

**Regulatory issues arising from the merger of
National Grid Group plc and Lattice Group
plc to create National Grid Transco plc**

**Decision document and notices under
sections 11 and 11A of the Electricity Act
1989 and section 23 of the Gas Act 1986**

September 2002

Summary

In April 2002, National Grid Group plc and Lattice Group plc (Lattice) announced their intention to merge to create National Grid Transco plc (NGT). In May 2002 Ofgem published a consultation paper considering the competition and regulatory issues raised by the merger. Following the Secretary of State's decision, on 2 July 2002, to clear the merger, Ofgem published its initial proposals for addressing the regulatory issues arising from the placing of NGC and Transco within a combined group.

This document summarises the responses received to the July 2002 consultation and sets out Ofgem's decisions in the light of further consideration of the issues raised in the responses. The document also sets out Ofgem's statutory proposals for modification to the licences of NGC and Transco and the standard licence conditions of electricity transmission licences.

Ofgem proposes to modify these licences so that they provide that:

- ◆ none of NGC, Transco nor any of their affiliated or related undertakings can be involved in the purchase or sale of electricity, other than with the consent of Ofgem or, as permitted by their respective licences for system operator (SO) balancing purposes. Ofgem intends to issue consents to allow NGT to retain all of Lattice's existing generation interests (on certain terms) and to allow for Compressed Natural Gas and Liquid Petroleum Gas to be provided to certain parties;
- ◆ to prevent the transfer of information from EnMo Limited (the operator of the on-the-day commodity market in gas) to NGC and/or Transco; and
- ◆ to remove, where appropriate, any differences between the two companies' financial ringfencing provisions and to update the ringfencing provisions for both NGC and Transco, bringing them into line with the obligations for electricity distribution licensees which were revised in October 2001.

Ofgem has considered the concerns raised by respondents to the May 2002 and July 2002 papers regarding the interaction between NGC and Transco's respective SO roles and the need to ensure transparency, where appropriate, in system operation. In considering the issues raised by respondents Ofgem has considered the regulatory arrangements which are currently in place. These arrangements include licence obligations in respect of the conduct of NGC and Transco and arrangements to provide

that their actions are transparent to market participants and to Ofgem. NGC and Transco are also subject to statutory obligations under the Electricity Act 1989 and the Gas Act 1986 respectively and the Competition Act 1998. Ofgem considers that the existing regulatory arrangements appear sufficient to address these concerns and as such does not propose, at this stage, to make any licence modifications in relation to this matter.

However, Ofgem will, as part of its ongoing work programme, seek to address any issues that arise in relation to the interaction between the two SO roles and information transparency. For example, in preparing and implementing a new SO incentive scheme for NGC from April 2003, Ofgem will take into account any interactions between NGC and Transco's respective SO incentive schemes.

Comments on the statutory modification proposals set out in this paper are requested by 5pm on Monday 21 October 2002

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1. Introduction

Purpose of this document

- 1.1 On 2 July 2002 the Secretary of State for Trade and Industry (Secretary of State) cleared the proposed merger of National Grid Group plc (National Grid) and Lattice Group plc (Lattice) to create National Grid Transco plc (NGT). In July, Ofgem published a consultation document which set out a number of areas where Ofgem considered that regulatory action might need to be taken to prepare for the combining of The National Grid Company plc (NGC) and Transco plc (Transco) within one group¹. Ofgem received 8 responses to its July 2002 initial proposals.
- 1.2 The purpose of this document is to:
- ◆ summarise responses received to Ofgem's July 2002 initial proposals;
 - ◆ set out Ofgem's decisions in the light of further consideration of the issues raised by those respondents; and
 - ◆ where appropriate initiate implementation of those decisions by making statutory proposals for modifications to the licences of NGC and Transco and the standard licence conditions for electricity transmission licences in accordance with sections 11 and 11A of the Electricity Act 1989 (the Electricity Act) and section 23 of the Gas Act 1986 (the Gas Act).
- 1.3 It should be noted that Ofgem's final proposals on the regulatory issues arising from the proposed merger seek to address current regulatory issues. Going forward, in the light of any future regulatory developments, the arrangements set out in this paper may need to be reviewed. For example, the Government has recently announced that it intends to bring forward legislation to implement new British Electricity Transmission and Trading Arrangements (BETTA) when

¹ "Regulatory issues arising from the merger of National Grid Group plc and Lattice Group plc to create National Grid Transco plc – Initial Proposals" July 2002 47/02. The publication of the July consultation document followed publication of an earlier paper, which focused on consideration of the competition issues raised by the merger in May 2002. Both documents are available on Ofgem's website together with all non-confidential responses to those documents.

Parliamentary time allows². As part of BETTA there is an ongoing process for identifying the GBSO³. It is likely that NGC will continue to be an electricity transmission licensee under BETTA and as such it will be necessary to review the detailed licensing arrangements for NGC in the light of any such BETTA reforms.

Structure of the document

- 1.4 Chapter 2 considers issues raised by the merger in relation to information and transparency. Chapter 3 considers issues connected with the vertical separation of the combined group. Chapter 4 sets out Ofgem's proposals in relation to financial ringfencing. Chapter 5 sets out Ofgem's proposals in relation to other issues raised by respondents. Chapter 6 explains the timetable for taking forward Ofgem's proposals to modify the licences of NGC and Transco and the standard licence conditions for electricity transmission licences.
- 1.5 Appendix A contains a list of non-confidential responses received to the July 2002 initial proposals. Appendix B sets out Ofgem's proposed modifications to NGC and Transco's licences. Appendix C sets out a draft consent for NGC under SLC C2, as described in Chapter 3. Appendix D contains copies of the statutory modification notices published in accordance with sections 11 and 11A (which includes the proposed modification to the standard licence conditions for electricity transmission licences) of the Electricity Act and section 23 of the Gas Act.

Timetable

- 1.6 Ofgem has today (20 September 2002) published modification notices in accordance with sections 11 and 11A of the Electricity Act 1989 and section 23 of the Gas Act. Comments on the modification proposals are requested by 5pm on Monday 21 October 2002. Comments should be sent to:

² See Hansard, 15th April 2002 Official Report Column 748W.

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Contact

- 1.7 If there are any questions regarding this document or the modification notices set out at Appendix D please contact, in the first instance, Lisa Vango on 020-7901-7178.

Confidentiality

- 1.8 In accordance with Ofgem's normal practice, responses will be made publicly available, through the Ofgem Library and on the Ofgem website. Respondents should mark any part of their response (or the whole response) which is to remain confidential, if this is the case, and where possible should consign any confidential material to appendices.

Current modification proposals under section 23 of the Gas Act

- 1.9 On 12 April 2002 and 1 August 2002, Ofgem issued notices under section 23 of the Gas Act in respect of proposed modifications to Transco's gas transporter licence to introduce, with effect from 1 April 2002, new price controls and system operator (SO) incentives for Transco. Ofgem is currently considering the responses that it has received to these consultations.

³ 'The process for identifying the GB system operator: key conclusions and invitation for applications' DTI/Ofgem August 2002.

1.10 Ofgem has taken account of those proposals in considering the regulatory issues arising from the merger and in identifying regulatory solutions. This paper does not in any way fetter the Authority's discretion in respect of those modification proposals. All comments in this paper regarding Transco's price control and SO incentives should be considered in the light of this statement. However, it will be noted that, while the licence modifications required as a result of the merger are being progressed independently of the price control and SO incentives proposals discussed above, if those proposed modifications are not to be introduced, Ofgem will need to further consider what proposals are required for Transco in respect of the merger. In particular, it will not be possible to make the proposed modification to Special Condition 26 of Transco's licence (see paragraph 3.6 below) if that condition has not been introduced into Transco's licence.

2. Information and transparency

July 2002 initial proposals

- 2.1 In its July 2002 initial proposals Ofgem said that it did not intend to make any additional changes to the licences held by NGC and Transco in respect of the accessibility of information and the transparency of its use as a result of the merger. However, Ofgem did propose that it would be considering the operation of and interaction between NGC and Transco's respective SO price controls and incentives within the NGT group, as part of its present work on SO price controls and incentives.
- 2.2 The purpose of this Chapter is to set out the views of respondents to the July 2002 initial proposals, Ofgem's responses to those views and Ofgem's final proposals.
- 2.3 Concerns raised by respondents to the May and July 2002 consultation papers on information and transparency centred broadly on four linked areas:
- ◆ interaction between the SO price controls and incentives;
 - ◆ transparency of information sharing between NGC and Transco;
 - ◆ transparency of the SOs' balancing actions in relation to both electricity and gas systems; and
 - ◆ potential for discriminatory behaviour.

Respondents' views

- 2.4 With regard to the interaction between NGC's SO price control and incentives and those proposed for Transco⁴ respondents stressed the importance of reviewing the operation of the two SO price controls and incentives as soon as possible in order to ensure that there were no perverse incentives operating on the combined group. In addition respondents took the view that it was important to ensure that the incentives were sufficiently challenging for the

combined group. Concern was also raised regarding the ability of NGT to balance one network at the expense of the other and the effect that this could have on those market participants (and ultimately customers) who were solely active in either gas or electricity.

- 2.5 One respondent commented that it would be appropriate to increase the vertical separation between the two SO activities and the rest of NGT rather than to focus on aligning the two sets of SO price controls and incentives.
- 2.6 A number of respondents raised concerns regarding the increased potential for information sharing between NGC and Transco as a result of the merger. Some respondents, while noting that some information sharing takes place today and recognising its possible benefits, took the view that NGC and Transco should not be allowed to take advantage of market information if it placed other parties at an unfair disadvantage. For example, information on unplanned constraints on one network would give NGT a commercial advantage in seeking to balance both networks.
- 2.7 Some respondents took the view that, in order to address these concerns, any new information flows that were established as a result of the merger should be clearly documented, allowing Ofgem to monitor/audit those flows to ensure that the information was not being misused. It was also suggested that no information should be shared between NGC and Transco unless it was to be made available to all market participants within the same timescales. One respondent also suggested that there should be a total bar on information sharing until Ofgem had taken steps to align the SO price controls and incentives for NGC and Transco.
- 2.8 A number of respondents raised concerns regarding the lack of transparency of the balancing actions undertaken by NGC and Transco in their respective SO roles. Many of these concerns were similar to those raised during the introduction of the New Electricity Trading Arrangements (NETA) and the New Gas Trading Arrangements (NGTA) regarding the ability of NGC and Transco (as SOs) to trade on their own account, with concern that those transparency issues could now have an effect over two networks.

⁴ See paragraphs 1.9 and 1.10.

- 2.9 Broadly, respondents were concerned that due to the lack of transparency in NGC and Transco's respective balancing actions, they might be able to take unfair advantage of market sensitive information without being detected.
- 2.10 Linked to this were general concerns that the existing regulatory arrangements in electricity (and those proposed for Transco in gas)⁵ were not sufficient to prevent such actions. In particular, concerns were raised regarding the monitoring and enforcement of Special Condition AA4 (Licensee's procurement and use of balancing services) of NGC's licence and proposed Special Condition 26 (Prohibited procurement activities) of Transco's licence⁶ to ensure that the respective SOs do not engage in speculative trading.
- 2.11 Further concerns were expressed over the operational fora⁷ that are held by NGC and Transco respectively to allow market participants to question the respective SO over its balancing actions. It was argued that the fora were conducted at too high a level to be of any assistance in detecting such action.
- 2.12 There was also concern that only NGC could instigate a review of its balancing activities statements⁸ which meant that changes were unlikely to be introduced if they were against the interests of NGC. It was suggested that these statements should be codified within the Balancing and Settlement Code (BSC) so that all market participants could instigate changes. Similar concerns were raised in gas in relation to statements required under proposed Special Condition 27 (Licensee's procurement and use of system management services)⁹.
- 2.13 Finally, in addition to the general concerns raised above regarding the increased potential for discriminatory behaviour, specific concern was raised that there would, as a result of the merger, be an incentive on NGT to favour the use of gas fired generation plant over other forms of generation. This incentive would arise because the use of gas-fired generation plant would result in higher overall

⁵ See paragraphs 1.9 and 1.10.

⁶ See paragraphs 1.9 and 1.10.

⁷ NGC and Transco have established regular operational fora. Their respective operational fora are used to inform and discuss information relating to such issues as the procurement of balancing services and operational issues and provide an opportunity for reporting by the respective SO and consequent discussion.

⁸ NGC is required to procure any balancing service contracts competitively via transparent process. Therefore, under NGC's Transmission Licence Special Condition AA4, NGC is required to have in place three documents: Procurement Guidelines, Balancing Principles Statement and Balancing Services Adjustment Data Methodology Statement.

⁹ See paragraphs 1.9 and 1.10.

revenues for NGT, with the use of gas-fired generation plant creating revenues for both NGC and Transco.

Ofgem's final proposals

- 2.14 Ofgem notes that it is the intention of NGT, if the merger is completed, to reorganise the group's management structure and place the electricity and national gas transmission systems under a single senior management team. Ofgem will be issuing consents, under SLC 10 (for NGC) and SLC 29 (for Transco) to provide for this restructuring, subject to certain conditions. Ofgem's final proposals have been considered in the light of this intention. However, in the future, it may be appropriate, in the light of any developments, including in the structure or organisation of the NGT group, for Ofgem to review this.
- 2.15 Ofgem recognises the concerns expressed by respondents (paragraphs 2.4 and 2.5 and in responses to the May 2002 consultation paper) regarding the interaction of the SO price control and incentive arrangements. In July 2002 Ofgem proposed that it would review the interaction between and operation of the respective SO price control and incentive arrangements as part of its planned work in that area and that Ofgem would seek to address any issues that were identified during that review. This continues to be Ofgem's proposal.
- 2.16 Paragraphs 2.6 and 2.7 above set out views raised by respondents regarding the sharing of information within NGT. Ofgem recognises that as a result of the merger, NGC and Transco may have access to information that was not previously available to either of them as separate businesses. However, Ofgem considers that such information exchanges should bring benefits for customers, through increasing the efficiency of system operation and through improving security of supply, and as such they do not cause concern for Ofgem provided that they take place within the rules governing the exchange and use of information.
- 2.17 With regard to the need to record all information flows between NGC and Transco so that they could be audited to determine whether or not that information has been used to gain an unfair advantage, Ofgem does not consider that it is necessary to put in place specific arrangements concerning the exchange of information between NGC and Transco, taking the view that the

existing regulatory arrangements on the exchange and use of information are sufficient. These regulatory arrangements include: licence obligations on NGC (and proposed for Transco)¹⁰ in respect of speculative trading and discrimination; the Competition Act 1998; and the Financial Services Authority (FSA)¹¹ rules on market conduct.

- 2.18 Several respondents requested that, in order to address concerns over the transparency of information sharing, any information that was to be shared between NGC and Transco should be shared with all market participants at the same time. Ofgem regards informational symmetry to be a key issue in ensuring successful market development under NETA and NGTA and as such believes that all parties should have access to the same information provided that it is practical to do so and that the information is not commercially sensitive or subject to overriding statutory or contractual restrictions on disclosure.
- 2.19 Some information shared between NGC and Transco, for example information on outages, is already available to all market participants. In addition, recent modifications to the Network Code¹² in gas provide for more gas information to be made available to all market participants and further modification proposals may come forward in the future. In electricity, NGC has recently announced that it intends to consult on proposed changes to its Procurement Guidelines in respect of transparency issues in relation to NGC's balancing actions.
- 2.20 Ofgem does not consider that it is necessary to mandate that all information that is shared between NGC and Transco should be made available to all market participants¹³. However, as part of its ongoing work to ensure that the wholesale gas and electricity markets operate effectively, Ofgem would welcome further views from all parties as to whether there is any additional information that NGC and/or Transco should be providing to market participants. Subject to these

¹⁰ See paragraphs 1.9 and 1.10.

¹¹ The Financial Services Market Act 2000 (FSMA) introduced the Code of Market Conduct and a new financial penalties regime to tackle market abuse. Ofgem and the FSA have been working together to prepare a Concordat. Ofgem and the FSA believe that they may be able to discharge their functions so as to better achieve their respective statutory objectives by working closely together in areas where there may be a degree of overlap in their respective functions (for example, in the area of market abuse) and also in certain areas of mutual interest where no such overlap exists, where there may be benefit in working in parallel as proposed in the Concordat. Once the Concordat has been signed by Ofgem and the FSA copies of the Concordat will be made publicly available.

¹² Modification 0561 'Publication of capacity forward and option costs.'

¹³ Subject to statutory and contractual restrictions.

views, it may be appropriate to review the existing information arrangements under the relevant governance structure.

- 2.21 Linked to concerns on the operation of the SO incentives and the sharing of information between NGC and Transco are concerns over the lack of transparency in NGC and Transco's balancing activities. Respondents expressed concerns (see paragraphs 2.8 to 2.12) that the operation of the SO incentives and the sharing of information might allow NGC and Transco to gain an unfair advantage over others without being detected. It is Ofgem's view that existing regulatory arrangements are sufficient to address the concerns raised by respondents.
- 2.22 For example, Special Condition AA4 of NGC's licence and proposed Special Condition 27 of Transco's licence¹⁴ prohibit NGC and, if the proposals referred to in paragraphs 1.9 and 1.10 are introduced, will prohibit Transco from discriminating in the procurement of balancing services. Furthermore, NGC and Transco are subject to other statutory and licence obligations, such as Special Condition SLC C7C (Non-discrimination) for NGC and proposed Special Condition 26 and SLC 4D (Conduct of transportation business) for Transco¹⁵, which impose obligations on the licensees. The provisions of the Competition Act 1998 and the FSA Code of Market Conduct (discussed below) may also apply.
- 2.23 In addition, Special Condition AA4 requires NGC to undertake an annual report on the manner in which and the extent to which they have complied with the balancing principles. This is accompanied by a statement from the licensee's auditors assessing the extent to which they have complied. The Balancing Principles Statement (BPS) report, covering the period from 27 March 2001 to 31 March 2002 was provided to the Authority, by NGC, on 28 May 2002 and is available on NGC's website. In summary, the auditors considered that, for the period in question, NGC did in all material respects procure and use the various aspects of balancing services in accordance with the BPS. If the proposed arrangements for Transco are put in place Transco will, in future, be subject to a similar audit process in respect of its system management principles statement.

¹⁴ See paragraphs 1.9 and 1.10.

¹⁵ See paragraphs 1.9 and 1.10.

In addition to annual auditing of the BPS, Ofgem takes a proactive approach to monitoring balancing actions and compliance.

- 2.24 NGC are also required, under Special Condition AA4 to produce an annual report on the balancing services that they have procured during the period. The Procurement Guidelines (PG) report covering the period from 27 March 2001 to 31 March 2002 was provided to the Authority, by NGC, on 28 May 2002 and is available on NGC's website. This report stated that balancing services procured during the period by NGC were procured in accordance with the principles set out in the PG. If the proposed arrangements for Transco are put in place¹⁶ Transco will, in future, be subject to a similar process. In addition, NGC has recently announced its intention to consult on proposed changes to the guidelines in relation to transparency issues.
- 2.25 A number of respondents raised specific concerns that the operational fora held to allow market participants to question the SOs balancing actions were not detailed enough to be of any assistance to market participants and provided no reassurance to market participants that the conduct of the respective SOs was being adequately monitored.
- 2.26 Ofgem has considered these concerns and acknowledges that due to the volume of balancing actions undertaken by the SO it is not feasible to provide a detailed description of each balancing action at the operational fora. However, Ofgem considers that the existing regulatory arrangements appear sufficient. While the operational fora are conducted at a high level market participants can ask NGC and Transco in their respective fora to explain specific balancing actions. In addition it is Ofgem's understanding that both NGC and Transco, prior to their respective fora, invite market participants to raise any issues that they wish to be discussed at those fora. Ofgem is also able to seek information from the SOs regarding balancing actions taken on specific days and has sought such information on previous occasions.
- 2.27 It is Ofgem's view that these arrangements provide market participants with an opportunity to take a proactive role in further understanding the balancing actions of the SO. As such Ofgem would urge market participants to make full

¹⁶ See paragraphs 1.9 and 1.10.

use of the operational fora, seeking clarification of specific balancing actions and the reasons for such decisions. Going forward, in addition to discussing issues relating to their respective roles, Ofgem expect that NGC and Transco will use their respective fora to discuss any interactions between the two networks.

- 2.28 Furthermore, Ofgem considers that, following the merger, it might be appropriate for NGC to consider what implications proposed modifications to the Balancing and Settlement Code (BSC) may have on the gas sector and for Transco to consider what implications proposed modifications to Transco's Network Code may have on the electricity sector. It is Ofgem's intention to request that both NGC and Transco adopt this approach going forward.
- 2.29 With regard to requests that the balancing activities statements are codified to allow market participants to instigate changes to the statements, Ofgem does not consider that it is necessary to codify these arrangements. Special Condition AA4 obliges NGC to review its statements as required but in any event for the BPS and the PG on an annual basis. In addition to this, Special Condition AA4 provides that Ofgem may direct NGC to conduct a review at any time. As such, if a party considers that a review should take place they may decide to raise the matter with Ofgem who could direct such a review, if Ofgem considers that it is appropriate to do so.
- 2.30 In relation to the actual review, NGC is required to consult with market participants and interested parties in reviewing its statement (any changes to which must be approved by the Authority). Similar arrangements have been proposed in respect of Transco¹⁷. Going forward, Ofgem will be looking to the companies to address, as part of this process, any issues concerning SO information provision that arise as a consequence of the merger.
- 2.31 In relation to the concerns raised by respondents and considered above on the potential for NGC and Transco to gain an unfair advantage and the transparency of balancing actions, Ofgem considers that the existing regulatory arrangements appear sufficient. In addition to the arrangements discussed in paragraphs 2.22 to 2.30 above, other obligations, such as Special Condition SLC C7C for NGC and proposed Special Condition 26 and SLC 4D (Conduct of transportation

¹⁷ See paragraphs 1.9 and 1.10.

business) for Transco¹⁸ and the licensees' respective statutory duties to facilitate competition in the supply and generation of electricity (for NGC) and the supply and shipping of gas (Transco), impose obligations enforceable by Ofgem to enable it to regulate the conduct of the two SOs.

- 2.32 In addition, Ofgem also has powers under the Competition Act 1998, which may allow Ofgem to take action if the activities of the merged entity are shown to have an anti-competitive effect and the FSA may be able to impose financial penalties under its Code of Market Conduct if there is evidence that market abuse has taken place.
- 2.33 Paragraph 2.13 above set out specific concerns raised by one respondent regarding incentives on NGT to discriminate in favour of gas-fired generation in order to maximise its revenues over both networks. It is Ofgem's view that the existing regulatory framework which includes licence (including Special Condition AA4 (NGC) and Special Conditions 26 and 27 and SLC 4D (Transco)) and statutory obligations, the Competition Act 1998 and the FSA rules, appear sufficient to address these concerns. In addition, market participants have the opportunity, through NGC and Transco's respective operational fora, to question the SO about specific balancing actions and can raise concerns about potential infringements with the Authority.

Final proposals on information and transparency

- 2.34 As explained above, Ofgem does not consider that it is necessary, at this stage, to make any changes to the regulatory arrangements that are currently in place (or are proposed in respect of Transco¹⁹) in relation to information and transparency. As such no changes have been proposed in this Chapter. However, in the future, it may be appropriate, in the light of any developments, including in the structure or organisation of the NGT group, to review this.
- 2.35 Ofgem will, as proposed in the July 2002 initial proposals, be considering the operation of and interaction between NGC and Transco's respective SO price controls and incentives within the NGT group as part of its work on SO price

¹⁸ See paragraphs 1.9 and 1.10.

¹⁹ See paragraphs 1.9 and 1.10.

controls and incentives. If as a result of that work Ofgem identifies any required changes it will seek to bring such changes forward.

3. Vertical separation

July 2002 initial proposals

3.1 Both National Grid and Lattice are engaged in other activities in addition to their main businesses of electricity transmission and gas transportation. In its July 2002 initial proposals, Ofgem sought views on the proposed regulatory solutions for dealing with NGT, in relation to:

- ◆ purchasing and selling gas and electricity other than for the purposes of balancing their networks; and
- ◆ operating the on-the-day commodity market (OCM) in gas, through its ownership of EnMo.

3.2 The purpose of this chapter is to set out the views of respondents to the July 2002 initial proposals, Ofgem's response to those views and its final proposals.

Purchase and sale of gas and electricity

3.3 In its initial proposals Ofgem was of the view that vertical separation was important in promoting confidence in the wholesale gas and electricity markets. Any vertical integration of the network businesses of NGC and Transco might lead to a loss of confidence in the independence of NGC and Transco in developing and in particular balancing their respective networks, which could have a detrimental effect on the operation of the wholesale markets. It was therefore important that none of NGC, Transco nor any of their affiliated or related undertakings should be allowed to be involved in the purchase or sale of gas or electricity, except with the consent of Ofgem or, as permitted by their respective licences, for SO balancing purposes.

3.4 However, Ofgem proposed allowing Lattice to retain within the combined group all of the electricity generation plant that it currently operates provided that it was appropriately ringfenced, on the basis that it was very small scale, it was connected to the distribution and not the transmission network and the generation was of an environmentally beneficial nature.

Respondents' views

- 3.5 In general respondents were supportive of the approach which Ofgem proposed both in terms of the importance it attached to vertical separation but also in allowing the existing small scale generation to remain within the group appropriately ringfenced. One respondent suggested that ringfencing was not necessary provided that procurement by NGC was transparent and carried out on a non-discriminatory basis.

Ofgem's final proposals

- 3.6 Having considered the responses received to its initial proposals, it remains Ofgem's intention to follow the approach set out in its initial proposals. This will include:
- ◆ a modification to proposed Special Condition 26 of Transco's licence²⁰ to prevent related undertakings as well as affiliates from buying or selling gas except with Ofgem's consent, whether as principal or agent. This will bring Transco's licence fully into line with NGC's licence which already prevents NGC and affiliates and related undertakings from buying or selling electricity without Ofgem's consent, except for SO balancing purposes;
 - ◆ a modification to Special Condition AA3 (Supplementary prohibited activities) of NGC's licence to allow Ofgem to issue a consent for the licensee and/or any affiliate or related undertaking to purchase or sell electricity consistent with SLC C2 (Prohibited activities) of its licence which already allows for consents to be issued;
 - ◆ issuing a consent under the revised Special Condition AA3 and under SLC C2 of NGC's licence to allow NGT to retain all of Lattice's existing generation capacity on the terms specified in the consents. The consent will among other things identify the specific sites and generating capacity allowed, be time limited for the CHP facilities, ringfence the activity to prevent information about the generation of electricity within the group being made available to NGC and will prevent sale of the output/other generation services from the plant to any company within NGT. If the

activities of any member of the combined group breach the terms of the consent, this will constitute a breach of NGC's licence; and

- ◆ issuing a consent under proposed Special Condition 26 of Transco's licence²¹ to allow the purchase of gas by Lattice Energy Services to provide Compressed Natural Gas to certain parties as vehicle fuel and to allow Transco to purchase LPG which is for supply to customers on the Isle of Lewis.

3.7 After further consideration, it is not thought necessary to issue a consent for the purchase of gas by Lattice Energy Services which is used to operate its three CHP facilities since no gas is resold. Details of the licence modifications referred to in the above paragraph are set out in Appendix B. A draft of the proposed consent to be issued to NGC under SLC C2 is set out in Appendix C. Ofgem intends to issue a similar consent under Special Condition AA3 if that condition is modified

EnMo

- 3.8 National Grid, through its subsidiary EnMo, operates the OCM, which is a trading platform through which shippers and Transco can buy and sell gas. The OCM is used by shippers to buy and sell gas in order to balance their positions. Transco, as SO, also buys and sells gas on the OCM to balance the system. EnMo does not buy and sell gas itself.
- 3.9 While the operation of a trading platform is not a breach of either company's licence (Transco does frequently trade through EnMo), it is Ofgem's view that the merger may give rise to concerns that Transco would be able to access information about the prices and volumes traded by other participants. However, Ofgem recognises that the parties have a vested interest in preventing confidential information being accessed by Transco, since failure to do so would reduce the commercial viability of EnMo and may make it more expensive for Transco, as SO, to balance its network.

²⁰ See paragraphs 1.9 and 1.10.

²¹ See paragraph 1.9 and 1.10.

3.10 In order to address concerns regarding the accessibility of information held by EnMo, Ofgem is proposing to ringfence EnMo from the two network businesses to prevent the transfer of information from EnMo to NGC and/or Transco. This proposal would be implemented via a new licence condition to be included in the licences of both NGC and Transco.

Respondents' views

3.11 In general respondents were supportive of the proposed ringfence as a means of preventing the transfer of information from EnMo to NGC and/or Transco. Two respondents considered that divestment was a more appropriate solution than ringfencing, although one of them recognised that a failure to prevent information flowing from EnMo would damage its commercial viability.

3.12 NGG and Lattice, in their joint response, supported the need to ringfence EnMo through the licences of NGC and Transco. They did not however agree with the strict liability imposed in the draft condition and proposed instead an undertaking to ensure that:

- ◆ appropriate procedures had been put in place to prevent the flow of information from EnMo to Transco and NGC; and
- ◆ reasonable endeavours were used to ensure compliance.

Ofgem's final proposals

3.13 It remains Ofgem's view that, while there are commercial incentives to ensure that information from EnMo is not made available to NGC or Transco, it is still appropriate to ringfence the activity from NGC and Transco. Ofgem has considered NGG and Lattice's proposals to modify the proposed licence condition so that the undertaking relates to the putting in place of procedures and compliance with those procedures. It is Ofgem's view that this approach is potentially more bureaucratic and less likely to be effective than the approach set out in its initial proposals whereby an undertaking is given by the ultimate holding company of the licensee and EnMo that no confidential information shall be disclosed. It is then a matter for the licensee to decide how to comply

effectively with the licence condition recognising the penalties that may be levied if it fails to do so.

3.14 On the basis of further consideration and dialogue with NGC and Transco, Ofgem has made a number of modifications to the licence condition proposed in July. It is now intended that there should be a separate condition for each licence, based on the July draft. In addition to changes to improve the drafting:

- ◆ the undertaking (in paragraph 5) to be given by the ultimate holding company is now to 'use its best endeavours' to prevent disclosure of EnMo information. This change has been made to recognise that an absolute duty could impose an unreasonable obligation where a breach could be by persons outside the direct control of the ultimate holding company;
- ◆ two additional exclusions from the disclosure prohibition have been added: where there is consent to its disclosure; and where EnMo is already contractually obliged to disclose it to Transco.

3.15 Final drafts of the proposed licence conditions to ringfence EnMo from NGC and Transco are set out at Appendix B.

4. Financial ringfencing

July 2002 initial proposals

4.1 In its July 2002 initial proposals Ofgem considered whether the proposed transaction raised any issues in relation to the security of electricity and gas supplies and more generally the operation of both networks. It considered these issues broadly under two headings:

- ◆ financial ringfencing; and
- ◆ managerial focus.

4.2 The purpose of this chapter is to set out, in respect of financial ringfencing, the views of respondents to the July 2002 initial proposals, Ofgem's response to those views and its final proposals. Issues raised in relation to managerial focus are addressed in Chapter 5.

Financial ringfencing

4.3 The network businesses of NGC, Transco and the electricity distribution businesses are currently 'ringfenced' from other activities that may be carried on within their respective groups²². This financial ringfence is designed to ensure that each licensee has available to it at all times the financial resources it requires to carry on its network business, and that these are not exposed to inappropriate risks nor diverted to other purposes.

4.4 Following the merger NGC and Transco will continue to be financially ringfenced from each other as well as from the rest of the NGT group. Generally, it is Ofgem's view that these existing restrictions are sufficient within the combined group but that there is merit in:

- ◆ bringing NGC's and Transco's licences (where appropriate) into line with each other; and

²² These ringfencing conditions are included in NGC's electricity transmission licence as special conditions and in Transco's gas transporter licence as standard licence conditions, amended standard licence conditions and special conditions.

- ◆ amending both NGC's and Transco's licences (as far as appropriate) to bring them into line with obligations that were introduced in October 2001 for all electricity distribution licensees and which represent Ofgem's current thinking with respect to financial ringfencing. NGC's obligations are, to a large extent, identical to the equivalent provisions of electricity distribution licences and require only a small number of amendments. A larger number of amendments are required to Transco's licence to update its ringfencing obligations, which have not been modified since they were first introduced in 1999.

4.5 In one respect however, Ofgem does not propose to bring the licences of NGC and Transco into line with the electricity distribution licences. In the licence conditions on 'Restriction of activity and financial ringfence' provision is made for all licensees to carry on activities not authorised by their licence where these are in aggregate immaterial, as judged by specific tests. One such test relates to the scale of the licensee's investment in such other activities. Investment for these purposes is defined, broadly speaking, as the cumulative total expenditure incurred or committed. No account is taken of income received. This definition makes it increasingly difficult for a licensee to carry on such activities as time passes, the more so according to the success encountered. This might prevent the licensee undertaking activities that could bring benefits to electricity or, as the case may be, to gas customers. Accordingly, Ofgem proposes to amend, in both licences, the definition of investment for these purposes to take account of income generated from the relevant activities to the extent received by the licensee²³. Similar changes will be proposed for the electricity distribution licences in due course.

Respondents' views

4.6 Those respondents who expressed a view were supportive of Ofgem's initial proposal to align the financial ringfences of Transco and NGC and as appropriate to bring them into line with the electricity distribution licences. One respondent said that as the unregulated activity increased, the gearing of the combined group would increase and this may affect its credit rating. It

²³ This principle is already reflected in Transco's licence but Ofgem proposes that the drafting currently included in the Transco licence will be amended in the interests of greater clarity.

suggested that the ringfence would need to be strengthened but did not suggest how.

Ofgem's final proposals

4.7 In the light of these comments and following further discussion with NGC and Transco on the detailed modifications, Ofgem is proposing a number of modifications to the financial ringfencing provisions for NGC and Transco. Some of the proposals relate to both NGC and Transco while others relate to only one of the businesses. For ease of reference the following table sets out the financial ringfencing provisions for NGC and Transco.

	NGC	Transco
Provision of information to the Authority	Special condition AA11	Amended SLC 24
Disposal of relevant assets	SLC 10	Amended SLC 29
Prohibition of cross-subsidies	SLC 12	SLC 41
Restriction on activity and financial ring fencing	Special condition AA6	Special condition 2
Availability of resources	Special condition AA7	Special condition 3
Undertaking from ultimate controller	Special condition AA8	Amended SLC 45
Credit Rating of licensee	Special condition AA9	Special condition 4
Indebtedness	Special condition AA10	Amended SLC 47 and Special condition 5

4.8 These proposals are set out in Appendix B.

4.9 In addition and in the light of the modifications proposed, it will be necessary to issue a number of consents to NGC and/or Transco. In general these consents are being issued because:

- ◆ as a result of changes to the licence to update the financial ringfence, a consent will be required to enable Transco to continue to run its businesses in the way that it did prior to the merger; or

- ◆ as a result of the merger, the companies - NGC and Transco – will want to operate their businesses in different ways, for example, by sharing certain functions between the licensees.

4.10 In some cases the consents would have been required during the ordinary course of business for NGC or Transco even if the merger had not taken place. For the sake of completeness all these consents are described below.

4.11 The following consents are being prepared and will be issued by Ofgem at the time the licence modifications described above are made.

Licence condition	Description and reason for consents
Transco - Special Condition 2 (Restriction on activity and financial ringfencing)	<p>The condition prevents the licensee from holding shares of certain kinds without the written consent of the Authority.</p> <p>The consent will allow Transco to retain its shareholding in C4Gas - a joint venture with Gaz de France International and Fluxys SA which aims to reduce the cost of purchasing supplies through co-operative sourcing of products.</p>
Transco - Amended SLC 29 (Disposal of assets) and NGC - SLC 10 (Disposal of relevant assets)	<p>The conditions require the licensee to obtain consent from the Authority to any arrangements whereby operational control of relevant assets (NGC) or transportation assets (Transco) ceases to be under the sole management of the licensee.</p> <p>The consent will allow NGC and Transco to relinquish operational control of their respective systems to an affiliate in the NGT group on certain conditions. A similar consent was issued to all distribution network operators and the Scottish transmission licensees on 27 September 2001. The conditions require, inter alia, that NGT shall undertake to each of NGC and Transco that it will ensure that the affiliate (which could be NGC or Transco for these purposes) performs its obligations to NGC or Transco, as the case may be, under these arrangements.</p>

<p>Transco - Special Condition 2 (Restriction on activity and financial ringfencing) and NGC - Special Condition AA6 (Restriction on activity and financial ringfencing)</p>	<p>The conditions require the licensee to obtain the consent of the Authority to any business or activity it undertakes other than for a purpose of its own licensed business, to the extent that the turnover and investment associated with such business or activity exceeds prescribed limits.</p> <p>The consents will allow each of NGC and Transco to perform services for each other and for other affiliates, and will stipulate that these services shall not count against the prescribed limits.</p>
<p>Transco - Special Condition 5 (Cross-default obligations) and Amended SLC 47 (Indebtedness) and NGC - Special Condition AA10 (Indebtedness)</p>	<p>As now to be modified (in the case of Transco), the conditions require the licensee to obtain the consent of the Authority to any arrangements to which the licensee is, or becomes, a party whereby it guarantees the obligations of any other person (with certain exceptions) or its liability to make any payment arises or is increased or accelerated by the default of a third party.</p> <p>The consents will allow:</p> <ul style="list-style-type: none"> (a) each of Transco and NGC to be or become a party to arrangements relating to interests in land transferred to a third party under which the licensee remains liable to perform certain obligations in the event the transferee defaults in the performance of those obligations; (b) subject to being appropriately indemnified, Transco to remain party to certain guarantees and other contingent commitments entered into by it prior to the 'Relevant Date' as defined in Transco's licence to the extent these remain unperformed. These arrangements relate in the main to the former upstream and international downstream gas operations of the former British Gas plc (now carried on by BG International plc). The consent will require Transco to continue to use its reasonable endeavours to obtain release from these commitments; and (c) each of Transco and NGC to be or become party to arrangements whereby they are contingently liable to customers for the default of their sub-contractors.

5. Other issues

Managerial focus

- 5.1 It has been suggested that international expansion by the combined group might raise concerns regarding the extent to which managerial resources are diverted away from the regulated businesses, in particular to the US business. In its July 2002 initial proposals, Ofgem did not consider that it was necessary to introduce specific obligations on NGC and Transco in order to secure that sufficient management resource was devoted to the GB regulated businesses.
- 5.2 Ofgem recognised the importance of the GB regulated businesses to NGT both in terms of the revenue that they provide and in terms of reputation. Ofgem considered that there would be sufficient incentives (particularly given Ofgem's increased focus on incentive based price regulation) on NGT to run the GB regulated businesses effectively. In addition, Ofgem considered that the regulatory framework for NGC and Transco in its present form was sufficient. At this stage it was therefore proposed not to place any additional obligations on NGC or Transco with respect to the managerial resources of the GB regulated businesses.

Respondents' views

- 5.3 Most of those who responded considered that the existing framework was sufficient and that additional measures were not required. One respondent suggested that managerial focus could become more of an issue in the future if the proportion of revenues derived from the regulated GB businesses decreased.

Ofgem's final proposal

- 5.4 It remains Ofgem's intention at this stage not to place any additional obligations on NGC or Transco with respect to the managerial resources of the GB regulated businesses.

TO price controls

- 5.5 In July 2002, Ofgem stated that it did not intend, as a result of the merger, to open the transmission operator (TO) price controls before they end in 2006 for NGC and 2007 for Transco²⁴.

Respondents' views

- 5.6 Two respondents commented that Ofgem should open the TO price controls for NGC and Transco straight away in order to deliver the large efficiency savings that are expected to result from the merger to customers as soon as possible. In addition, one respondent commented that to do otherwise would be inconsistent with Ofgem's stated policy in relation to mergers in the electricity distribution sector.

Ofgem's final proposals

- 5.7 Ofgem does not consider that it is necessary to open the NGC and Transco TO price controls before they expire in 2006 for NGC and 2007 for Transco²⁵. The efficiency savings that result from the merger will be considered and passed back to customers at the time of the next periodic reviews, along with general efficiency savings.
- 5.8 In accordance with Ofgem's policy statement on mergers in the distribution sector²⁶, where a merger in the electricity distribution sector results in the loss of a comparator, Ofgem will seek immediate compensation for customers for the detriment associated with the loss of that comparator. This approach is appropriate for electricity distribution due to the extensive use that is made of comparative information in setting the electricity distribution price controls. In electricity distribution price controls, comparative analysis is used in helping to determine operating expenditure and capital expenditure and on quality of supply issues. The only comparative analysis between NGC and Transco at the last price control reviews was undertaken to assist Ofgem in determining the cost of capital. It is Ofgem's view that the very limited use of NGC and Transco

²⁴ See paragraphs 1.9 and 1.10.

²⁵ See paragraphs 1.9 and 1.10.

²⁶ 'Mergers in the electricity distribution sector: a policy statement' Ofgem May 2002.

as comparators for each other means that it would not be appropriate to seek compensation for customers for any detriment associated with the loss of a comparator in this instance.

- 5.9 As such this approach is consistent with Ofgem's approach in the electricity distribution sector where efficiency savings (which are distinct from the payment discussed at paragraph 5.8) are delivered to customers at the next periodic review.

6. Next Steps

- 6.1 In the light of its decisions in the earlier chapter, Ofgem is now initiating the Statutory licence modification procedures set out in Section 11 and 11A of the Electricity Act and Section 23 of the Gas Act by publishing on its website the notices, copies of which are set out in Appendix D. Responses to the notices and to this document are required to be received by Ofgem by 21 October 2002.

- 6.2 Ofgem will consider any representations or objections received. If no objection is made to the modification proposed under Section 11A of the Electricity Act, and subject to considering any representations, Ofgem would expect to make that modification. In the light of responses to the other proposed modifications and its principal objective and general duties, Ofgem will then decide whether it should make them and will publish its reasons for its decision. As noted in paragraph 1.10, Ofgem will not be able to make the proposed modifications to special condition 26 of Transco's licence if that condition has not been introduced at that time.

Appendix A – July 2002 responses

Non-confidential responses were received from:

British Energy

British Gas Trading

Coalpro

Corus

Dynegy

London Electricity Group

NGC/Lattice

Scottish and Southern Energy

TXU Energy

Appendix B - Modification proposals

This Appendix sets out Ofgem's modification proposals in respect of NGC's electricity transmission licence and Transco's gas transporter licence in the following manner:

- ◆ Part 1 contains a schedule detailing Ofgem's proposals to modify NGC's electricity transmission licence;
- ◆ Part 2 contains red-line and strike-out text of some of those proposals (as explained in the Part 1 schedule);
- ◆ Part 3 contains a schedule detailing Ofgem's proposals to modify Transco's gas transporter licence; and
- ◆ Part 4 contains red-line and strike-out text for some of those proposals (as explained in the Part 3 schedule).

PART 1

Proposed Licence modifications to the transmission licence of the National Grid Company plc

Special Condition No.	Modification	Effect	Reason
AA2	In paragraph 3, for “paragraph 3” substitute “paragraph 2”	Ensures reference to the relevant paragraph	To correct a typographical error
AA3	In paragraph 1, insert before “the licensee shall not”, the words “Except with the written consent of the Authority.”	This will enable the Authority to consent to derogations from the prohibited activities.	To allow the Authority to permit activities which it does not consider prejudice the purpose of the condition and to align it with standard condition C2.
AA5C	In paragraph 6(b) for “Authority” substitute “a director”	Ensures appropriate person acts	To correct a typographical error.
AA6	Modifications are shown by underlining and strike out on the copy of the condition, in Part 2.	Provides that activities for which the Authority grants consent may be excluded from the de-minimis business and adjusts the calculation of the value of an investment for de-minimis purposes.	This will enable the Authority, in appropriate cases to permit activities which would otherwise exceed the de-minimis limit. It also aligns, with adjustments, the calculation of the value of investments to the existing concept applicable to Transco plc.

AA7	Modifications are shown by underlining and strike out on the copy of the condition, in Part 2.	To clarify the obligation on the licensee on availability of resources. To ensure that references are to the correct person to exercise certain functions and correct grammar.	To clarify the nature of the obligation. To correct typographical errors.
AA10	Insertion of a definition of "investment grade issuer credit rating"	To include the definition of the term used in the condition.	To facilitate understanding of the condition if read alone.
AA12	Addition of a new condition, copy in Part 2.	To impose a prohibition on the availability of information from EnMo Limited to other companies within the National Grid Transco plc group except in specified circumstances.	To prevent the transfer of information from EnMo Limited to The National Grid Company plc or Transco plc (except as expressly allowed) to avoid discrimination or market distortion.

PART 2

Special Condition AA6: Restriction on Activity and Financial Ringfencing

1. Save as provided by paragraphs 3 and 4, the licensee shall not conduct any business or carry out any activity other than the transmission business and the interconnector (s) business.

2. The licensee shall not without the prior written consent of the Authority hold or acquire shares or other investments of any kind except:
 - (a) shares or other investments in a body corporate the sole activity of which is to carry on business for a permitted purpose; or

 - (b) shares or other investments in a body corporate which is a subsidiary of the licensee and is incorporated by it solely for the purpose of raising finance for the transmission business or the interconnector(s) business; or

 - (c) investments acquired in the usual and ordinary course of the licensee's treasury management operations, subject to the licensee maintaining in force, in relation to those operations, a system of internal controls which complies with best corporate governance practice as required (or in the absence of any such requirement recommended) from time to time for listed companies in the United Kingdom.

3. Subject to the provisions of paragraph 2, nothing in this special condition shall prevent:

- (a) any affiliate in which the licensee does not hold shares or other investments from conducting any business or carrying on any activity;
- (b) the licensee from holding shares as, or performing the supervisory or management functions of, an investor in respect of any body corporate in which it holds an interest consistent with the provisions of this licence;
- (c) the licensee from performing the supervisory or management functions of a holding company in respect of any subsidiary; or
- (d) the licensee from carrying on any business or conducting any activity to which the Authority has given its consent in writing.

4. Nothing in this special condition shall prevent the licensee or an affiliate or related undertaking in which the licensee holds shares or other investments (a "relevant associate") conducting de-minimis business as defined in this paragraph so long as the limitations specified in this paragraph are complied with:

- (a) For the purpose of this paragraph "de-minimis business" means any business or activity carried on by the licensee or relevant associates other than:

(i) the transmission business and the interconnector(s) business; and

(ii) any other business activity to which the Authority has given its consent in writing under paragraph 3(d).

- (b) The licensee or a relevant associate may carry on de-minimis business provided that the relevant associate carries on no other business except the activities of the transmission business and interconnector(s) business and business activities authorised by the Authority under paragraph 3(d), and neither of the following limitations is exceeded, namely:
- (i) the aggregate turnover of all the de-minimis business carried on by the licensee and all its relevant associates does not in any period of twelve months commencing on 1 April of any year exceed 2 $\frac{1}{2}$ % of the aggregate turnover of the transmission business and the interconnector(s) business as shown by the most recent audited accounting statements of the licensee produced under paragraphs 3(b)(i) and (c) of standard condition 5; and
 - (ii) the aggregate amount (determined in accordance with subparagraph (d) below) of all investments made by the licensee and all its relevant associates in their de-minimis business or de-minimis businesses does not at any time after 31 March 2001 exceed 2 $\frac{1}{2}$ % of the sum of share capital in issue, share premium and consolidated reserves of the licensee as shown by its most recent audited historical cost financial statements then available.
- (c) For the purpose of subparagraph (b) of this paragraph, "investment" means any form of financial support or assistance given by or on behalf of the licensee or a relevant associate for the de-minimis business whether on a temporary or permanent basis including (without limiting the generality of the foregoing) any commitment to provide any such support or assistance in the future.

- (d) At any relevant time, the amount of an investment shall be the sum of:
- (i) the value at which such investment was included in the audited historical cost balance sheet of the licensee or a relevant associate as at its latest accounting reference date to have occurred prior to 31 March 2001 (or, where the investment was not so included, zero);
 - (ii) the aggregate gross amount of all expenditure (whether of a capital or revenue nature) howsoever incurred by the licensee or a relevant associate in respect of such investment in all completed accounting reference periods since such accounting reference date; ~~and~~
 - (iii) all commitments and liabilities (whether actual or contingent) of the licensee or a relevant associate relating to such investments outstanding at the end of the most recently completed accounting reference period;

less the sum of:

the aggregate gross amount of all income (whether of a capital or revenue nature) howsoever received by the licensee in respect of such investment in all completed accounting reference periods since such accounting reference date.

Special Condition AA7: Availability of Resources

1. The licensee shall at all times act in a manner calculated to secure that it has available to it all such resources, including (without limitation) management and financial resources, personnel, fixed and moveable assets, rights, licences, consents and facilities on such terms and with all such rights as shall ensure that it is at all times able: ~~sufficient management resources, financial resources and financial facilities to enable it:~~
 - (a) to properly and efficiently carry on the transmission business and the interconnector(s) business; and
 - (b) to comply in all respects with its obligations under this licence and such ~~of its~~ obligations under the Act as apply to the transmission business and the interconnector(s) business including, without limitation, its duty to develop and maintain an efficient, co-ordinated and economical system of electricity transmission.
2. The licensee shall submit a certificate to the Authority, approved by a resolution of the board of director~~s~~ of the licensee and signed by a ~~Authority director~~ of the licensee pursuant to that resolution. Such certificate shall be submitted in June of each year. Each certificate shall be in one of the following forms:
 - (a) "After making enquiries, the director~~s~~ of the licensee have a reasonable expectation that the licensee will have available to it, after taking into account in particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid, sufficient financial resources and financial facilities to enable the licensee to carry on the transmission business and the interconnector(s) business for a period of 12 months from the date of this certificate."
 - (b) "After making enquiries, the director~~s~~ of the licensee have a reasonable expectation, subject to what is said below, that the licensee will have available to it, after taking into account in particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid, sufficient financial resources and

financial facilities to enable the licensee to carry on the transmission business and the interconnector(s) business for a period of twelve months from that date of this certificate. However, they would like to draw attention to the following factors which may cast doubt on the ability of the licensee to carry on the transmission business and/or the interconnector(s) business.”

(c) “In the opinion of the director’s of the licensee, the licensee will not have available to it sufficient financial resources and financial facilities to enable the licensee to carry on the transmission business and the interconnector(s) business for a period of 12 months from the date of this certificate.”

3. The licensee shall submit to the Authority with that certificate a statement of the main factors which the director’s of the licensee have taken into account in giving that certificate.
4. The licensee shall inform the Authority in writing immediately if the ~~director’s~~ directors of the licensee become aware of any circumstance which causes them no longer to have the reasonable expectation expressed in the then most recent certificate given under paragraph 2.
5. The licensee shall use its best endeavours to obtain and submit to the Authority with each certificate provided for in paragraph 2 a report prepared by its auditors and addressed to the Authority stating whether or not the auditors are aware of any inconsistencies between, on the one hand, that certificate and the statement submitted with it and, on the other hand, any information which they obtained during their audit work.
6. The director’s of the licensee shall not declare or recommend a dividend, nor shall the licensee make any other form of distribution within the meaning of section 263 of the Companies Act 1985, unless prior to the declaration,

recommendation or making of the distribution (as the case may be) the licensee shall have issued to the Authority a certificate complying with the following requirements of this paragraph.

(a) The certificate shall be in the following form:

“After making enquiries, the director^s of the licensee are satisfied:

(i) that the licensee is in compliance in all material respects with all obligations imposed on it by special condition AA11 (Provision of Information to the Authority), special condition AA6 (Restriction on Activity and Financial Ring-fencing), special condition AA7 (Availability of Resources), special condition AA8 (Undertaking from ultimate controller), special condition AA9 (Credit Rating) and paragraph 1 of special condition AA10 (Indebtedness) of the licence; and

(ii) that the making of a distribution of [] on [] will not, either alone or when taken together with other circumstances reasonably foreseeable at the date of this certificate, cause the licensee to be in breach to a material extent of any of these obligations in the future.”

(b) The certificate shall be signed by a director^{Authority} of the licensee and approved by a resolution of the board of director^s of the licensee passed not more than 14 days before the date on which the declaration, recommendation or payment will be made.

(c) Where the certificate has been issued in respect of the declaration or recommendation of a dividend, the licensee shall be under no obligation to issue a further certificate prior to payment of that dividend provided such payment is made within six months of that certificate.

Draft Special Condition [AA12]: Restriction on Use of Information deriving from the EnMo Business

- 1 The licensee shall procure that each ultimate holding company of the licensee which is also an ultimate holding company of EnMo (a "relevant ultimate holding company") shall give an undertaking in the form described in paragraph 5.
- 2 Without prejudice to the licensee's obligation under paragraph 1, any breach of the undertaking given pursuant to paragraph 1 shall be a breach by the licensee of the licence.
- 3 Any information, held by EnMo or any subsidiary or holding company of EnMo, or by any employee, agent, adviser, consultant, contractor, director or officer of EnMo or of any subsidiary or holding company of EnMo (each such legal or natural person being called an "Enmo source"), relating to volumes or prices of gas, electricity and related products or services, traded or to be traded in the course of EnMo business or relating to any of the parties to any such trade in relation thereto shall be confidential information ("EnMo confidential information").
- 4 Notwithstanding paragraph 3, the following information shall not fall within the definition of EnMo confidential information for the purpose of this special condition:-
 - (i) information which is in the public domain, other than through breach of the undertaking given pursuant to paragraph 1;
 - (ii) information solely in relation to trades by or on behalf of the licensee through the EnMo business (to the extent the same is properly disclosed to the licensee in the ordinary course of the EnMo business in compliance with all applicable laws, regulations and contracts);

- (iii) information which is disclosed in accordance with the terms of any consent given by the Authority or by the person entitled to disclose it; or
 - (iv) information which EnMo is contractually obliged to provide to Transco plc pursuant to the Network Code or a contract entitled "Within Day Gas Market: Market Operator Appointment Contract dated 1 September 1999".
- 5 The licensee shall procure from each relevant ultimate holding company a legally enforceable undertaking in favour of the licensee that the relevant ultimate holding company shall use its best endeavours to ensure that no EnMo confidential information shall be disclosed to or otherwise howsoever come into the possession of the licensee whether directly or indirectly from an EnMo source. Such undertaking shall be obtained from each relevant ultimate holding company within seven (7) days of that company becoming a relevant ultimate holding company and shall remain in force so long as it remains a relevant ultimate holding company.
- 6 The licensee shall:
 - (a) deliver to the Authority evidence (including a copy of the undertaking) that the licensee has complied with the obligation to procure the undertaking pursuant to this special condition;
 - (b) inform the Authority immediately in writing if the directors of the licensee become aware that any such undertaking has ceased to be legally enforceable or that its terms have been breached or that there has been a change in identity of a relevant ultimate holding company; and
 - (c) comply with any direction from the Authority to enforce any such undertaking.
- 7 In the event that any EnMo confidential information comes into the possession of the licensee, the licensee shall ensure that such information shall be treated as confidential, and shall not be used in any respect for the purpose of or in connection with the management or operation of its transmission business.
- 8 In this special condition:

“EnMo”	means EnMo Limited, a company incorporated in England and Wales under the Companies Act 1985 (registered number 3751681) and having its registered office at 15 Marylebone Road, London, NW1 5JD.
“EnMo business”	means any business carried on by EnMo including, without limitation, the operation of the On-the-Day Commodity Market in gas operated by EnMo.
“information”	shall include, without limitation, any documents, accounts, estimates, returns, records or reports and data in written, verbal or electronic format and information in any form or medium whatsoever.
“Network Code”	has the meaning given in standard condition 1 of the gas transporter licence held by Transco plc.
“ultimate holding company”	shall mean any company or body corporate which is a holding company and is not itself a subsidiary of another company or body corporate.

PART 3

Proposed Licence Modifications to the Gas Transporter Licence of Transco plc

Special Condition No.	Modification	Effect	Reason
Amended standard condition 1	<p>Delete definition of Ultimate Holding Company.</p> <p>Amend definition of “covenantor” by substituting the words “ultimate controller” (already used in the standard condition) for “Ultimate Holding Company”.</p>	<p>The definition ceases to apply.</p> <p>To make correct the title of the condition referred to.</p>	<p>To align with the transmission licence of The National Grid Company plc, this term is replaced throughout the licence by “ultimate controller” and is therefore no longer required.</p>

Amended standard condition 24	Modifications are shown by underlining and strike out on the attached copy of the condition.	To align the terms of paragraph 2 to the equivalent paragraph in special condition AA11 of the transmission licence of the National Grid Company plc and to change references to Ultimate Holding Company to ultimate controller.	To enable a common obligation to apply in relation to the provision of information by the two licensees in the National Grid Transco plc group.
Amended standard condition 29	Modification to insert definition of "relinquishment of operational control" in the same terms as in electricity transmission licence standard condition 10.	To align the provisions of this licence condition to the equivalent obligation on The National Grid Company plc.	To enable a common concept of the defined term to apply to each of the two licensees in the National Grid Transco plc group.
Amended standard condition 30	Amend the term "Ultimate Holding Company" to revert to the phrase "ultimate controller" already in the standard condition wherever it appears.	To enable the appropriate defined term to be used throughout the condition.	This is consequential to the modification made to amended standard condition 1.
Standard condition 41	For "ensure" substitute "procure".	To align the obligation with that in standard condition 12 of the transmission licence of The National Grid Company plc.	To enable the cross subsidy prohibition to be the same for each of the two licensees in the National Grid Transco plc group.

Amended standard condition 45	Amend the term "Ultimate Holding Company" to revert to the phrase "ultimate controller" already in the standard condition wherever it appears.	To enable the appropriate defined term to be used throughout the condition.	This is consequential to the modification made to amended standard condition 1.
Amended standard condition 47	Modifications are shown by underlining and strike out on the attached copy of the condition, in Part 4.	To align the provisions of this condition to those in special condition AA10 of the transmission licence of the National Grid Company plc.	To enable a common obligation to apply in respect of the two licensees in the National Grid Transco plc group, subject only to necessary savings relating to the establishment of Transco plc.
Special condition 2	Modifications are shown by underlining and strike out on the attached copy of the condition, in Part 4.	To align the provisions of this condition to those in special condition AA10 of the transmission licence of The National Grid Company plc	To enable a common obligation to apply in respect of the two licensees in the National Grid Transco plc group, subject only to necessary savings relating to the establishment of Transco plc.
Special condition 3	Modifications are shown by underlining and strike out on the copy of the condition, in Part 4.	To align the provisions of this condition to those in special condition AA6 of the transmission licence of The National Grid Company plc	To enable a common obligation to apply in respect of the two licensees in the National Grid Transco plc group, subject only to necessary differences to reflect the different activities and statutory duties.

Special condition 4	Modification to make the definition in paragraph 2 apply to amended standard condition 47 and special condition 5 and omit the words “as issuer of any corporate to debt” in paragraph 1.	To apply the definition where it is used elsewhere in the licence, and omit wording which is no longer required.	To enable a common term to be used where applicable in other conditions.
Special condition 5	Modifications are shown by underlining and strike out on the copy of the condition in Part 4.	To apply the definition in paragraph where it is used elsewhere in the licence; to adjust the definition of permitted purpose and to remove the proviso in the definition.	To enable a common term to be used where applicable in other conditions. To clarify that only certain permitted purposes apply. To remove the express proviso, so that, as appropriate, it can be addressed by a consent by the Authority.
Special condition x (new)	Addition of a new condition (copy in Part 4) (to be inserted after the last special condition at the time the modification is made.	To impose a prohibition on the availability of information from EnMo Limited to other companies within the National Grid Transco plc group except in specified circumstances.	To prevent the transfer of information from EnMo Limited to The National Grid Company plc or Transco plc (except as expressly allowed) to avoid discrimination or market distortion.

<p>Special Condition 26</p>	<p>This condition has been the subject of a notice under section 23 of the Gas Act 1986. If the licence is modified to include it, paragraphs 1 and 2 shall be modified as shown in Part 4.</p>	<p>The effect is to extend the proposed prohibition to apply to related undertakings and to allow the Authority to consent to prohibited activities.</p>	<p>To extend the proposed prohibition so as to apply to the whole group of companies, and to enable the Authority in appropriate cases to allow a prohibited activity. Each amendment will align the principle of the condition with the prohibited activities conditions in transmission licence of The National Grid Company plc.</p>
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PART 4

AMENDMENT TO STANDARD CONDITION 24:

For standard condition 24 there is substituted the following condition (the additions to the existing standard condition are shown emboldened and italicised).

“Condition 24: Provision of Information to the Authority

1. Subject to paragraphs 5 and 7, the licensee shall furnish the Authority, in such manner and at such times as the Authority may reasonably require, such information and shall procure and furnish to it such reports, as the Authority may reasonably require or as may be necessary for the purpose of performing -
 - (a) the functions conferred on the Authority by or under the Act; and
 - (b) any functions transferred to or conferred on the Authority by or under the Utilities Act 2000.

2. The licensee shall procure from each company or other person which the licensee knows or reasonably should know is at any time an ~~and every~~ Ultimate-ultimate controller of the licensee a legally enforceable undertaking in favour of the licensee in a form specified by the Authority that that ultimate controller (“the information covenantor”) will give to the licensee, and will procure that any person (including, without limitation, a corporate body) which is a subsidiary of, or is controlled by, the information covenantor (other than the licensee and its subsidiaries) will give the licensee, all such information as may be necessary to enable the licensee to comply fully with the obligation imposed on it in paragraph 1. Such undertaking shall be obtained within 7 days of such corporate body or other person in question becoming an ultimate controller of the licensee and shall remain in force for so long as the licensee remains the holder of this licence and the information covenantor remains an ultimate controller of the licensee. ~~each subsidiary of that information covenantor (other than the licensee and its subsidiaries) will give to the licensee, all such information as may be necessary to enable the licensee to meet its obligation under the Act and under the licence to produce documents and furnish information to the Authority.~~

3. The licensee shall deliver to the Authority evidence (including a copy of each such undertaking) that the licensee has complied with the obligation to procure undertakings pursuant to paragraph 2, and shall comply with any direction from the Authority to enforce any undertaking so procured.
4. The licensee shall not, save with the consent in writing of the Authority, enter (directly or indirectly) into any agreement or arrangement with any ~~Ultimate Holding Company~~Ultimate Controller of the licensee or, where the ~~Ultimate Holding Company~~Ultimate Controller is a corporate body, ~~or~~ any of the subsidiaries of such a corporate ~~Ultimate Holding Company~~Ultimate Controller (other than the subsidiaries of the licensee) at a time when:
 - (a) an undertaking complying with paragraph 2 is not in place in relation to that ~~Ultimate Holding Company~~Ultimate Controller; or
 - (b) there is an unremedied breach of such undertaking; or
 - (c) the licensee is in breach of the terms of any direction issued by the Authority under paragraph 3 of this condition.
5. The licensee shall not be required by the Authority to furnish it under this condition with information for the purpose of the exercise of its functions under section 34 of the Act.
6. The licensee shall, if so requested by the Authority, give reasoned comments on the accuracy and text of any information or advice (so far as relating to its activities as holder of a gas transportation licence) which the Authority proposes to publish pursuant to section 35 of the Act.
7. This condition shall not require the licensee to produce any documents or give any information which it could not be compelled to produce or give in evidence in civil proceedings before a court.
8. The power of the Authority to call for information under this condition is in addition to the power of the Authority to call for information under or pursuant to any other condition. There shall be a presumption that the provision of information in accordance with any other condition is sufficient for the purposes of that condition, but that presumption shall be rebutted, if the Authority states in writing that in its opinion such further information is,

or is likely to be, necessary to enable it to exercise functions under the condition in question.

9. In this condition "transportation business" includes –
- (a) *LNG storage arrangements; and*
 - (b) *the provision of Metering Services and of Meter Reading Services.*
10. If the Authority, having regard, in particular, to any representations made to it by the licensee and other persons as to the extent to which there is competition in relation to the storage of gas in *LNG Storage Facilities* and its view on that question, considers it appropriate that *this condition* should be modified by the omission of sub-paragraph (i) of paragraph 9, then the sub-paragraph shall be omitted with effect from a date specified in a notice published by the Authority for *that purpose*; and the reference thereto in the definition of "transportation business" in standard condition 1 (Definitions and Interpretation) shall cease to have effect.
- 11 *If the Authority, having regard, in particular, to any representations made to it by the licensee and other persons as to the extent to which there is competition in relation to either metering or meter reading and its view on that question, considers it appropriate that references to either the provision of Metering Services or of Meter Reading Services should be deleted for the purposes of paragraph 9 of this condition, those references shall cease to have effect from the date or dates specified in a notice published by the Authority for that purpose."*

AMENDMENT TO STANDARD CONDITION 47:

For standard condition 47 there is substituted the following condition (the additions to the existing standard condition are shown emboldened and italicised).

"Condition 47. Indebtedness

1. In addition to the requirements of standard condition 29 (Disposal of Assets) *and Special Condition 5 (Cross-Default Obligations)*, *except where the Authority has consented prior to the Relevant Date (as defined in Special Condition 1)*, the licensee shall not, without the prior written consent of the Authority (following *full* disclosure *by the licensee* of all material facts), *after the Relevant Date* –

- (a) create or continue or permit to remain in effect any mortgage, charge, pledge, lien, or other form of security or encumbrance whatsoever, undertake any indebtedness to any other person or enter into any guarantee *any liability or any obligation of another person* otherwise than -
 - (i) on an arm's length basis;
 - (ii) on normal commercial terms;
 - (iii) for *purposes within sub-paragraphs (a), (b), (c), (d) or (f) of the definition of* permitted purpose; *or*
 - (iv) *for purposes within sub-paragraph (e) of the definition of permitted purpose and it is required to fulfil an obligation of the licensee contained in an agreement or arrangement entered into before the Relevant Date or arising from the exercise of pre-emption rights of the licensee arising from such an agreement or arrangement provided that any such commitment is made no later than 12 months from the relevant Date; (if the transaction is within the ambit of standard condition 29 (Disposal of Assets)) in accordance with that condition;*

- (b) transfer, lease, license or lend any sums, asset, right or benefit to any affiliate or related undertaking of the licensee otherwise than by way of:
- (i) a dividend or other distribution out of distributable reserves;
 - (ii) repayment of capital;
 - (iii) payment properly due for any goods, services or assets provided on an arm's length basis and on normal commercial terms;
 - (iv) transfer, lease, licence or loan of any sum or sums, asset, right or benefit on an arm's length basis and on normal commercial terms and made in compliance with the payment condition;
 - (v) repayment of or payment of ~~any~~ interest on a loan not prohibited by sub-paragraph (a);
 - (vi) payments for group corporation tax relief or for the surrender of Advance Corporation Tax calculated on a basis not exceeding the value of the benefit received;
 - (vii) ***a transfer for the purpose of satisfying paragraph 3A of Special Condition 2 (Restriction on Activity and Financial Ring-Fencing); or***
 - (viii) an acquisition of shares or other investments in conformity ~~[with the restriction on the acquisition of shares set out in the licence with paragraph 2 of special condition 2 (Restriction on Activity and Financial Ring-Fencing,]~~ made on an arm's length basis and on normal commercial terms.

(c) the payment condition referred to in sub-paragraph (b)(iv) is that the consideration due in respect of the transaction in question is paid in full when the transaction is entered into unless either:

- (i) the counter-party to the transaction has and maintains until payment is made in full an investment grade issuer credit rating; or
- (ii) the obligations of the counter-party to the transaction are fully and unconditionally guaranteed throughout the period during which any part of the consideration remains outstanding by a guarantor which has and maintains an investment grade issuer credit rating.

2. In this condition:

“indebtedness” means all liabilities now or hereafter due, owing or incurred, whether actual or contingent, whether solely or jointly with any other person and whether as principal or surety, together with any interest accruing thereon and all costs, charges, penalties and expenses incurred in connection therewith.”

Special Condition 2. Restriction on Activity and Financial Ring-Fencing

1. ~~Save as provided by~~ Subject to paragraphs 3, 3A, 4 and 5, ~~except with the written consent of the Authority,~~ the licensee shall not, ~~and shall procure that its subsidiary undertakings shall not,~~ conduct any business or carry on any activity other than the Transco Business.
2. The licensee shall not, without the written consent of the Authority, hold or acquire ~~or retain,~~ shares or other investments of any kind ~~in any affiliate after the Relevant Date~~ except:
 - (a) shares or other investments in ~~any~~ body corporate the sole activity of which is to carry on business for a ~~which is a subsidiary of the licensee with the function only of facilitating the financing of activities of the licensee or of its subsidiaries falling within sub-paragraphs (a) (b), (c) or (d) of the definition of~~ permitted purpose; or
 - (b) ~~shares or other investments in a body corporate which is a subsidiary of the licensee and incorporated by it solely for the purpose of raising finance for the~~ Transco Business
 - ~~(c)~~ shares acquired in a body corporate to which is transferred an activity that ceases, or is to cease, to be for a purpose within sub-paragraphs (a) (b), (c), (d) or (e) of the definition of permitted purpose; or
 - ~~(d)~~ investments acquired in the usual and ordinary course of the licensee's treasury management operations, subject to the licensee maintaining in force, in relation to those operations, a system of internal controls which complies with best corporate governance practice as required (or in absence of any such requirement recommended) from time to time for listed companies in the United Kingdom. ~~the shares in a body corporate which conducts business only for a purpose within sub-paragraph (a), (b), (c) or (d) of the definition of permitted purpose;~~
 - ~~(d)~~ ~~shares acquired in order to avoid dilution of a shareholding in a body corporate in which the licensee holds shares in conformity with the licence; or~~

~~(e) — shares in a body corporate which conducts business only for a permitted purpose within sub-paragraph (e) of the definition of permitted purpose where the acquisition of those shares is required to fulfil an obligation of the licensee contained in an agreement or arrangement entered into before the Relevant Date or arises from the exercise of pre-emption rights of the licensee arising from such an agreement or arrangement provided that such acquisition is made no later than 12 months from the Relevant Date.~~

3. Subject to the provisions of paragraph 2, nothing in this condition shall prevent:
- (a) any affiliate in which the licensee does not hold shares or other investments ~~related undertaking of the licensee (other than a subsidiary undertaking)~~ from conducting any business or carrying on any activity;
 - (b) the licensee from holding shares as, or performing the supervisory or management functions of, an investor in respect of any body corporate in which it holds an interest consistently with the provisions of this licence;
 - (c) the licensee from performing the supervisory or management functions of a holding company in respect of any subsidiary ~~in which it holds an interest consistently with the provisions of this licence;~~ or
 - (d) the licensee from carrying on any business or conducting any activity to which the Authority has given its consent in writing.
- 3A. The licensee shall use reasonable endeavours to cease to conduct or carry on any such business or activity prohibited by paragraph 1 which it was conducting or carrying on at the Relevant Date and shall submit to the Authority by 31 March in each calendar year a report setting out details of the endeavours it has made to cease to conduct or carry on such business or activity in the period of twelve months ending on the preceding 31 December, provided that for so long as the licensee is making such reasonable endeavours, it may continue to conduct any such business or carry on any such activity.

4. Nothing in this condition shall prevent the licensee or an affiliate or related undertaking~~any subsidiary~~ of the licensee in which the licensee holds shares or other investments (a 'relevant associate') conducting de-minimis business as defined in this paragraph so long as the limitations in this paragraph are complied with:

~~(a)~~For the purpose of this paragraph “de minimis business” means any business or activity carried on by the licensee ~~or any subsidiary of the licensee other than businesses or activities falling within sub-paragraph (a), (b), (c) or (e) of the definition of permitted purpose (in this paragraph “the de-minimis business”)-~~ or a relevant associate or relevant associates other than:

the businesses or activities falling within sub-paragraph (a), (b), (c) or (e) of the definition of permitted purpose~~distribution business~~; and

any other business activity to which the Authority has given its consent in writing in accordance with paragraph 3(d).

~~(b)~~The licensee or a relevant associate ~~or any subsidiary of the licensee~~ may carry on de-minimis business provided that the relevant associate carries on no other business except activities of the businesses or activities falling within sub-paragraph (a), (b), (c) or (e) of the definition of permitted purpose and activities authorised by the Authority under paragraph 3(d), and neither ~~none~~ of the following limitations is exceeded, namely

- (i) the aggregate turnover of all the de-minimis business carried on by the licensee and all its relevant associates does not in any period of twelve months commencing on 1 April of any year exceed ~~of the licensee does not in any period of twelve months commencing on 1 January of any year exceed~~ 2.5% of the aggregate turnover of the Transportation and LNG Storage Business, the Metering Business and the Meter Reading Business (excluding the turnover on transactions which each of those businesses make with each other) as shown by ~~the~~its most recent audited accounting statements of the licensee produced under paragraph 2(b)(i) and (c) of standard condition 30 (Regulatory Accounts);

(ii) the aggregate amount (determined in accordance with sub-paragraph (d) below) of all investments made by the licensee and all its relevant associates in their ~~or any of its subsidiaries in the~~ de-minimis business or de-minimis businesses does not at any time after the date ~~when~~ this condition takes effect in this licence exceed 2.5% of the sum of share capital in issue, share premium and consolidated reserves of the licensee as shown by its most recent audited historical cost ~~consolidated~~ financial statements then available; ~~and~~

~~(iii) — the business is conducted employing persons or assets first employed or acquired for a purpose within sub-paragraph (a), (b) and (c) of the definition of permitted purpose.~~

(c) For the purpose of sub-paragraph (b) of this paragraph,

“investment” means any form of financial support or assistance given by or on behalf of the licensee or a relevant associate ~~any of its subsidiaries~~ for the de-minimis business whether on a temporary or permanent basis including (without limiting the generality of the foregoing) any commitment to provide any such support or assistance in the future.

(d) At any relevant time, the amount of an investment shall be the sum of –

(i) the value at which such investment was included in the audited historical cost balance sheet of the licensee or a relevant associate as at ~~its~~ the latest accounting reference date to have occurred prior to the date this condition takes effect in this licence ~~1 January 2000~~ (or, where the investment was not so included, zero); ~~and~~

(ii) the aggregate gross amount of all expenditure (whether of a capital or revenue nature) howsoever incurred by the licensee or a relevant associate ~~any of its subsidiaries~~ in respect of such investment in all completed accounting reference periods since such accounting reference date; ~~and~~

(iii) all commitments and liabilities (whether actual or contingent, ~~contingent liabilities being estimated and disclosable in the manner provided in Financial Reporting Standard 12 as issued by the Accounting Standards Board (as the same may be amended or replaced to be consistent with prevailing UK GAAP)~~) of the licensee or a relevant associate ~~any of its subsidiaries~~ relating to such investment outstanding at the end

of the most recently completed accounting reference period,
and

~~(iv) — the amount of any dividends (if any) paid by that business or activity in all completed accounting reference periods since such reference date;~~

less the sum of the aggregate gross amount of all income (whether of a capital or revenue nature) howsoever received by the licensee in respect of such investment in all completed accounting reference periods since such accounting reference date.:

~~(iv) — the amount of turnover generated by that business or activity in all completed accounting reference periods since such accounting reference date; and~~

~~(vi) — the value of disposal proceeds on disposal of that business by the licensee or a subsidiary of the licensee other than to a subsidiary of the licensee~~

~~(e) — Any business or activity so designated by the Authority shall not be considered a de minimis business for the purpose of the limitations in this paragraph 4.~~

5. If the Authority, having regard, in particular, to any representations made to it by the licensee and other persons as to the extent to which there is competition in relation to the storage of gas in LNG Storage Facilities and its view on that question, considers it appropriate that this amended standard condition should be construed as if the definition of “the Transco Business” made no reference to the “LNG Storage Business” then for the purpose of this amended standard condition, the effect from the date specified in a notice published by the Authority for that purpose, the definition of “the Transco Business” shall be so construed and shall be treated as modified accordingly.

Special Condition 3. Availability of Resources

1. The licensee shall at all times act in a manner calculated to secure that it has available to it all such resources, including (without limitation) management and financial resources, personnel, fixed and moveable assets, rights, licenses, consents and facilities on such terms and with all such rights as shall ensure that it is at all times able: ~~sufficient management resources, financial resources and financial facilities to enable it—~~
 - (a) to properly and efficiently carry on the Transportation and LNG Storage Business; and

~~(b)~~(a) to comply in all respects with its obligations under this licence and such of its obligations under the Act as apply to those businesses including, without limitation, its duty to develop and maintain an efficient and economical system of gas transportation.

2. The licensee shall submit a certificate as to the adequacy (or otherwise) of its management resources and financial resources and facilities for the period of 12 months commencing on the date of the certificate addressed to the Authority, approved by a resolution of the board of directors of the licensee and signed by a director of the licensee pursuant to that resolution. Such certificate shall be submitted on 31 March of each year. Each certificate shall be in one of the following terms:
 - (a) “After making enquiries, the directors of the licensee have a reasonable expectation that the licensee will have available to it, after taking into account in particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid, sufficient management resources and financial resources and financial facilities to enable the licensee to carry on the activities authorised by the licence in accordance with its obligations under the Act and under the licence for a period of 12 months from the date of this certificate.”
 - (b) “After making enquiries, the directors of the licensee have a reasonable expectation, subject to the factors set out below, that the licensee will have available to it, after taking into account in particular (but without

limitation) any dividend or other distribution which might reasonably be expected to be declared or paid, sufficient management resources and financial resources and financial facilities to enable the licensee to carry on the activities authorised by the licence in accordance with its obligations under the Act and under the licence for a period of 12 months from the date of this certificate. However, they would like to draw attention to the following factors which may cast doubt on the ability of the licensee to carry on the activities authorised by the licence as aforesaid."

(c) "In the opinion of the directors of the licensee, the licensee will not have available to it sufficient management resources and financial resources and financial facilities to enable the licensee to carry on the activities authorised by the licence in accordance with its obligations under the Act and under the licence for a period of 12 months from the date of this certificate."

3. The licensee shall submit to the Authority with that certificate a statement of the main factors which the directors of the licensee have taken into account in giving that certificate.

4. The licensee shall -

~~(a) inform the Authority in writing immediately if the directors of the licensee become aware of any circumstance that causes them no longer to have the reasonable expectation expressed in the then most recent certificate given under paragraph 2;~~ ~~and~~

~~(b) subject to compliance with the listing rules (within the meaning of Part IV of the Financial Services Act 1986) of the Stock Exchange, publish its notification to the Authority in such form and manner as the Authority may direct.~~

5. Save in so far as they relate to management resources, the licensee shall use its best endeavours to obtain and submit to the Authority with each certificate provided for in paragraph 2 a report prepared by its auditors and addressed to the Authority stating whether or not the auditors are aware of any inconsistencies between, on the one hand, that certificate and the statement

submitted with it and, on the other hand, any information which they obtained during their audit work.

6. The directors of the licensee shall not declare or recommend a dividend, nor shall the licensee make any other form of distribution within the meaning of section 263 of the Companies Act 1985, unless prior to the declaration, recommendation or making of the distribution (as the case may be) the licensee shall have issued to the Authority a certificate complying with the following requirements of this paragraph.

(a) The certificate shall be in the following form:

“After making enquiries, the directors of the licensee are satisfied:

- (i) that the licensee is in compliance in all material respects with all obligations imposed on it by paragraphs (2), (3) and (4) of standard condition 24 (Provision of Information to the Authority), standard condition 45 (Undertaking from Ultimate Controller), and paragraph 1 of standard condition 47 (Indebtedness), Special Condition 2 (Restriction on Activity and Financial Ring-fencing), Special Condition 3 (Availability of Resources), Special Condition 4 (Credit Rating of Licensee), paragraph 1 of Special Condition 5 (Cross-Default Obligations) of the licence; and
- (ii) that the making of a distribution of [amount] on [date] will not, either alone or when taken together with other circumstances reasonably foreseeable at the date of this certificate, cause the licensee to be in breach to a material extent of any of these obligations in the future”.

(b) The certificate shall be signed by a director of the licensee and approved by a resolution of the board of directors of the licensee passed not more than 14 days before the date on which the declaration, recommendation or payment will be made.

(c) Where the certificate has been issued in respect of the declaration or recommendation of a dividend, the licensee shall be under no obligation to issue a further certificate prior to payment of that dividend.

~~7. To the extent that the licensee procures any of the matters referred to in paragraph 1 from any Ultimate Holding Company or any subsidiary undertaking~~

~~of such Ultimate Holding Company (other than subsidiaries of the licensee) the licensee shall ensure that the arrangements for procuring these matters do not involve an unjustified cross-subsidy from the Transco Business to any Ultimate Holding Company or to any subsidiary undertaking of such Ultimate Holding Company (other than the subsidiaries of the licensee).~~

- 78 If the Authority, having regard, in particular, to any representations made to it by the licensee and other persons as to the extent to which there is competition in relation to the storage of gas in LNG Storage Facilities and its view on that question, considers it appropriate that this amended standard condition should be construed as if the definition of “the Transco Business” made no reference to the “LNG Storage Business” then for the purpose of this amended standard condition, with effect from the date specified in a notice published by the Authority for that purpose, the definition of “the Transco Business” shall be so construed and shall be treated as modified accordingly.

Special Condition 5. Cross-Default Obligations

1. In addition to the requirements of standard condition 29 (Disposal of Assets) and amended standard condition 47 (Indebtedness) ~~as amended~~, except where the Authority has consented prior to the Relevant Date, the licensee shall not, without the prior written consent of the Authority (following full disclosure by the licensee of all material facts), after the Relevant Date –
 - (a) enter into an agreement or incur a commitment arrangement incorporating a cross-default obligation, or
 - (b) continue or permit to remain in effect any agreement or arrangement incorporating a cross-default obligation subsisting on the Relevant Date save that the licensee may permit any cross-default obligation in existence at that date may remain in effect for so long as and provided that:
 - (i) the cross-default obligation is solely referable to
 - (aa) an instrument relating to the provision of a loan or other financial facilities granted, or
 - (bb) an arrangement or agreement entered into prior to that date and the terms on which that loan or those facilities have been made available or of that agreement or arrangement as subsisting on that date are not materially varied to the detriment of the licensee or otherwise made more onerous or where there is a material change in terms, such change is outside the licensee's effective control;
 - (ii) the licensee shall no later than three months from the Relevant Date procure that ~~a~~-affiliate of the licensee shall indemnify the licensee in respect of its liabilities and potential liabilities under the cross-default obligation on terms approved in writing by the Authority which terms shall include an obligation that the person granting the indemnity shall maintain, at all relevant times, an investment grade credit rating; and
 - (iii) the licensee shall enforce the terms of the indemnity if so directed in writing by the Authority.

~~(e)~~(b) the provisions of sub-paragraph (a) and (b) shall not prevent the licensee from giving any guarantee permitted by and compliant with the requirements of amended standard condition 47 (Indebtedness)~~as amended~~.

(d) this sub-paragraph applies where the licensee, with the consent of the Authority ___ pursuant to this paragraph, enters into any agreement or arrangement incorporating a cross-default obligation. In those circumstances, unless the Authority otherwise consents, the licensee shall:

- (i) procure that ~~a~~-affiliate of the licensee shall indemnify the licensee in respect of its liabilities and potential liabilities under the cross-default obligation on terms approved in writing by the Authority;
- (ii) procure that the terms of that indemnity shall include an obligation that the person granting the indemnity shall maintain, at all relevant times, an investment grade credit rating; and
- (iii) enforce the terms of the indemnity if so directed in writing by the Authority.

1.2. In this condition:

“cross-default obligation” means a term of any agreement or arrangement whereby the licensee’s liability to –

- (i) pay or repay any debt or other sum, or
- (ii) to do any thing pursuant to a term of any agreement or arrangement to which the licensee is a party

arises or is increased or accelerated or is capable of arising, increasing or of acceleration by reason of a default (howsoever such default may be described or defined) by any person other than the licensee, unless:

- (i) that liability can arise only as the result of a default by a subsidiary of the licensee, and
- (ii) the licensee holds a majority of the voting rights in that subsidiary and has the right

to appoint or remove a majority of its board of directors, and

- (iii) that subsidiary carries on business only for a purpose within paragraphs (a), (b) (c) and (d) of the definition of permitted purpose.

~~provided that a liability on the part of the licensee arising from a breach of covenant on the part of any successor in title to the licensee in relation to any interest in land in respect of which no affiliate of the licensee other than a subsidiary of the licensee has received or may receive any profit on its disposal shall not be regarded as a cross-default obligation.~~

Proposed Special Condition 26: Prohibited Procurement Activities

1. Except with the written consent of the Authority, the licensee shall not and shall procure that any affiliate or related undertaking of the licensee shall not, on its own account (or that of the licensee or of any affiliate or related undertaking of the licensee as the case may be), purchase, enter into or otherwise acquire transportation commodities, gas or gas derivatives with the intention of subsequently selling, assigning or otherwise disposing of such assets to third parties.

2. The prohibition in paragraph 1 of this Special Condition shall not apply to the purchase, entering into or acquisition by the licensee or any affiliate or related undertaking on the account of the licensee of transportation commodities, gas or gas derivatives with the intention of selling, assigning or otherwise disposing of such transportation commodities, gas or gas derivatives for the purpose of facilitating balancing management and constraint management so long as such transactions:
 - (a) are conducted on economic and efficient term; and

 - (b) facilitate the economic and efficient operation of the transportation system.

[paragraph 3 is unchanged]

Draft Special Condition [X]: Restriction on Use of Information deriving from the EnMo Business

- 1 The licensee shall procure that each ultimate holding company of the licensee which is also an ultimate holding company of EnMo (a "relevant ultimate holding company") shall give an undertaking in the form described in paragraph 5.
- 2 Without prejudice to the licensee's obligation under paragraph 1, any breach of the undertaking given pursuant to paragraph 1 shall be a breach by the licensee of the licence.
- 3 Any information, held by EnMo or any subsidiary or holding company of EnMo, or by any employee, agent, adviser, consultant, contractor, director or officer of EnMo or of any subsidiary or holding company of EnMo (each such legal or natural person being called "an EnMo source"), relating to volumes or prices of gas, electricity and related products or services, traded or to be traded in the course of EnMo business or relating to any of the parties to any such trade in relation thereto shall be confidential information ("EnMo confidential information").
- 4 Notwithstanding paragraph 3, the following information shall not fall within the definition of EnMo confidential information for the purpose of this special condition:-
 - (v) information which is in the public domain, other than through breach of the undertaking given pursuant to paragraph 1;
 - (vi) information solely in relation to trades by or on behalf of the licensee through the EnMo business (to the extent the same is properly disclosed to the licensee in the ordinary course of the EnMo business in compliance with all applicable laws, regulations and contracts);
 - (vii) information which is disclosed in accordance with the terms of any consent given by the Authority or by the person entitled to disclose it; or
 - (viii) information which EnMo is contractually obliged to provide to the licensee pursuant to the Network Code or a contract entitled "Within

Day Gas Market: Market Operator Appointment Contract dated 1 September 1999".

- 5 The licensee shall procure from each relevant ultimate holding company a legally enforceable undertaking in favour of the licensee that the relevant ultimate holding company shall use its best endeavours to ensure that no EnMo confidential information shall be disclosed to or otherwise howsoever come into the possession of the licensee whether directly or indirectly from an EnMo source. Such undertaking shall be obtained from each relevant ultimate holding company within seven (7) days of that company becoming a relevant ultimate holding company and shall remain in force so long as it remains a relevant ultimate holding company.
- 6 The licensee shall:
 - (d) deliver to the Authority evidence (including a copy of the undertaking) that the licensee has complied with the obligation to procure the undertaking pursuant to this special condition;
 - (e) inform the Authority immediately in writing if the directors of the licensee become aware that any such undertaking has ceased to be legally enforceable or that its terms have been breached or that there has been a change in identity of a relevant ultimate holding company; and
 - (f) comply with any direction from the Authority to enforce any such undertaking.
- 7 In the event that any EnMo confidential information comes into the possession of the licensee, the licensee shall ensure that such information shall be treated as confidential, and shall not be used in any respect for the purpose of or in connection with the management or operation the Transco Business.
- 8 In this special condition:

“EnMo”	means EnMo Limited, a company incorporated in England and Wales under the Companies Act 1985 (registered number 3751681) and having its registered office at 15 Marylebone Road, London, NW1 5JD.
“EnMo business”	means any business carried on by EnMo including, without limitation, the operation of the On-the-Day Commodity Market in gas operated by EnMo.
“information”	shall include, without limitation, any documents, accounts, estimates, returns, records or reports and data in written, verbal or electronic format and information in any form or medium whatsoever.
“ultimate holding company”	shall mean any company or body corporate which is a holding company and is not itself a subsidiary of another company or body corporate.

Appendix C – Vertical separation consent

As discussed in Chapter 3 of this paper, this Appendix sets out a draft consent which Ofgem intends to issue under SLC C2 for NGC.

The National Grid Company plc

Draft form of consent

THE ELECTRICITY ACT 1989 (AS AMENDED)

ELECTRICITY TRANSMISSION LICENCE

CONSENT ISSUED TO THE NATIONAL GRID COMPANY PLC PURSUANT TO STANDARD LICENCE CONDITION C2 (PROHIBITED ACTIVITIES) OF THE ELECTRICITY TRANSMISSION LICENCE

This consent is given by the Gas and Electricity Markets Authority (“the Authority”) under and for the purpose only of paragraph 2 of Standard Condition C2 (Prohibited Activities) of the electricity transmission licence (“the licence”) treated as granted under section 6(1)(b) of the Electricity Act 1989 (as amended) (“the Act”) to The National Grid Company plc (“the licensee”). The consent takes effect on and from the date specified below.

This consent is given at the request of the licensee in connection with the proposed merger of the licensee’s ultimate controller, National Grid Group plc, with Lattice Group plc to create National Grid Transco plc. Certain subsidiaries of Lattice Group plc generate electricity and thereby purchase or otherwise acquire electricity for the purpose of sale or disposition to third parties.

The Authority hereby consents to those affiliates or related undertakings of the licensee referred to in Appendix 1 to this consent purchasing or otherwise acquiring electricity for the purpose of sale or other disposition to third parties subject to the terms set out below.

APPENDIX 1 TO THE CONSENT GIVEN BY THE GAS AND ELECTRICITY MARKETS AUTHORITY ON 2002 PURSUANT TO STANDARD CONDITION C2 OF THE ELECTRICITY TRANSMISSION LICENCE GRANTED TO THE NATIONAL GRID COMPANY PLC.

The arrangements are the purchase or other acquisition of electricity by any company referred to in column 1 below by generating electricity at any of its facilities listed in column 2 in relation to that company but only to the extent that such generation does not exceed the maximum capacity of that facility set out in column 3.

1	2	3	4
Company	Facility	Maximum Capacity	Duration of consent
Lattice Energy Services Ltd	Cleveland	22.4 MW	Disposal of generation facility at Cleveland or [] 2003 (date being 12 months from date of consent) whichever is the earliest
	Hemel Hempstead	4.076 MW	Disposal of generation facility at Hemel Hempstead or [] 2003 (date being 12 months from date of consent) whichever is the earliest
	Bristol	1.204 MW	Disposal of generation facility at Bristol or [] 2003 (date being 12 months from date of consent) whichever is the earliest
Advantica Technologies Ltd	Loughborough	1.2 MW	Disposal of generation facility at Loughborough
Transco plc	St Mary Cray	1.0 MW	Disposal of generation facility at St Mary Cray

Transco plc	Isle of Grain	14 MW	Disposal of generation facility at Isle of Grain
Transco plc	Dynevor Arms	2.5 MW	Disposal of generation facility at Dynevor Arms
Transco plc	Partington	6.6 MW	Disposal of generation facility at Partington
Transco plc	Avonmouth	5.8 MW	Disposal of generation facility at Avonmouth

'Disposal' means any sale or other disposal other than a sale or disposal to an affiliate or related undertaking of the licensee.

Appendix D - Statutory modification notices

This Appendix sets out statutory notices published under sections 11 and 11A of the Electricity Act and section 23 of the Gas Act to make modifications to the licences of NGC and Transco and to the standard licence conditions for electricity transmission licence as a result of the merger.

NOTICE UNDER SECTION 11(2) OF THE ELECTRICITY ACT 1989

The Gas and Electricity Markets Authority ("the Authority") hereby gives notice pursuant to section 11(2) of the Electricity Act 1989 ("the Act") as follows:

1. The Authority proposes to modify Special Conditions AA2, AA3, AA5, AA6, AA7 and AA10 and to introduce a new special condition AA12 in the transmission licence ("the licence") treated as granted to The National Grid Company plc ("the licensee") under section 6(1)(b) of the Act.
2. The nature of the modifications and their effect and the reasons for them are set out in the text of, and Appendix B Parts 1 and 2 to, the document "Regulatory issues arising from the merger of National Grid Group plc and Lattice Group plc to create National Grid Transco plc Decision document and notices under sections 11 and 11A of the Electricity Act 1989 and section 23 of the Gas Act 1986" ("the decision document").
3. The reasons for the modifications arise from the proposed merger between the National Grid Group plc (of which the licensee is a subsidiary) and the Lattice Group plc, of which Transco plc ("Transco"), which holds a gas transporter licence, is a subsidiary and are set out in the document "Regulatory issues arising from the merger of National Grid Group plc and Lattice Group plc to create National Grid Transco plc – Initial Proposals July 2002 47/02" and the decision document. In summary they are to align conditions common to the respective licences of the licensee and Transco, to take account of the fact that the licensee and Transco will become affiliated companies and to introduce the new special condition AA12 to prevent disclosure of information held by or obtained from EnMo Limited, a member of the new group which might enable discrimination or market distortion by the licensee or Transco.

4. Copies of the proposed licence modifications and the documents referred to in paragraphs 2 and 3 are available (free of charge) from the Ofgem Library, 9 Millbank, London, SW1WP 3GE (020 7901 7003) or on the Ofgem website (www.ofgem.gov.uk).
5. Any representations or objections to the proposed licence modification may be made on or before 21 October 2002 to Lisa Vango, 9 Millbank, London, SW1P 3GE (020 7901 7178) or lisa.vango@ofgem.gov.uk.

Maxine Frerk

Duly authorised on behalf of the Authority

20 September 2002

NOTICE UNDER SECTION 11A(3) OF THE ELECTRICITY ACT 1989

The Gas and Electricity Markets Authority ("the Authority") hereby gives notice pursuant to Section 11A(3) of the Electricity Act 1989 ("the Act") as follows:

1. The Authority proposes to modify the standard licence conditions contained in each transmission licence treated as granted under Section 6(1)(b) of the Act by amending standard licence condition 10 to align the wording in paragraph 3 (a)(ii) to that used in Condition 29 (Disposal of relevant assets) in distribution licences.
2. The reason why the Authority proposes to make this licence modification is to effect a further step in achieving standardisation of the wording used in licences of network operators wherever practicable.
3. The effect is to achieve such standardisation in respect of this condition without material change to the effect of the condition.
4. The proposed modification is set out in the schedule below and copies of the existing standard licence condition are available (free of charge) from the Ofgem Library, 9 Millbank, London, SW1WP 3GE (020 7901 7003) or on the Ofgem website (www.ofgem.gov.uk).
5. Any representations or objections to the proposed licence modification may be made on or before 21 October 2002 to Lisa Vango, 9 Millbank, London, SW1P 3GE (020 7901 7178) or lisa.vango@ofgem.gov.uk.

Maxine Frerk

Duly authorised on behalf of the Authority

20 September 2002

THE SCHEDULE

For the existing provision in paragraph 3(a)(ii) of standard licence condition 10, there shall be substituted:

“(ii) the transaction or the relevant assets are of a description to which such directions apply and the disposal or relinquishment is in accordance with any conditions to which the consent is subject; or”

NOTICE UNDER SECTION 23(3) OF THE GAS ACT 1986

The Gas and Electricity Markets Authority ("the Authority") hereby gives notice pursuant to section 23(3) of the Gas Act 1986 ("the Act") as follows:

1. The Authority proposes to modify standard condition 41, amended standard conditions 1, 24, 30, 45 and 47 and Special Conditions 2, 3, 4 and 5, prospective Special Condition 26 and to introduce a new special condition in the gas transporter licence ("the licence") treated as granted to Transco plc ("the licensee") under section 7 of the Act.
2. The nature of the modifications and their effect and the reasons for them are set out in the text of, and Appendix B Parts 1 and 2, to the document "Regulatory issues arising from the merger of National Grid Group plc and Lattice Group plc to create National Grid Transco plc Decision document and notices under sections 11 and 11A of the Electricity Act 1989 and section 23 of the Gas Act 1986" ("the decision document").
3. The reasons for the modifications arise from the proposed merger between the National Grid Group plc (of which The National Grid Company plc (NGC) is a subsidiary) and the Lattice Group plc, (of which Transco is a subsidiary) and are set out in the document "Regulatory issues arising from the merger of National Grid Group plc and Lattice Group plc to create National Grid Transco plc – Initial Proposals July 2002 47/02" and the decision document. In summary they are to align conditions common to the respective licences of NGC and the licensee, to take account of the fact that NGC and the licensee will become affiliated companies and to introduce the new special condition to prevent disclosure of information held by or obtained from EnMo Limited, a member of the new group which might enable discrimination or market distortion by NGC or the licensee.
4. Copies of the proposed licence modifications and the documents referred to in paragraphs 2 and 3 are available (free of charge) from the Ofgem Library, 9

Millbank, London, SW1WP 3GE (020 7901 7003) or on the Ofgem website (www.ofgem.gov.uk).

5. Any representations or objections to the proposed licence modification may be made on or before 21 October 2002 to Lisa Vango, 9 Millbank, London, SW1P 3GE (020 7901 7178) or lisa.vango@ofgem.gov.uk.

Maxine Frerk

Duly authorised on behalf of the Authority

20 September 2002