behalf of each of NGT, Transco NTS, Transco RDN, and each of the four DN companies. Where the context requires, references in this section to Transco should be construed as references to each of these companies.

¹⁸ 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, Transco open letter, 25 May 2005.

Transco noted that the UNC has been the subject of considerable development, discussion and consultation with industry, whereby industry parties were provided with a forum to raise issues on the developing text of the UNC, and that the two-stage consultation by Ofgem through March and April 2005 allowed refinements to the drafting in response to respondents' views. Transco stated its view that the UNC was sufficiently robust to support a divested industry structure and allow hive-down to proceed.

Transco outlined that, during the period following hive-down, it had undertaken a thorough review of the UNC and remained 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. Transco also noted that DN purchasers also considered the UNC to be fit for purpose and that they had not identified any material issues that they considered needed to be addressed prior to share sale.

Transco also confirmed that it was not aware of any material issues that had arisen following the transition from Transco's Network Code to the UNC or in relation to any other aspects of industry code arrangements that would require changes to be made to the UNC or other aspects of industry code arrangements prior to the completion of share sale.

In addition, Transco noted that industry parties had not raised material issues associated with the operation of the UNC at the UNC Modification Panel meetings, committee meetings or workstream meetings held since hive-down.

Furthermore, Transco confirmed that the Joint Office became operational on 1 May 2005, and that the UNC modification panel was in place and operative and, as such, two meetings of the modification panel had been held. Transco confirmed that the modification panel was operating in accordance with the new 5:5 panel structure.

Transco further noted that all of the "Mods in Flight" had made the transition to the new modification process, in accordance with the transition rules, and had been renumbered as UNC Modification Proposals. Transco noted that four new modification proposals had been raised since hive-down, none of which had been raised as a result of issues arising through hive-down or in anticipation of share sale and that Transco did not consider that these proposals were sufficiently material or relevant that they need to be addressed prior to share sale.

Overall, Transco emphasised that it considered the UNC governance arrangements to be fully operational and effective, providing the fullest opportunity for interested parties to raise issues and modification proposals to address any concerns they may have. Transco also provided assurance that, in the event that unexpected regulatory, commercial or operational issues were to arise or come to light in the future as a result of DN sales, it would 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 address issues identified.

Authority's views

The Authority notes Transco's view that the UNC will provide a robust commercial framework to support a divested industry framework and that it will serve to facilitate the relevant objectives as set out under Standard Special Condition A11 of the GT licence. The Authority also notes the view that the new UNC governance arrangements were the subject of considerable development, discussion and consultation with industry and are operating effectively. The Authority further notes that the modification process provides a forum for modifications to be raised and that no material issues have been raised since hive-down regarding the UNC.

Following careful consideration of Transco's final report and in view of the various assurances provided by Transco in this regard, the Authority does not consider that there is any reason to oppose or delay consent to share sale on the basis of outstanding issues associated with the industry code arrangements. The Authority welcomes assurances that, if any unexpected regulatory, commercial or operational issues arise or come to light Transco will work with the Authority to resolve these in an economic, efficient and expedient manner.

The Authority notes that industry participants had an opportunity to comment on the open letter issued on 20 May 2005, and no substantive issues have been raised by respondents to this open letter and as such, has concluded that sales can proceed.

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.

Transco's views

Transco stated that UK-Link and associated IT systems (with the exception of changes to the invoicing suite) are fully operational and sufficiently developed to support a divested industry structure. More specifically, it stated that the agency (xoserve) was implemented on 1 May 2005 enabling a smooth transition to the new multi-transporter environment.

Transco stated that the implementation of these systems had been completed seamlessly, without any disruption to services and service users. Transco noted that there have been no adverse impacts identified or reported by the shipper community, or any other party, and that there was no reason to believe that there will be any such adverse impacts following the sale of the DN companies.

With respect to the changes relating to the invoicing suite, Transco confirmed that all issues had been resolved and indicated that the changes had been successfully tested and were in the final stages of implementation, which was scheduled to be completed by the end of May 2005.

Transco noted that xoserve was 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. Transco further noted that xoserve had proactively engaged the shipper community, making all reasonable enquiries as to the community's readiness to implement the invoicing changes at scheduled operational meetings as well as during less formal interactions.

Transco stated that, if, in the unlikely event that any issues associated with the operation of xoserve arise as a consequence of DN sales, Transco will notify the Authority and work with xoserve, shippers and the DN purchasers to resolve any such issues in an economic, efficient and expeditious manner.

In addition, Transco highlighted that all of the necessary application changes required in relation to the front office systems had been completed successfully. It stated that Front Office Managed Service Agreements (FOMSAs) would be available to the DN companies for a period of 18 months following share sale and that parties should not therefore experience any associated adverse consequences. Transco further noted that the necessary changes took place over the hive-down weekend and there have been no reported issues. As part of the sales process, Transco noted that the potential purchasers' plans for exiting the FOMSA systems had been agreed and that it was confident that the transition from the Transco applications could be conducted in a safe and effective manner and that they were supporting the DN potential purchasers in migrating to their own front office applications in an efficient and seamless manner.

Transco also set out that new back office systems have been fully operational for each of the DN companies since 1 May 2005. It also detailed that DN purchasers had been developing individual back office systems over a period of 8 months and that plans were in place to cutover to these systems at share sale completion on 1 June 2005. Transco noted that the DN companies have provided written confirmation to Transco that they are confident that their back office systems would be operational from 1 June 2005. Transco further noted that several key milestones associated with confirming the respective potential purchasers' readiness to exit at share sale completion were built into the implementation programme and that Transco was working with potential purchasers on delivery of these milestones.

Overall, Transco stated that it was confident that all the system changes necessary to enable 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. Transco further stated that, in the unlikely event that any issues associated with such systems arise or come to light as a consequence of DN sales, it would notify the Authority and work with the potential purchasers and xoserve to resolve any such issues in an economic, efficient and expeditious manner.

Authority's view

The Authority notes Transco's assurances that the UK-Link and other IT systems are fully operational, and that all required changes will be implemented by 1 June 2005. The Authority also notes Transco's view that the front and back office systems are in place, that no adverse impacts have been identified or reported, and that Transco does not foresee any adverse implications for industry participants arising from the operation of these systems. Further, the Authority notes Transco's statements that xoserve has proactively engaged the community, and

that they will be providing a higher level of support for the first month after implementation. The Authority welcomes assurances that if any unexpected regulatory, commercial or operational issues arise Transco will work to resolve these in an economic, efficient and expedient manner.

Following careful consideration of Transco's final report, and in view of the various assurances provided by Transco in this regard, the Authority does not consider that there is any reason to oppose or delay consent to share sale on the basis of outstanding issues associated with UK-Link and other relevant IT systems.

The Authority notes that industry participants had an opportunity to comment on the open letter issued on 20 May 2005, and no substantive issues have been raised by respondents to this open letter and as such, has concluded that sales can proceed.

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 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.*

Transco's view

Transco stated that the HSE had completed its assessment of the four IDN safety cases, as well as the Scottish Independent Undertakings safety case and the Transco safety case. Transco confirmed that the HSE has concluded that the safety cases as submitted met all the requirements of GS(M)R, and therefore the HSE has accepted the safety cases.

Authority's view

On the basis that the HSE has informed Ofgem that it has approved the safety cases necessary for share sale to occur, and Transco has provided copies of such approvals. Consequently, the Authority is satisfied with Transco's response to these issues and therefore sees no reason to oppose or delay consent to share sale on the basis of HSE issues.

The Authority notes that industry participants had an opportunity to comment on the open letter issued on 20 May 2005, and no substantive issues have been raised by respondents to this open letter and as such, has concluded that sales can proceed.

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;*

Transco's view

Transco noted that an extensive licence consultation process had been conducted to date in the context of the DN sales process. Transco further noted that it had conducted an extensive review of each of the six relevant GT licences and that it was not aware of any issues associated

with the operation of the licences (subject to the points outlined below) 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, Transco stated that each of the six licences are drafted in such a way that its terms operate effectively and consistently with each licensee's statutory obligations and the Authority's principal objective and other statutory and public law duties.

Transco noted that it had thoroughly reviewed the price control conditions within the six relevant GT licences, taking into account the modifications which were the subject of the previous section 8AA and section 23 consultations issued on 14 February 2005 and the section 23 consultation issued on 26 April 2005. Transco noted that this thorough review had not raised any concerns as to the operation of any conditions which affect revenue flows and that it continued to be satisfied that these provisions and all associated revenue flows will operate appropriately within all six relevant GT licences and in accordance with the Authority's policy intent.

Transco further noted that, in giving this assurance, it had made relevant enquiries of the potential purchasers of Blackwater SC A Limited, Blackwater 2 Limited, Blackwater F Limited and Blackwater G Limited and these potential purchasers had confirmed that they were not aware of any issues associated with the operation of the licence(s) that give rise to a requirement to modify the licence(s).

However, Transco noted that a number of minor modifications had been identified.

Furthermore, Transco noted that, a 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 was necessary in order to address some residual concerns of the Authority in relation to business separation and to clarify the licensees' obligations in this regard. Transco stated its understanding that the Authority was 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 Transco plc will conduct its NTS and RDN businesses as if such modifications were already in effect.

Authority's view

The Authority notes that, as Transco recognised, there has been an extensive process of licence consultation. Further, the Authority notes Transco's statement that it is 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. Furthermore, the Authority would note that Transco continues to be satisfied that the price control provisions and all associated revenue flows will operate appropriately within all six relevant GT licences and in accordance with the Authority's policy intent.

The Authority has today directed the implementation of the modifications which were set out in the April section 23 notice.

The Authority also notes that Transco has provided an undertaking to the Authority stating that it will conduct its NTS and RDN businesses as if the Authority's proposed modifications relating to Special Condition C19 and Special Condition E9 are already in effect.

The Authority notes that industry participants had an opportunity to comment on the open letter issued on 20 May 2005, and no substantive issues have been raised by respondents to this open letter and as such, has concluded that sales can proceed.

- (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.*

Transco's view

Transco noted that it had conducted an extensive review of each of the relevant GT licences in order to identify the consents, clearances, permissions, authorisations and approvals ("licence related instruments" ("LRIs")) required by Transco NTS, Transco RDN and each DN company for completion of share sale. Transco noted that, following such review, Transco, as licensee for the NTS and the RDNs had applied for all consents, clearances, permissions, authorisations and approvals that it considers necessary for completion of share sale. Transco further noted that it had seen the final draft versions of these LRIs and was 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 further stated that it did not consider that there were any LRIs outstanding.

Transco stated that, following the review of each of the relevant GT licences in order to identify the LRIs 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 had also applied for all LRIs that they considered necessary for completion of share sale. Transco confirmed that all potential purchasers had 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. Transco stated that all potential purchasers had 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.

Authority's view

The Authority notes the confirmation by Transco and the potential purchasers that there are no LRIs outstanding, and that, subject to the Authority granting the LRIs applied for with effect from 1 June 2005, all necessary consents required for share sale will be in place.

The Authority notes that industry participants had an opportunity to comment on the open letter issued on 20 May 2005, and no substantive issues have been raised by respondents to this open letter and as such, has concluded that sales can proceed.

- (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's view

Transco stated that it was 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.

Transco also stated that each potential purchaser had confirmed that they will be in a position to comply in full with their licence obligations, including those imposed by consents, after share sale completion.

Authority's view

The Authority notes Transco's view that the NTS, RDNs and IDNs will be in a position to comply with the provisions of the relevant GT licences following the receipt of Authority approval in relation to the various LRI applications and subject to the implementation of proposed licence modifications.

Following careful consideration of Transco's final report and in view of the various assurances provided by Transco in this regard, the Authority does not consider that there is any reason to oppose or delay consent to share sale on the basis of outstanding licensing issues.

The Authority notes that industry participants had an opportunity to comment on the open letter issued on 20 May 2005, and no substantive issues have been raised by respondents to this open letter and as such, has concluded that sales can proceed.

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.

Transco's view

Transco stated that it has put in place business separation arrangements between Transco NTS and Transco RDN that ensure compliance with the business separation licence conditions. To that end, it has appointed a business separation compliance officer for each of Transco NTS and Transco RDN who has been allocated the tasks required by their licences. Transco confirmed that a compliance statement has been submitted and approved by Ofgem, and that 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. Transco also stated that the required actions identified by the review have been implemented to secure managerial independence of Transco NTS from Transco RDN, operational independence of Transco NTS from Transco RDN, and appropriate restrictions on access to NTS systems, accommodation and resources.

Effective at hive-down, Transco stated that Transco NTS has put in place the ultimate controller undertaking required by Special Condition C19 and has provided a copy to Ofgem. It stated that

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. Transco confirmed that 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.

Transco NTS and Transco RDN acknowledged that Ofgem has 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. Transco considered that 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. In addition, Transco stated that the proposed new RDN licence condition would have the effect of clarifying that written arrangements would be 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.

Transco also stated that 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.

Authority's view

The Authority notes the views expressed by Transco in relation to the extent of its compliance with the business separation regime. The Authority welcomes Transco's statement that it has put in place business separation arrangements that ensure compliance with the business separation conditions and that a compliance statement has been submitted to Ofgem (and subsequently approved). In addition, the Authority notes that Transco has provided an undertaking to the Authority stating that it will conduct its NTS and RDN businesses as if the modifications relating to Special Condition C19 are already in effect.

Whilst the Authority considers that further clarification of Special Condition C19 is required (this is discussed further below in the section entitled 'Special Condition C19 of Transco's NTS licence'), the Authority considers that these issues do not constitute a reason to oppose or delay consent to share sale as they are more appropriately addressed by other means, including the Transco undertaking and further section 23 licence consultation.

The Authority notes that industry participants had an opportunity to comment on the open letter issued on 20 May 2005, and no substantive issues have been raised by respondents to this open letter and as such, has concluded that sales can proceed.

- 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's view

Transco stated that, as NTS licensee, it 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) capacity rights to those DNs. It confirmed that these 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.

Transco considered that these 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 (with this arrangement being confirmed between those responsible for Transco NTS and Transco RDN). Transco stated that 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.

In addition, it confirmed that 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. Transco also stated that 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.

Transco considers that the effect of the arrangements will be 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. Transco also confirmed that each of the buyers has confirmed in writing their consent to these arrangements, and that identical arrangements have now been signed between Transco NTS, Transco RDN, and each IDN.

Authority's view

The Authority notes Transco's view that customers will not be exposed to any costs associated with the unconstrained incremental release of NTS offtake (flexibility) capacity that will be in place prior to the implementation of the enduring exit arrangements. The Authority also notes that Transco NTS has implemented identical arrangements for the RDNs as for the IDNs in relation to the unconstrained incremental release of NTS offtake (flexibility) capacity, in conformity with the business separation arrangements. The Authority also notes Transco's statement that it will ensure these arrangements will be implemented in accordance with the provisions of Special Condition C19 of the Transco NTS licence.

Following careful consideration of Transco's final report and in view of the various assurances provided by Transco in this regard, the Authority considers that Transco has discharged its requirements under the conditions subsequent regarding the unconstrained release of NTS offtake (flexibility) capacity rights.

The Authority notes that industry participants had an opportunity to comment on the open letter issued on 20 May 2005, and no substantive issues have been raised by respondents to this open letter and as such, has concluded that sales can proceed.

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.*

Transco's view

Transco stated that, 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.

It also stated that, 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.

Transco considered that 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.

Transco stated that 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, Transco considered that 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. It stated the view that 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.

Transco also confirmed that 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, it noted that a number of contracts remain outstanding as at today's date and that the relevant NGT companies hope that many of these can be transferred over the next few weeks, and the NGT companies are in active discussion with the relevant counterparties in seeking their consent.

Authority's view

The Authority notes that Transco has not novated all contracts to the DN companies. Today, the Authority granted consent to Transco under Standard Special Condition A39 in relation to any possible cross default issues that might arise in the absence of such novation. The Authority

notes Transco's view that the hive-down arrangements will allow all contracts which require novation to operate as if they have been novated, thus serving to protect the interests of customers. The Authority also welcomes Transco's view that customers will in no way be affected by the operation of any of these arrangements.

Following careful consideration of Transco's final report and in view of Transco's assurance that customers will not be affected by any failure to novate contracts, the Authority considers that a failure to novate contracts does not constitute a reason to delay granting consent to share sale.

The Authority notes that industry participants had an opportunity to comment on the open letter issued on 20 May 2005, and no substantive issues have been raised by respondents to this open letter and as such, has concluded that sales can proceed.

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.*¹⁹

Transco's view

Transco's letter stated that the relevant NGT companies were 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. Since receipt of this letter, the relevant NGT companies have given their consent to the proposed modifications to the six relevant GT licences.

Transco stated that 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 stated that they continued to believe that this drafting is consistent with the intent of Ofgem's Final Proposals (taking into account a typographical error within Special Condition C14).

Authority's view

As noted above, Transco has given its consent to the proposed modifications to the six relevant GT licences, and the Authority has directed the modifications contained within the section 23 notice issued on 26 April 2005. The Authority does not consider that there is any reason to oppose or delay consent to share sale on the basis of outstanding issues associated with the April section 23 notice.

The Authority notes that industry participants had an opportunity to comment on the open letter issued on 20 May 2005, and no substantive issues have been raised by respondents to this open letter and as such, has concluded that sales can proceed.

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,*

¹⁹ *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.*

please provide details of the issue, as well as your view of the materiality of the issue and a suggested way forward.

Chemical Industries Association's (CIA's) view

The CIA responded to Ofgem's open letter stating that although it did not object to share sale in principle, it did object to the enduring reform of the NTS offtake arrangements. The CIA expressed its view that the case for enduring exit reform had not been made, and raised a number of concerns with the proposals for enduring reform as they currently stood. The CIA concluded its response by requesting that the licence condition implementing the enduring offtake arrangements be removed.

Transco's view

Transco expressed the view that the issues raised in the CIA's response did not relate to share sale completion. Transco further stated that it was not aware of any further issues of which the Authority should be informed prior to reaching its decision regarding whether to allow share sale to proceed on 1 June 2005.

Authority's view

The Authority notes that the CIA disagrees with numerous elements of the proposed enduring offtake arrangements. However, the Authority considers that none of the objections or issues raised by the CIA are relevant to the Authority's assessment of whether all of the conditions subsequent have been met.

The Authority notes that industry participants had an opportunity to comment on the open letter issued on 20 May 2005, and no substantive issues have been raised by respondents to this open letter and as such, has concluded that sales can proceed.

Other matters considered by the Authority

In addition to the matters addressed in Transco's report, the Authority also had regard to certain other issues including Ofgem's review of the potential purchasers' proposed financing arrangements and the mergers clearances of purchasers.

Review of potential purchasers' proposed financing arrangements

Without limitation, the February 2005 Authority decision document noted that the Authority would not consent to the share sale until it was satisfied as to the proposed financing structures of the potential purchasers of the DN companies.²⁰

Ofgem subsequently undertook a review of the proposed financing arrangements of the potential purchasers. The review was limited to the scope Ofgem considered necessary for obtaining a reasonable degree of assurance that the potential purchasers' proposed financing structures for the DN companies could reasonably be expected to remain robust and stable under a range of conditions less favourable to the relevant licensee than those assumed in setting the present price controls. No work was undertaken to verify independently the information provided by the potential purchasers. Following this review, the Authority did not consider that there was any reason not to grant consent to share sale on the basis of lack of prospective financial stability or material threats to the DN companies' ability to finance the continued development of the network in an economic and efficient manner.

²⁰ *National Grid Transco – Sale of gas distribution networks: Transco plc applications to dispose of four gas distribution networks Authority decision*, 1 February 2005, 21/05, page 87.

The Authority's conclusions on the review do not provide an indication of, or in any way fetter, the Authority's policies and methods appropriate to any subsequent price control review and do not imply that the Authority has accepted or will accept the projections of future costs and revenues made by the potential purchasers in the information provided to Ofgem. In addition, the Authority's conclusions on the review do not imply any derogation from the requirements of the relevant licences nor can they form the basis of any expectation that any such derogation as may be sought will be forthcoming. It will be the responsibility of the DN companies to ensure compliance with these requirements and to apply in due time and form for any consent that may be necessary.

Furthermore, the review was undertaken solely for the Authority's own limited regulatory purposes and no other person may rely on the Authority's decision nor on any statement made by Ofgem in relation to the review for any other purpose. In particular but without limitation, neither such decision nor any such statement may be construed to be an express or implied opinion or recommendation regarding the merits or otherwise of investing in any security of the DN companies, and neither Ofgem nor the Authority accepts any responsibility nor shall it or they have any liability to any other person in relation thereto.

Merger clearances of potential purchasers

The merger of two or more distinct enterprises can raise competition concerns under the Enterprise Act 2002 and also the EC merger regulations.²¹ Whilst the clearance of the purchasers' acquisitions by the relevant authority was not a condition to the Authority's consent, the Authority notes that the Office of Fair Trading (OFT) decided not to refer the purchase of Wales & West DN, Scotland DN or Southern DN to the Competition Commission because the OFT did not expect that the acquisition would result in a substantial lessening of competition within a market or markets in the United Kingdom. Similarly, the European Commission decided not to oppose the purchase of North of England DN and declared the acquisition compatible with the common market and with the EEA agreement.

Special Condition C19 ('Undertaking from ultimate controller concerning non-discrimination between the NTS transportation activity and the Distribution Network transportation activity')

Special Condition C19 provides, among other things, for Transco to procure from NGT, as its ultimate controller, an undertaking that it will procure that Transco NTS shall conduct its business in a manner best calculated to secure that its RDN businesses do not obtain any unfair commercial advantage. In addition, the condition provides that Transco NTS shall enter into arrangements with its RDN businesses on terms which do not unduly differ from corresponding contractual arrangements entered into between Transco NTS and the independent DNs.

The Authority believes that it may be appropriate to modify Special Condition C19 to clarify that:

- ◆ the purpose of the condition is to mimic the effect of legal separation (i.e. as if the NTS and RDN were held as separate and unrelated legal entities);
- ◆ the condition applies in circumstances where Transco NTS procures services from Transco RDN as well as situations where Transco RDN procures services from Transco NTS; and

²¹ Council Regulation of 20 January 2004 on control of concentrations between undertakings, No 139/2004.

- ◆ arrangements should be in writing on arm's length commercial terms that do not unduly differ from those that would apply if the NTS or RDN were to enter into such a contract with an unrelated party.

The Authority also considers that an equivalent condition for Transco's RDN licence, Special Condition E9, providing for equivalent ultimate controller undertakings in respect of services that the RDN procures from or provides to the NTS should be introduced.

In order to consult upon these proposed changes, the Authority intends to issue a further section 23 notice to modify the NTS and RDN licences. This notice will be issued for a 28 day statutory consultation shortly after share sale.

NGT has today provided an undertaking to the Authority indicating, among other things, that Transco's NTS and RDN businesses will conduct their activities as if the NTS and RDN licences had been modified in the manner proposed. This undertaking remains in full force until such time as the NTS and RDN licences have been modified following the conclusion of the section 23 consultation process.

Decision

Having due regard to its principal objective and statutory and public law duties, and having carefully considered representations and objections received in the various related consultations, the Authority has decided that the conditions set out in the January Consent Directions have been sufficiently satisfied to allow Transco to sell the shares in four DN companies to third party purchasers on 1 June 2005.

In reaching its decision today, the Authority has, among other things, taken into account the fact that industry parties have had extensive opportunity to contribute and comment on the various elements of the DN sales process.

Nature of decision

The Authority's final Consent Direction gives unconditional consent for Transco to sell the shares of its four DN companies to third party purchasers on 1 June 2005. The Authority's consent has been provided on the basis that the proposed share sales take place not earlier than 00:01 hours BST on 1 June 2005 and not later than 23:59 hours BST on that same day. If any of the share sales do not take place between these hours, the consent in respect of those share sales shall fall away unless the Authority decides to waive the requirement for share sales to occur on 1 June 2005 or to extend the period for satisfying the requirement. However, for the avoidance of doubt, the Authority's consent is unconditional in the context of a 1 June 2005 share sale date.

In issuing this letter, it is important to make clear that there can be no expectation on the part of NGT, Transco, DN companies, potential DN purchasers or any other interested parties as to any future decisions of the Authority. In particular, nothing in this letter restricts the Authority in taking enforcement or other appropriate action, now or in the future (and regardless of share sale), against any or all of NGT, Transco plc and/or the four relevant DN companies in respect of any or all of the six GT licences.

If you have any questions about any of the issues addressed in this letter, please contact Sonia Brown (020 7901 7412) or Mark Feather (020 7901 7434), who would be happy to help.

Yours sincerely,



ALISTAIR BUCHANAN
CHIEF EXECUTIVE OFFICER

Signed on behalf of the Authority and authorised for that purpose by the Authority