Gas Transporters, Shippers, Suppliers and other interested parties

Promoting choice and value for all gas and electricity customers

Direct Dial: 020 7901 7483
Email: james.grayburn@ofgem.gov.uk

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Dear Colleagues,

Open letter consultation: Review of Xoserve

In our March Strategy Decision document for the gas distribution price control review (RIIO-GD1), we set out our intention to undertake a review of Xoserve's funding, ownership and governance arrangements.[1] The purpose of the review is to examine whether the current arrangements facilitate the provision of an efficient and high quality service, and one that is responsive to network users' needs, and wider industry change.

We commissioned Cambridge Economic Policy Associates (CEPA) to undertake our review of Xoserve, and we are inviting stakeholders' views on the potential options for change set out by CEPA. We summarise the key issues and options in this letter, and set out the questions for consultation in appendix 1. We have also published the CEPA report along with this open letter.[2]

Background to Xoserve and our review

The industry relies upon the Gas Distribution Networks (GDNs) and National Grid Gas National Transmission System (NGG NTS) (collectively known as the Gas Transporters or GTs) to provide wider data services such as billing shippers for use of the transportation network, managing the booking of capacity on the distribution network, running the industry settlement systems and managing the change of supplier process. As a condition of the sale of the four distribution networks by National Grid in 2005, we required the GTs to establish a central agent (the "GT Agent") to provide a common system and service interface between multiple GTs and the wider industry, mainly shippers and suppliers.[3]

Xoserve fulfils the role of the agency on behalf of the GTs in accordance with the terms of the Agency Services Agreement (ASA). The ASA sets out the services to be provided by Xoserve and the standards of service to be achieved. It also sets out the arrangements by which Xoserve charges GTs for its services. We provide an allowance within the price control to enable GTs to pay these charges.

We initiated a review of Xoserve in response to concerns expressed to us by network users[4] about whether the current arrangements enabled Xoserve to provide an efficient and high

[1] See: Ofgem (March 2011) Decision on strategy for the next gas distribution price control – RIIO-GD1 Outputs and incentives. Link: http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/GD1decisionoutput.pdf
[2] CEPA (August 2011) Review of Xoserve Funding, Governance and Ownership, Final Report
[3] The requirement for GTs to establish a central agent is set out in Standard Special Condition (SSC) A15 of the DN Licence.
[4] See for example response to our consultation on Xoserve: Ofgem (March 2011) op. cit., para. 5.8

quality of service, and one that is responsive to industry change. Change management is particularly important in the context of the anticipated roll-out of smart meters and the development of the Data Communications Company (DCC) which could have a substantial effect on the data services the industry requires and on the future role of Xoserve.

Independent report by CEPA

We appointed CEPA in April 2011 to conduct a review of Xoserve. As part of their review, they consulted widely with Xoserve and other relevant organisations. Their report includes: an appraisal of the current regulatory framework for Xoserve, including an assessment of the User Pays model; identification of alternative arrangements for Xoserve; and, an initial evaluation of the possible options.[5] We summarise the key findings of their report below.

Potential problems with the current framework

The CEPA report acknowledges that there is generally a high level of satisfaction with Xoserve with regard to day-to-day service provision.[6] Xoserve's own customer satisfaction survey also shows a high level and improving level of customer service. However, the report also notes two broad concerns expressed by shippers. First, shippers expressed the view that Xoserve was poor at managing industry change, e.g. in relation to requests for new services or industry modifications. Second, the report notes that there is a general concern with the lack of transparency with regard to how Xoserve derives charges for services and how it makes strategic decisions.[7]

CEPA considers that a key factor explaining shippers' concerns is the contractual arrangement under which Xoserve operates. The GTs contract with Xoserve through an Agency Service Agreement (ASA). The ASA effectively establishes Xoserve as an outsourced IT contractor to the GTs, with the result that Xoserve is focussed on meeting its contractual obligations to the GTs rather than focussed on providing services to the wider industry.

CEPA also identified problems with the funding arrangements. First, they note that a price cap regime – under which Xoserve operates – is principally designed to create incentives for network operators to drive out cost from capital intensive businesses and is less suited to IT service providers with relatively short-lived assets and changing industry requirements. CEPA considers that Xoserve requires a more flexible regulatory model which would allow it to respond to change and network users' needs. CEPA also observes that the funding of Xoserve through transporter charges also makes the cost of the services provided by Xoserve non-transparent (as the costs of Xoserve constitute a fraction of the overall network charge). In addition, the introduction of a User Pays model has created further concerns about the transparency of Xoserve's cost allocation and funding arrangements.

CEPA considers that overall the current governance (i.e. ASA), funding and ownership arrangements are not fit-for-purpose given the challenges facing the industry, and they identify changes to these arrangements which would enable Xoserve to manage change more effectively.

Options for change

CEPA considers three broad options for change to address the shortcomings identified in the current institutional arrangements. Under Option A, CEPA sets out changes which seek to optimise the arrangements within the current governance (i.e. ASA) and ownership (i.e. owned by the GTs) framework. Under options B (separate licensed entity) and C (co-

[5] See CEPA (August 2011) op. cit. p 74 for full terms of reference.
[6] CEPA (August 2011) op. cit. p.27.
[7] CEPA (August 2011) op. cit. p.28.

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operative model), CEPA proposes more fundamental changes to the current framework. We briefly describe each of the options below. (CEPA report references in parentheses.)

Option A – Changes within the current ownership and governance framework (pp.38 to 47)

This model retains the current governance (i.e. ASA) and ownership model (i.e. owned by the GTs) but proposes a number of potential changes to provide wider industry participation in the determination of services provided by Xoserve. CEPA proposes to formalise the industry involvement in determining the services provided by Xoserve through a "User Requirement Planning Group"[8] comprising Xoserve and network users, which would work along similar lines to the current Project Nexus group. They also note that this could be combined with the proposed UNC Modification Oversight Committee, as proposed by the recent UNC review group of Xoserve.[9]

CEPA also proposes complementary changes to the current funding mechanisms. In particular, they consider that user requirements could be explicitly linked to funding through an extended User Pays model, and/or a negotiated settlement model.

Under an extended User Pays model, more existing services would be provided under User Pays to reflect more closely the functions considered to support "market operations" (i.e. those services with wider stakeholder interest). The extension of User Pays would also provide a mechanism for funding new services, i.e. rather than relying on funding set at the price review, User Pays would enable users to determine outputs and funding on an on-going basis.

As an alternative but similar model to extending User Pays, CEPA proposes a negotiated settlement process. Under such a process, the GTs and the industry would agree the services to be delivered and the funding levels, and the funding would be provided by a separate revenue item in the price control formula. Ofgem would only intervene in the event that the parties could not agree on service or funding levels or potentially where the parties proposed a significant increase in the costs borne by end-users.

Finally, as part of the package of proposed changes, CEPA proposes a non-executive board member to sit on the Xoserve's board in order to represent network users' interests.

Option B – Separate licence, customer facing GT Subsidiary (pp.47 to 49)

This option is based on removing the current contractual arrangement (i.e. ASA) between Xoserve and GTs, and establishing Xoserve as a separate licensed activity. The GTs would continue to own Xoserve, and certain service obligations which are critical to the operation of the GTs businesses (e.g. invoicing shippers) might be retained within the GT licences, and managed through a contract between the GTs and Xoserve (as per current arrangements). However, the obligation to provide all other market services would lie with Xoserve as the licensed entity. The objective of this model would be to create a more empowered central agent and one that is directly responsible to network users.

Under this option, CEPA also envisages changing the funding arrangements in order to recover the costs of the central agent directly from industry users instead of through network charges. Such a change would increase the transparency of current charging arrangements. The GTs would be allowed to recover the costs allocated to them (associated with the provision of network services) through network charges.

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8 See page 40 for a description of the User Requirements Planning Group.

9 The gas industry has also undertaken its own review of central system funding and governance arrangements (UNC Review 334). See CEPA (August 2011) op. cit., Chapter 6. For UNC 334 report, see: http://gasgovernance.co.uk/0334

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CEPA also envisages the adoption of a negotiated settlement process to define the services and funding levels (as with option A). However, under this option, Xoserve (as the licensee) would be empowered to lead the negotiation as opposed to the GTs leading on behalf of Xoserve as envisaged under option A.

Option C - Cooperative body (p.49)

Under this option, CEPA proposes a co-operative not-for-profit agent, similar to the current arrangements in the electricity sector, namely the Meter Registration Service Company (MRASCo) and Elexon.

A model similar to Elexon would involve nominal ownership of Xoserve by the GTs but a separate board of directors. Alternatively, a similar model to MRASCo could be adopted whereby a shell company (UNCCo) would be jointly owned by industry participants which would then appoint an outsourced service provider, i.e. Xoserve as the central gas agency service provider. Under either approach, Xoserve would be funded based on recharging to the user group that benefits from those services. Funding of the GT element of the central agency services would be recovered through the price control formula.

CEPA evaluation and recommendation (Chapter 8 and 9, pp. 53-73)

CEPA does not consider that the current governance (i.e. ASA) arrangements should remain in place (as is envisaged under option A) if Xoserve is to be empowered to manage change effectively. Thus, CEPA considers that only options B and C can fully address the problems they identified with the existing framework.

For option B, they consider the establishment of a separate licensed entity and extension of User Pays or negotiated settlement would allow Xoserve to be more responsive to users' needs. However, they also note that there are considerable risks with this model. They raise material concerns about extending User Pays to all incremental services; they also note that the alternative proposal to introduce negotiated settlement would require significant behavioural change from the industry. There is also a lack of regulatory precedent in the UK for a negotiated settlement model, and a risk that the parties would default to adjudication by Ofgem.

By contrast, CEPA observes that a co-operative model under option C would align industry incentives and interests, and potentially avoid the complexity of the periodic negotiations/referral to Ofgem under option B. Unlike the negotiated settlement model, there is also precedent in other parts of the energy sector for a centralised co-operative model. However, they also note that option C could lead to the greatest upheaval in industry arrangements at a time when the industry needs to be focussed on meeting the wider industry challenges.

CEPA does not set out a definitive recommendation. Instead, they consider that the decision with regard to the optimal model rests on the following core questions:[10]

- *First, are the activities managed by Xoserve separable from GTs businesses?* If complete functional separation were considered challenging, they consider a licensed Xoserve model might on balance provide the optimal arrangements.

- *Second, following from the first question, are the activities performed by Xoserve "co-operative" in nature? With UNC administration under separate governance from Xoserve, is a shared ownership/interest model in this context appropriate?* CEPA considers that if the answer is yes, and Xoserve's systems and services are separable from the GTs business, then a co-operative model could be optimal.

[10] CEPA (August 2011) op. cit. p.72.

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- *The next question is what appetite is there amongst industry participants outside of the GTs to assume a greater role, responsibility and therefore accountability for Xoserve and its activities?*

- *Finally, are the systems and services provided by Xoserve of such criticality to the industry during a period of significant change in the energy sector, that fundamental change to Xoserve raises too great a risk?* If so, they consider we should revisit option A, albeit noting the limitations of such a model.

Our preliminary views

We agree with CEPA's analysis that the current institutional arrangements hinder the ability of Xoserve to be customer focussed, and to respond effectively to the wider industry challenges arising from the smart meter roll-out, and the development of the DCC. CEPA's analysis is consistent with the views expressed to us by shippers regarding Xoserve's management of change. We therefore consider that there is a strong rationale for a change to the current arrangements governing Xoserve.

Of the three options set out by CEPA, our preliminary view is that option C (co-operative model) represents the optimal set of arrangements. We consider that this option should result in improved service levels and costs by aligning network users' and GTs' interests as shared owners of Xoserve. This option should also facilitate a more responsive central agent by moving away from a more rigid 8 year review of costs and service levels. We would also expect a reduction in the regulatory burden by removing the need for us to ultimately set allowed revenues. Finally, we also consider that the risks associated with adopting this model can be managed by learning lessons from existing successful arrangements elsewhere in the energy sector, namely MRASCo and Elexon.

By contrast, our initial view is that option B – the success of which would depend on the proposed negotiated settlement process – is high risk as such a process is largely untested in the UK. There are also significant short-term costs associated with introducing a separate licensed entity.

However, we would like to seek the views of industry on the options set out by CEPA before making our decision. In particular, as set out by CEPA, we would like to understand the wider industry appetite to be involved in the provision of central agency services.

Next steps

We have set out a set of questions for consultation in appendix 1. We request that you send responses to RIIO.GD1@Ofgem.gov.uk by **Friday 18th November 2011**. Following a review of the submissions, we aim to provide a decision on the framework for Xoserve in early 2012.

We also intend to hold a workshop on the potential options for Xoserve in order to understand the wider views of the industry, and to inform our decision. We propose to hold the workshop in mid-October. We will announce further details on our website. If you would like to attend the workshop, please send an e-mail to RIIO.GD1@Ofgem.gov.uk.

Yours sincerely,

James Grayburn
Head of RIIO-GD1

Appendix 1: Questions for consultation

We have the following questions for consultation. The references relate to the CEPA report published along with this open letter.

1. *Xoserve's performance:* What, if any, concerns do you have with regard to the performance of Xoserve? Do you agree or disagree with CEPA's articulation of network users' concerns about the responsiveness of Xoserve to industry change, and lack of transparency (pp.28-29)? Please provide reasons.

2. *Current arrangements:* What concerns, if any, do you have with the current funding, governance and ownership arrangements? Do you agree or disagree with CEPA's assessment of the limitations of the current arrangements for Xoserve (pp.29-32)? Please provide reasons.

3. *Options for change:* What are your views on the costs and benefits of the three options for change (Chs. 7)? Do you agree or disagree with CEPA's assessment of the options (Ch 8)? Are there any other options not identified by CEPA that we should consider?

4. *Critical issues:* What are your views on the critical issues identified by CEPA for determining the preferred option (p.73)? Are there any other critical issues we should take into account before making our decision?

5. Should we change the current arrangements? If so, what is your preferred option?

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