

Ian Rowson
The Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Chris Train
Director, National Grid Gas plc

Malcolm Cooper
Director, Gas Distribution Sale

23rd September 2016.

Dear Ian,

Conditions precedent and subsequent to the Authority's conditional consent direction of 6th July 2016 (pursuant to Standard Special Condition A27 and Paragraph 3 of Schedule 3 of the Gas Act 1986) for the disposal of transportation assets and compulsorily purchased land by National Grid Gas plc ("NGG") to National Grid Gas Distribution Limited ("NGGDL")

We are writing to set out the assurance and information required by the Authority in accordance with the conditions precedent to the Authority's conditional consent direction, numbered in accordance with the consent direction.

a) The Secretary of State has not directed NGG pursuant to SSC A27 not to proceed with the disposal of, or the relinquishment of operational control over, the Transportation Assets

Under paragraph 11 of Standard Special Condition A27 of NGG's distribution gas transporter licence, NGG is required to notify the Secretary of State at least 60 days in advance of the proposed disposal of transportation assets that comprise a significant part of the gas conveyance system in Great Britain. If the Secretary of State directs NGG, within 30 days of notification not to proceed with the disposal, NGG must comply with that direction.

On 24 June 2016, NGG posted by first class recorded delivery a notice to the Secretary of State providing notice of its intention to dispose of transportation assets in accordance with paragraph 11, Standard Special Condition A27 of its gas transporter licence in respect of its gas distribution business. The notice was delivered to the Secretary of State and a signature of receipt was obtained on 27 June 2016.

The Secretary of State did not direct NGG not to proceed with the disposal within 30 days of that notice. The requirements of this condition are therefore met

b) The Health and Safety Executive ("HSE") has received safety cases in respect of each of NGG (NTS) and NGGDL and accepted each of those safety cases pursuant to the Gas Safety (Management) Regulations 1996

On 5 April 2016, NGG submitted to the HSE a revised safety case numbered V8 in respect of the changed structure for its retained transmission business to be implemented not sooner than 1 October 2016. On 27 June 2016 the HSE wrote to NGG stating that it will be content to approve this safety case at the time that NGG intends to operate under it.

On 5 April 2016 NGG also submitted to the HSE a revised Safety Case numbered V8 in respect of NGGDL. This version contained some but not all of the changes that would need to be applied to the distribution safety case. On 27 June 2016 the HSE wrote to NGG confirming that it was happy for the

contents of this safety case to go forward to the next version of the NGGDL safety case. On 10 June 2016, NGG submitted to the HSE a further revised Safety Case numbered V9 in respect of NGGDL containing the V8 changes and the remaining changes required for NGGDL to move to its new intended structure not earlier than 1 October 2016. On 30 August 2016 the HSE wrote to NGG confirming that it accepts V9 and will approve it on such date that NGG confirms that NGG and NGGD intend to begin operations under those safety cases.

On 2 September 2016, the HSE wrote to NGG stating that it accepts v8 of NGG's Safety Case and v9 of NGGDL's Safety Case to be effective upon the date that NGGDL commences operation of the gas distribution networks (such date and time to be notified to the HSE within 12 hours of it occurring).

c) The Secretary of State has consented in writing to the transfer of NGG(DN)'s Distribution Licence to NGGDL pursuant to SSC A45 (Assignment of Licence)

On 18 July 2016 NGG sent by recorded post to the Secretary of State a notice under SSC45 of its gas transporter licence in respect of its gas distribution business, requesting permission for the transfer of that licence to NGGD, not sooner than 1 October 2016. The notice is required to be served not less than sixty days prior to the proposed transfer. The notice was delivered to the offices of the Secretary of State on 19 July 2016. NGG expects to receive the Secretary of State's consent prior to 05.00 1 October 2016 and will confirm to Ofgem prior to the proposed disposal that it has received it.

d) The Authority has consented (pursuant to section 8AA of the Act) in writing to the transfer of NGG(DN)'s Distribution Licence to NGGDL in accordance with the Authority's consent

On 23 June 2016 NGG served a notice on the Authority in accordance with section 8AA of the Gas Act 1986 (as amended) requesting consent for its gas transporters licence in respect of its gas distribution business to be transferred to NGGDL not earlier than 1 October 2016. In its consultation dated 8 July 2016 "National Grid's intended sale of its Gas Distribution Networks Statutory licence consultations under section 8AA and section 23 of the Gas Act 1986" the Authority acknowledges receipt of this notice.

It is NGG's expectation that the Authority will issue formal consent under section 8AA of the Gas Act 1986 to the transfer of NGG's distribution licence to NGGDL prior to 05.00 hours on 1 October 2016 in order that such consent may take effect from such time and date.

e) In the reasonable opinion of the Authority, in light of information submitted by NGG, the allocation of non-transportation assets, obligations and associated operational changes will remain consistent with existing price control arrangements and ongoing commitments

i) NGG's separation of its shared functions

National Grid operates a shared support functions model to efficiently manage a number of support and corporate functions. Our Transmission and Distribution RIIO networks are then allocated their respective share of the costs of these services. These services are:

- Human Resources
- Corporate Affairs
- IS
- Procurement
- Audit
- Regulation
- Legal
- Finance
- Safety, Security and Resilience (SSR)

- Corporate functions, including
 - Tax and Treasury
 - Corporate Strategy
 - Corporate Finance

The larger share of costs in our RIIO businesses are directly attributed activities, i.e. the core operational businesses.

Principles of separation

Over the past 9 months, National Grid has carefully planned how to separate these shared functions such that a standalone Gas Distribution business can be formed and subsequently sold. In separating these functions we have adhered to a number of key principles which are in the interests of both consumers and shareholders as incentivised under the RIIO price controls; these are:

- Not to disrupt the safe and efficient operation of the regulated businesses during separation;
- On an enduring basis, protect the provision of necessary and value adding service offerings to the regulated businesses;
- Driving to achieve a position that support function costs to the retained regulated businesses are no greater on a like for like basis than would have been the case with a retained Gas Distribution business (e.g. achieve a net zero stranded cost position); and
- Driving to achieve a position that support function costs to the Gas Distribution businesses are no greater on a like for like basis than would have been the case when provided on the previously shared basis.

The team managing the sale process has been structured in a way that helps deliver these principles. Two of the key sub-teams are as follows:

- Separation – Focussed on creating a standalone Gas Distribution business with its own support functions at a cost no greater than the previous allocation; and
- Commercial – Focussed on ensuring the costs allocated to the retained business (and so to customers) do not exceed what they would have been in the absence of the sale of the Gas Distribution business

Approach

Clearly a number of principles that we applied to the design of the new support functions within Gas Distribution and the retained support functions have the potential to conflict with each other. The principle of sharing support functions is to create efficiency and improved service offering from scale and therefore reducing scale in the retained business and creating standalone support functions within Gas Distribution is likely to create additional cost or impact service without careful design.

Our approach has therefore been to design new service functions within a clear “cost envelope” (broadly using present allocated costs as the benchmark) whilst maintaining the necessary and value adding service offering to the regulated businesses. This has required the identification of cost efficiencies to mitigate any diseconomies of scale. Examples of efficiencies include combining teams, renegotiating third party contracts, enhancing demand control on service, reducing fixed costs (e.g. property and infrastructure) and altering service levels. These efficiencies have been identified through an iterative cycle of challenge and review.

We have also taken the approach of considering costs on an aggregate basis as well as in respect of individual functions. This has allowed us to make trade-offs between functions to mitigate risks. Some functions have been able to reduce costs below their cost envelope and these savings offset functions where further cost reductions may have created a material impact on the service offering to

the regulated businesses.

Our approach in terms of people, assets and contracts for our shared support functions has been as follows:

- For people we have designed two new organisational structures; which due to the principles described above that we have worked to meant broadly splitting our staff in to the two new organisations;
- Assets (for example property) have been allocated to the main user. Where this has created a potential stranded cost issue (e.g. Warwick office) we have applied a strategy to offset, for example by closing an office across our wider property portfolio and relocating. Shared assets (e.g. IS) will be duplicated, where necessary, with one-off costs associated with the separation of the GD business (including shared asset separation) captured centrally and excluded from totex; and
- Contracts have been novated or renegotiated (as necessary), again with the principle of ongoing costs needing to fit within "cost envelope" principle.

Transitional Service Arrangements (TSAs) and Long Term Service Arrangements (LTAs)

We have taken an approach to "stand up" separate support functions within Gas Distribution by 1 October 2016, where possible. However, there are some support function services where this has not been possible due to the complexity and risk associated with separation. In this case the retained NGG functions will continue to provide services to Gas Distribution for a period of time which then allows time for Gas Distribution to set up the relevant services and exit the TSA arrangements. The majority of our TSAs are in relation to IS, with these broadly running for up to 2 years whilst IS systems are physically separated. As these TSAs fall away over the two year period, we will ensure the IS support function costs fall in line with the TSA income. We also have TSAs covering facilities management at a number of shared sites; access to training facilities and access to specialist capital delivery skills. There are also a small number of reverse TSAs (Gas Distribution to retained businesses) with these mainly covering access and use of certain sites.

In addition to the TSAs we also have a number of GSAs, these are very short-term transitional arrangements that will fall away before share sale. These are focused to deal with specific short-term skills gaps, for example where we are externally recruiting to fill a role that won't be in place for 1 October 2016.

Finally we have a number of LTAs where the provision of services from either business is deemed efficient on a longer-term basis. These include pensions' administration, demand forecasting, metering services and emergency service provision.

Summary

For the Gas Distribution business we have developed a projected view of the separated business cost base. Based on this analysis we are confident that the GD separated business cost base will be no greater than the current totex numbers on a like for like basis.

For the retained businesses the approach described above means that each of the separate support functions was challenged individually to find ways to operate within the "cost envelope". This programme of work is not yet complete, and for IS will need to continue as TSAs fall away, but there is a good level of confidence that these costs can be mitigated.

The programme remains on track to separate all support functions to enable Gas Distribution to stand up its own support functions by 1 October 2016. The effective organisation of both sub-streams; (separation and commercial) means the principles set out in this document are driving the right approach to implementation; challenging support functions to remain within their 'cost envelopes'.

ii) Pensions Liabilities

From hive across the newly created Gas Distribution business will provide a temporary guarantee to provide assurance to the NGUKPS Defined Benefit (DB) scheme that through the scheme sectionalisation process it will take full responsibility for its current and future pension liabilities. At sectionalisation, the NGUKPS Defined Benefit scheme will be split into three sections. One section will not be funded by consumers and reflects the unfunded element of the regulatory fraction. The two other sections are funded and NGG and NGGDL respectively will become Lead Employer for one section each. The liabilities that will be allocated to each section reflect the regulatory split of liabilities as at 30 September 2015 as agreed by Ofgem and rolled forward to the sectionalisation date. The methodology for splitting the liabilities has been developed by a third party actuarial consultancy – Punter Southall and will further be verified by another independent data firm ITM Ltd.

As a result of sectionalisation gas transmission and distribution customers will ultimately be responsible for funding DB pension liabilities commensurate with their notional share of the scheme's overall liabilities immediately prior to sectionalisation. The key difference will be that the liabilities that they will be responsible for will be ring-fenced and immediately identifiable.

The assets of the existing scheme will be allocated to each section in proportion to the share of liabilities in each section as calculated at the point of sectionalisation by the independent scheme actuary Willis Towers Watson.

f) In the reasonable opinion of the Authority appropriate arrangements relating to industry codes and other industry agreements, including without limitation the Uniform Network Code, have been made, an Individual Network Code has been prepared for NGGDL, NGG has taken all reasonable endeavours to ensure that the relevant shippers have signed the new shipper framework agreement, and NGGDL has signed the Transporters' Framework Agreement, the agency services agreement (ASA), and the Joint Governance Arrangements Agreement (JGAA)

A review of industry agreements has been carried out to identify which of these agreements are required to be amended as a result of the minimal changes required by the hive across of NGG's gas distribution business sale.

i) Uniform Network Code

NGG has identified that a small number of "housekeeping" changes are required so that the Uniform Network Code "UNC" accommodates NGGDL as a separate gas transporter after the hive across of NGG's gas distribution business to NGGDL. These changes have been proposed under UNC "self governance" Modification 0582S. Additionally, a change to billing arrangements pursuant to which NGG will bill and operate credit arrangements on behalf of NGGDL for a limited transitional period, while a systems change is developed, has been identified. These changes are set out in UNC "self governance" Modification 0592S. Both modifications have been directed for implementation into the UNC at 05.00 on 1 October 2016. An extensive shipper engagement exercise continues to accompany the UNC Modification process with NGG issuing advisory letters, making presentations at industry groups and providing access to enable the provision of e-mail and telephone contacts to permit queries to be raised and answered. This will ensure that industry participants understand the need for, and the effects of, these changes and can seek information and, where appropriate, discuss relevant matters with NGG if they wish to do so.

ii) Individual Network Code for NGGDL

An individual Network Code has been prepared for NGGDL to be effective at 05.00 1 October 2016 and Ofgem will be provided with a copy in accordance with paragraph 3 of Standard Special Condition A11.

iii) Reasonable endeavours have been taken to ensure that relevant shippers sign the Shipper Framework Agreement for NGGDL

NGG has undertaken an exercise to identify all shippers that will be active gas distribution shippers on NGGDL's proposed network at 05.00 1 October 2016. Each shipper has received an execution version of the Shipper Framework Agreement and instructions on how to sign it, when to sign it by and contact details for any questions or clarifications. The shipper engagement exercise referred to above has also included an explanation of this process. A significant number of shippers have signed and

returned the Shipper Framework Agreement and the vast majority of the remainder have indicated that they intend to sign and return it on or before the date requested following formalities within their organisation. All shippers are expected to have signed and returned the Shipper Framework Agreement prior to 05.00 1 October 2016. NGG has and will continue to use all reasonable endeavours to ensure that each relevant shipper signs the Shipper Framework Agreement.

iv) Signature by NGGDL of the Transporters' Framework Agreement, the Agency Service Agreement and the Joint Governance Arrangements Agreement

NGG has prepared the necessary paperwork for NGGDL to accede to these documents and execute these to be effective from 05:00 on 1 October 2016.

g) Any other consent, clearance, permission, authorisation or approval required under statute, the Distribution Licence or otherwise in respect of the proposed hive across of NGG's Transportation Assets to NGGDL is obtained

NGG has followed a rigorous planning process focussing on people, processes, systems, assets, contracts and services to ensure that at hive across, both NGG and NGGDL have (amongst other things) all of the consents, clearances, permissions, authorisations and approvals (the "permissions") that each needs to carry out its business compliant with all requirements. At 05.00 1 October 2016, each organisation will have obtained the permissions required to run its respective gas transporter business.

Gas Transporter Licence consents

NGG has considered the need for and requested of the Authority the gas transporter licence consents needed for NGG and NGGDL from 05.00 1 October 2016. The Authority has indicated that it will grant the required consents to NGG to be effective at 05.00 1 October 2016. NGGDL will receive approval for the consents that it requires and which have been requested on its behalf by NGG. These consents will be granted and effective upon the transfer of assets and licence at 05.00 on 1 October 2016 (since consents cannot be granted to NGGDL until the gas transporter licence in respect of the gas distribution business is transferred to it). NGGDL's consents will therefore not be provided to it in executed form until shortly after hive across, although they will be in place and effective at the point of hive across.

Conditions Subsequent

The Authority also requires and NGG additionally undertakes that:

- i) It shall implement, or use all reasonable endeavours to procure the implementation of, any other regulatory, commercial or operational changes following hive across that the Authority considers are necessary in order to ensure that the interests of consumers are protected with regard to the Proposed Disposal (as defined in the consent direction of 6th July 2016);
- ii) It shall notify the Authority immediately if it becomes aware of any material change to information on the basis of which consent was granted;
- iii) Having met a condition precedent, it shall take no action which would result in the condition not being satisfied; and

Section 23 notice dated 8 July 2016

NGG shall with effect from 05.00 1 October 2016 conduct its NTS gas transporter business as if the licence amendments contained in the Authority's Section 23 notice "Notice of statutory consultation on a proposal to modify the Special Conditions of the gas transporter licence held by National Grid Gas plc in respect of the National Transmission System (NTS)" dated 8 July 2016 were in full force and effect as at 05.00 1 October 2016. This undertaking recognises that if the licence changes

contemplated by the Section 23 notice are directed on or around 1 October 2016 they will not take effect for a further 56 days by virtue of the provisions of Section 23(9) Gas Act 1986.

Project Nexus and the FGO programme

In accordance with paragraphs 2.19 to 2.21 of Ofgem's Final Decision document "National Grid's sale of Gas Distribution Network business – decision on regulatory aspects and the transfer of assets" dated 6th July 2016, NGG and NGGDL affirm their commitment to Project Nexus and the FGO programme.

Nominated date of hive across

NGGDL shall commence operation of the gas distribution networks at 05.00 1 October 2016 simultaneous with the transfer of the gas distribution assets and gas transporters licence granted to NGG in respect of its gas distribution networks. Accordingly such time and date is the nominated hive across date.

Yours sincerely,



Malcolm Cooper
Director, Gas Distribution Sale
Malcolm.Cooper@nationalgrid.com
Tel: +44 (0)207 0043340



Chris Train
(NGG Board Director and CEO of NGGDL)
chris.train@nationalgrid.com
Tel: +44 (0)1455 892161

