

To: The Company Secretary
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The Company Secretary
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The Company Secretary
Wales and West Utilities Limited
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DIRECTION UNDER SECTION 23 OF THE GAS ACT 1986 - MODIFICATION OF RELEVANT GAS TRANSPORTER LICENCES

Whereas:

- 1 National Grid Gas plc, previously named Transco plc, ("the NTS Licensee") is the holder of a gas transporter (GT) licence in respect of its National Transmission System (NTS) ("the NTS Licence") treated as granted under section 7 of the Gas Act 1986 ("the Act");
- 2 National Grid Gas plc, Northern Gas Networks Limited, Scotland Gas Networks Limited, Southern Gas Networks plc and Wales and West Utilities Limited ("the DN Licensees") are the holders of GT licences in respect of their Distribution Network (DN) businesses ("the DN Licences") granted under section 7 of the Act;
- 3 Pursuant to section 23(3) of the Act, the Gas and Electricity Markets Authority ("the Authority") gave notice on 25 November 2005 ("the Notice"), that it proposed to modify certain of the Special Conditions of the NTS Licence and the DN Licences;
- 4 The licence modifications proposed to the NTS Licence were as set out in Appendix 7B to the Final Proposals consultation on the transitional

incentive schemes and formal licence consultation under section 23 of the Gas Act 1986 and paragraph 3(a) of Standard Special Condition A2 ("the Final Proposals consultation")¹. The licence modifications proposed to the DN Licences were as set out in Appendix 7C to the Final Proposals consultation;

- 5 Prior to the close of the consultation period in respect of the Notice, the Authority received 7 responses and no formal objections in relation to the proposed modifications of the NTS Licence and the DN Licences. No responses were withdrawn. All non-confidential responses are available from the Ofgem Research and Information centre and on the Ofgem website at www.ofgem.gov.uk;
- 6 The Authority has carefully considered all representations made in relation to the proposed modification of the NTS Licence and the DN Licences and not withdrawn;
- 7 Pursuant to section 23(4)(b) of the Act, the Authority gave notice of its intention to modify the NTS Licence and the DN Licences to the Secretary of State and has not received a direction from the Secretary of State not to make the modification;
- 8 On 20 December 2005 the NTS Licensee gave its written consent to the proposed modification of the NTS Licence. By 28 December 2005 each of the DN Licensees had given their written consent to the proposed modification of their respective DN Licence;
- 9 Pursuant to section 38A of the Act, the reasons for making this Direction to modify the NTS Licence and the DN Licences are set out in the following documents:
 - (a) 204/05 - Initial proposals on transitional incentive schemes supporting the offtake arrangements, Ofgem, 21 September 2005;
 - (b) the Final Proposals consultation; and
 - (c) Appendix 1 to this document;
10. Copies of the documents referred in this Direction are available on request from Ofgem or are on the Ofgem website at www.ofgem.gov.uk.

Pursuant to the powers contained in section 23 of the Act, and with effect on and from 26 January 2006, the Authority hereby directs that:

- 1 the NTS Licence be modified by:
 - (a) substituting for the existing Special Condition C5 (Licensee's procurement and use of system management services) a new Special Condition C5 (Licensee's procurement and use of system management services) in the form annexed in Appendix 2 to this Direction;
 - (b) substituting for the existing Special Condition C7 (Charging obligations) a new Special Condition C7 (Charging obligations) in the form annexed in Appendix 2 to this Direction;
 - (c) substituting for the existing C8A (Revenue restriction definitions in respect of the NTS transportation owner activity and NTS system operator activity) a new Special Condition C8A (Revenue

¹ 252/05 - Final proposals on transitional incentive schemes and formal licence consultation under section 23 of the Gas Act 1986 and paragraph 3(a) of Standard Special Condition A2, November 2005, Ofgem.

- restriction definitions in respect of the NTS transportation owner activity and NTS system operator activity) in the form annexed in Appendix 2 to this Direction;
- (d) substituting for the existing Part 1a, Part 1b(12) and Part 1b(13)(1) of Special Condition C8B (Restriction of revenue in respect of the NTS transportation owner activity and NTS system operation activity) a new Part 1a, Part 1b(12) and Part 1b(13)(1) of Special Condition C8B (Restriction of revenue in respect of the NTS transportation owner activity and NTS system operation activity) in the form annexed in Appendix 2 to this Direction;
 - (e) substituting for the existing Special Condition C14 (Information to be provided to the Authority in connection with the transportation system revenue restriction in respect of the NTS transportation owner activity and NTS system operation activity) a new Special Condition C14 (Information to be provided to the Authority in connection with the transportation system revenue restriction in respect of the NTS transportation owner activity and NTS system operation activity) in the form annexed in Appendix 2 to this Direction;
 - (f) substituting for the existing Special Condition C18 (Licensee's methodology for determining incremental exit capacity volumes) a new Special Condition C18 (Licensee's methodology for determining incremental exit capacity volumes) in the form annexed in Appendix 2 to this Direction; and
 - (g) substituting for the existing Schedule A (NTS output measures for the price control) a new Schedule A (NTS output measures for the price control) in the form annexed in Appendix 2 to this Direction;
- 2 the DN Licence held by National Grid Gas plc be modified by:
- (a) substituting for the existing Special Condition E2A (Revenue restriction definitions in respect of the Distribution Network) a new Special Condition E2A (Revenue restriction definitions in respect of the Distribution Network) in the form annexed in Appendix 3(1) to this Direction;
 - (b) substituting for the existing Special Condition E2B (Restriction of revenue in respect of the Distribution Network transportation activity) a new Special Condition E2B (Restriction of revenue in respect of the Distribution Network transportation activity) in the form annexed in Appendix 3(1) to this Direction; and
 - (c) substituting for the existing Special Condition E6 (Information to be provided to the Authority in connection with the transportation system revenue restriction in respect of the Distribution Network) a new Special Condition E6 (Information to be provided to the Authority in connection with the transportation system revenue restriction in respect of the Distribution Network) in the form annexed in Appendix 3(1) to this Direction;
- 3 the DN Licence held by Northern Gas Networks Limited be modified by:
- (a) substituting for the existing Special Condition E2A (Revenue restriction definitions in respect of the Distribution Network) a new Special Condition E2A (Revenue restriction definitions in respect of the Distribution Network) in the form annexed in Appendix 3(2) to this Direction;
 - (b) substituting for the existing Special Condition E2B (Restriction of revenue in respect of the Distribution Network transportation activity) a new Special Condition E2B (Restriction of revenue in

- respect of the Distribution Network transportation activity) in the form annexed in Appendix 3(2) to this Direction; and
- (c) substituting for the existing Special Condition E6 (Information to be provided to the Authority in connection with the transportation system revenue restriction in respect of the Distribution Network) a new Special Condition E6 (Information to be provided to the Authority in connection with the transportation system revenue restriction in respect of the Distribution Network) in the form annexed in Appendix 3(2) to this Direction;
- 4 the DN Licence held by Scotland Gas Networks Limited be modified by:
- (a) substituting for the existing Special Condition E2A (Revenue restriction definitions in respect of the Distribution Network) a new Special Condition E2A (Revenue restriction definitions in respect of the Distribution Network) in the form annexed in Appendix 3(3) to this Direction;
 - (b) substituting for the existing Special Condition E2B (Restriction of revenue in respect of the Distribution Network transportation activity) a new Special Condition E2B (Restriction of revenue in respect of the Distribution Network transportation activity) in the form annexed in Appendix 3(3) to this Direction; and
 - (c) substituting for the existing Special Condition E6 (Information to be provided to the Authority in connection with the transportation system revenue restriction in respect of the Distribution Network) a new Special Condition E6 (Information to be provided to the Authority in connection with the transportation system revenue restriction in respect of the Distribution Network) in the form annexed in Appendix 3(3) to this Direction;
- 5 the DN Licence held by Southern Gas Networks Plc be modified by:
- (a) substituting for the existing Special Condition E2A (Revenue restriction definitions in respect of the Distribution Network) a new Special Condition E2A (Revenue restriction definitions in respect of the Distribution Network) in the form annexed in Appendix 3(4) to this Direction;
 - (b) substituting for the existing Special Condition E2B (Restriction of revenue in respect of the Distribution Network transportation activity) a new Special Condition E2B (Restriction of revenue in respect of the Distribution Network transportation activity) in the form annexed in Appendix 3(4) to this Direction; and
 - (c) substituting for the existing Special Condition E6 (Information to be provided to the Authority in connection with the transportation system revenue restriction in respect of the Distribution Network) a new Special Condition E6 (Information to be provided to the Authority in connection with the transportation system revenue restriction in respect of the Distribution Network) in the form annexed in Appendix 3(4) to this Direction; and
- 6 the DN Licence held by Wales and West Utilities Limited be modified by:
- (a) substituting for the existing Special Condition E2A (Revenue restriction definitions in respect of the Distribution Network) a new Special Condition E2A (Revenue restriction definitions in respect of the Distribution Network) in the form annexed in Appendix 3(5) to this Direction;
 - (b) substituting for the existing Special Condition E2B (Restriction of revenue in respect of the Distribution Network transportation activity) a new Special Condition E2B (Restriction of revenue in

- respect of the Distribution Network transportation activity) in the form annexed in Appendix 3(5) to this Direction; and
- (c) substituting for the existing Special Condition E6 (Information to be provided to the Authority in connection with the transportation system revenue restriction in respect of the Distribution Network) a new Special Condition E6 (Information to be provided to the Authority in connection with the transportation system revenue restriction in respect of the Distribution Network) in the form annexed in Appendix 3(5) to this Direction.

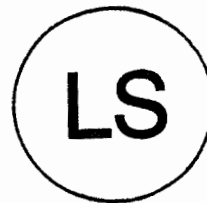
The official seal of the Gas and Electricity Markets Authority is affixed to this Direction and is authenticated by



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Robert Hull
Director, Transmission

Duly authorised on behalf of the Authority
26 January 2006



APPENDIX 1: FURTHER REASONS FOLLOWING CONSIDERATION OF RESPONSES RECEIVED

1. The Authority has carefully considered all representations made in relation to the proposed modification of the NTS Licence and the DN Licences and not withdrawn and, in this Appendix, considers the responses received and provides reasons for making the direction given these responses.
2. Prior to the close of the consultation period in respect of the Notice, the Authority received 7 responses in relation to the proposed modifications of the NTS Licence and the DN Licences. No responses were withdrawn. All non-confidential responses are available from the Ofgem Research and Information centre and on the Ofgem website at www.ofgem.gov.uk.

DN licensee responses

3. Each of the DN licensees responded to Ofgem's Final Proposals consultation.
4. One DN licensee stated its support for the Ofgem proposals for the transitional incentives, including the introduction of an absolute cap / collar. However, this DN licensee noted that the figures provided by National Grid NTS with respect to its Incremental Exit capacity Release Methodology Statement (IExCR), and included in Annex 1 of the Final Proposals consultation included errors and that the licensee had written to National Grid NTS in this regard. This licensee also stated its continued concerns regarding the comparison of NTS directed connected customers (DCs) and DNs and the difference in timescales applied to these two categories of customers.
5. Another DN licensee expressed its concerns regarding the potential for a double penalty under the provisions of a DN Advanced Reservation of Capacity Agreement (ARCA). This licensee also stated its concern that a DN cannot back off liabilities with respect to general load growth and emphasised the difference between DNs and DCs as DN offtake requirements are driven by multiple customers. Furthermore, this licensee stated its concern at the difference between its requirement and the proposed incentive allowance.
6. Another DN licensee stated that there were two points of detail in the consultation where further consideration may be required. The first related to cash flows under the transitional arrangements and the potential implementation of an "Option 2A" model of payment flows from 1 October 2008. This DN licensee noted that changing to a model where DNs pay for NTS exit capacity would require significant alteration to DN charging systems and, given that the introduction of the enduring arrangements is likely to require further changes to the DN charging systems, they remained to be convinced that the benefits of moving to "Option 2A" in the transitional arrangements outweighed the additional costs involved.
7. The second of the points raised by this DN licensee related to the proposed DN ARCA contracts and the potential inability of the DN to back off all stranding risks in the event that existing DN connectees cease to consume gas. This DN licensee suggested that a possible

solution would be to link a DN ARCA to an increase in the consumption of gas at a specified site.

8. The final DN licensee respondent stated that it continued to have concerns about the incentive targets that had been set, but welcomed Ofgem's inclusion of an absolute limit on a DN's financial exposure under the incentive scheme and the recent publication of a consultation on the income adjusting event licence provisions. This DN licensee respondent stated that whilst it believed that the licence drafting proposed achieved the intent of the incentive scheme, it would be helpful if Ofgem could clarify how the incentive performance measure calculation for 2010/11 will be pro-rated to apply only for the period 1 April to 30 September 2010. Finally, this licensee emphasised that the issues they had raised as part of the consultation process (such as the determination of appropriate targets and the relationship between flexibility requirements and load growth) must be addressed as part of the enduring arrangements.
9. This DN licensee respondent also noted that the existing licence drafting would allow for the mechanism for payment flows to move to an "Option 2A" approach on 1 October 2008 and stated that this would have significant implications for the DNs in terms of charging methodologies, setting charges, and associated system changes. This respondent stated its view that the Option 2A approach was discussed in the context of the enduring arrangements and therefore should not be implemented until such arrangements have been finalised. This respondent said that it would welcome Ofgem's early determination on this issue.
10. This DN licensee also noted that Ofgem described the NTS offtake arrangements (i.e. the DN ARCA) that are the subject of a concurrent National Grid NTS consultation and, in doing so, it appeared that Ofgem had accepted their implementation as an integral part of the incentive regime. However, this respondent stated that the detail of National Grid NTS's proposals in this regard were inappropriate and raised a number of detailed concerns in this regard.

NTS licensee response

11. In its response to the Final Proposals consultation, National Grid NTS agreed that the NTS transitional incentives should be considered as part of the current transmission price control review to allow consideration of the interactions between entry and exit and enable the incentives to be set in the context of the wider price control agreement.

Shipper responses

12. One shipper responded to the Final Proposals consultation. This shipper stated that it remained broadly supportive of Ofgem's proposals and stated that the introduction of an absolute limit to the overall cap and collar exposures represented an appropriate and proportional way of addressing the concerns expressed during the consultation process.

Energywatch response

13. In its response to the Final Proposals consultation, energywatch stated its support for Ofgem's proposals. However, energywatch expressed disappointment that its suggestion of a "shadow NTS offtake incentive scheme" had not been pursued by Ofgem. Furthermore, energywatch stated its continued belief that, if the interim and transitional offtake arrangements are operating satisfactorily, there should be no need for an enduring set of arrangements. However, energywatch also reiterated that the offtake arrangements should have non-discriminatory application, whether the request for capacity is made by DNs or by directly connected customers.

Further statement of reasons following consideration of responses

14. Ofgem welcomes the responses to its Final Proposals consultation and the general support for these proposals. However, Ofgem acknowledges that there are areas of outstanding concern, particularly amongst DN licensees, and therefore provides further reasons for making the direction given some of these concerns raised below.

Interaction with related National Grid NTS consultations

15. Ofgem notes the concerns raised by one DN licensee with respect to the numbers provided in Annex 1 of the Final Proposals consultation and would note that the errors identified have been corrected by National Grid NTS within the IExCR (upon which Ofgem published an open letter stating that it would not veto the latest proposals, on 24 January 2006).
16. Ofgem notes that one DN respondent stated that Ofgem's high level description of the NTS offtake arrangements in the Final Proposals consultation, including references to DN ARCAs seemed to imply that Ofgem had accepted their implementation as an integral part of the incentive regime and expressed concern that the detail of the National Grid NTS proposals were inappropriate. Ofgem would emphasise that, as noted in its open letter of 15 December, there is no express power of the Authority to review or approve ARCAs. Furthermore, whilst Ofgem believes that, where a request for incremental capacity triggers a need for investment on the NTS, an ARCA is appropriate, Ofgem does not believe that it is appropriate for Ofgem to endorse the detailed principles of the ARCAs themselves.
17. Ofgem notes the concerns expressed by another DN licensee regarding the potential for a double penalty under the provisions of a DN ARCA. Ofgem, however, does not accept that the arrangements provide for a double penalty as a DN will only make payments under the incentive regime within its licence in the event that capacity is booked (and that booked capacity exceeds the volumetric target set), whereas any DN ARCA payments would only be required in the event that capacity requested at the three year ahead stage is not booked.
18. In relation to the comments on the operation of the ARCAs and the effect of load growth, Ofgem, would note that the "initial volume allocation" numbers referenced by the IExCR, against which incremental exit capacity is defined, implicitly include some load growth. Furthermore, Ofgem notes the concerns of another DN

respondent regarding risks posed by multiple customers at a single offtake. However it is for DNs to manage demands on their networks consistent with their 1 in 20 obligation.

Differential treatment of DNs and NTS direct connects

19. Ofgem notes that under the transitional arrangements, different arrangements continue to be in place for DNs, relative to NTS direct connects. Ofgem continues to consider that it is inappropriate to retain such differential arrangements in the long term, and envisages that enduring arrangements that apply to capacity allocated for the period from 1 October 2010 will address such issues.

The level of DN incentive targets

20. Ofgem continues to recognise DNs' concerns regarding the determination of the incentive targets. Ofgem would emphasise that the independent analysis performed by Ofgem applied the same methodology to all DNs. Furthermore, as stated in the Final Proposals consultation, it should not be assumed that, in the future, the same methodology will be applied for the determination of targets.

Option 2A payment flows

21. Ofgem acknowledges that the NTS and DN-GT licences, as currently drafted, envisage that the mechanism for payment flows will move to an "Option 2A" approach² on 1 October 2008 (or such date that the Authority shall otherwise direct in writing). As such, from this date, DNs would take a more central role in the payments process, with all NTS-related payments from DN shippers passing through DNs.
22. In its Final Proposals consultation, Ofgem stated that it was not proposing to modify the licence to change this timing at the present time. However, Ofgem noted that the licence drafting gives the Authority the power to direct an alternative date, and, without fettering the discretion of the Authority, anticipated that the possibility of proposing a later date would be considered in due course. Ofgem has considered the concerns expressed by DN licensees in relation to the introduction of the "Option 2A" payment flows and proposes to publish a "minded to" position in this regard as part of the next Transmission Price Control Review consultation relating to NTS exit, which is planned for publication in March 2006.

Pro-rating for formula year 2010/11

23. Ofgem notes the request for clarification from one DN licensee regarding the method of pro-rating that would be applied in the event that the incentive target for 2010/11 applies only to the period 1 April to 30 September 2010. Ofgem notes that both the "target volume of NTS exit flat capacity" and the "target volume of NTS exit flow flexibility" are specified in GWh/d and, as such, could be applied to a six month period without issue. In relation to the equivalent performance measures e.g. "maximum actual allocation of NTS exit flat capacity" and "maximum actual allocation of NTS exit flow flexibility", Ofgem will consider the maximum allocation across the 2009/10 gas

² This was explained in 255/04a – National Grid Transco – Potential sale of gas distribution network businesses Final Impact Assessment, November 2004.

year as the period 1 April 2010 to 30 September 2010 falls within this gas year. Ofgem will consider maximum allocation across this full gas year as the targets were derived on the basis of peak, winter capacity.