

Joanna Whittington  
Director of Gas Distribution  
Ofgem  
9 Millbank  
London  
SW1P 3GE

Jon Carlton  
e: Jon.carlton@xoserve.com  
t: +44 (0) 121 713 5128  
f: +44 (0) 121 713 5174

25<sup>th</sup> January 2007

Dear Joanna,

**xoserve's response to Ofgem's third GDPCR consultation document, ref 203/06**

Thank you for the opportunity to respond to Ofgem's third consultation document on the Gas Distribution Price Control Review. We will be limiting our response to cover only those issues raised that relate to xoserve.

We welcome the Industry Dialogue on xoserve Services and believe the Work Group has made good progress against a challenging Terms of Engagement and timescale. We are confident that the Work Group will recommend practical and pragmatic proposals for achieving Ofgem's objectives, although we recognise that a number of outstanding issues would need to be resolved and significant work would be required to develop a full framework that could be implemented.

We believe Ofgem's objectives can be met, but not necessarily in the form of Option 2 as described in the consultation documents. In particular, we are concerned that treating user pays services as excluded services will make the contracting and invoicing arrangements unnecessarily complex and inflexible. With appropriate governance and transparency, a more direct contracting model could provide the necessary reassurance to yourselves and Users, without incurring unnecessary additional cost.


An area where further consideration is required is the funding of change within the industry. Arguably, under a User Pays model, the potential for key developments being delayed through lack of clarity of funding and governance arrangements will be greater than the perceived inefficiencies in the conventional allowance approach. Where developments have been agreed within the industry, we believe that a mechanism to allow for efficient costs is the most appropriate. Further detail on our thoughts in this area is given in the attached document.

We note the document's use of such phrases as 'regulated assets', 'regulated activities' and 'fully ring fenced' in relation to xoserve. We recognise that we are in a unique position and that many of our services cannot be provided by alternative suppliers, therefore we have procedures in place to ensure revenue generated from resources funded by GTs' allowances is separately identified, as well as ensuring appropriate use of systems and no discrimination between users. We see these as an essential element of a user pays charging methodology and would be very happy to discuss them with you. Any additional proposals to introduce new ring fencing requirements have the potential to increase costs and would be unnecessary.

As discussed, we welcome the industry dialogue on user pays. However, it should be recognised that such a regime inherently involves greater risk which would need to be reflected in the margin applied to charging for such services. This cannot be quantified until there is more clarity on how the regime will operate and a fuller impact assessment has been completed, in particular the change of behaviours resulting from a user pays regime. We would welcome the opportunity to help structure the more detailed impact assessment planned for the initial proposals document.

We look forward to discussing these important topics with you and your team at the earliest opportunity. In the meantime, if you have any questions or comments about what we have raised in this letter please do not hesitate to contact myself or Nick Salter. We are happy for you to publish this letter and the attached document as part of the consultation process.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Jon Carlton', is centered within a light blue rectangular box.

Jon Carlton  
Chief Executive Officer  
xoserve Limited

**Gas Distribution Price Control Review**  
**Third Consultation Document**  
**xserve Ltd Response to Consultation**

**Chapter 8 – Other issues**

**Question 1: Do you agree with our assessment of the risks, costs and benefits attributable to the two options for the funding of xserve?**

The qualitative impact assessment provides a clear exposition of the issues that need to be considered. However, we don't believe that the conclusion is as clear-cut as described in Appendix 7. Our view of each of the key issues identified is described in the following sections.

*Cost Efficiency* – xserve is already forecasting to reduce underlying operating costs during the next price control period. Due to the major projects planned for the period, total annual costs will be higher than those forecast for 2006/07.

The current funding arrangements provide incentives for GTs to constrain costs but arguably Option 2 could reduce that incentive. For shippers, it is unclear how a direct xserve charge for a service will change their economic decision on whether to utilise the service: many of the services are not discretionary; some services result in additional income for the shipper; and they may already be incurring internal costs to utilise the service far in excess of the xserve charge. The strength of this incentive needs to be evaluated in the next impact assessment.

*Responsiveness* – Incentives and mechanisms already exist for GTs, through xserve, to respond to customer demands and provide additional services. For existing services, xserve has a strong track record in responding to customer demands, as demonstrated by high customer satisfaction feedback. It is not clear how for new or existing services Option 2 would increase the incentive. Indeed, GTs have made it clear that their priority for xserve is to minimise the risks to existing services, where they have obligations, rather than generating additional revenue.

Governance arrangements are crucial if the provision of new services is going to be responsive. We believe the arrangements need to be agreed before any adjustment is made to allowances as part of the GDPCR process.

We do not see any linkage between option 2 and greater, or some, use of the UNC Class 3 Modifications process.

*Promoting Competition* – As discussed above, new services sought by shippers can already be provided without option 2. We agree that Option 2 would help to ensure inefficient shippers bear the additional costs they impose on GTs. Until the extent to which this takes place has been quantified, it is not possible to assess whether the additional complexity of Option 2 would be justified through more efficient use of the service. We believe this should be considered in the Impact Assessment.

*xserve service standards* – Where revenue is directly dependent on the quality of service provided, then clearly a greater incentive exists to deliver the desired quality. This is similar to the incentive resulting from the liability regime. If there was general dissatisfaction with the current service standard, you would expect to see UNC modification proposals extending the liability regime. This is not happening.

Providing different levels of service to different customers is on the face of it attractive but may be complex to implement. For existing services, often the service standard is defined in the UNC. To provide a higher standard would require a separate agreement to provide a different standard. Similarly, many of the interfaces with shippers are governed by the UK Link Committee which may need to consider different standards for different users. The rationale for xserve was to reduce costs through retaining centralised common systems and processes. Differentiating services between users has the potential to increase costs and reduce the benefit of centralised processes.

*Simplicity* – Unless a pragmatic approach is taken to option 2, there is a significant risk of adding risk and cost through over complex contracting, charging and invoicing arrangements.

We are not clear about the references to the ambiguity relating to the regulatory treatment of xserve's additional services or the potential to create issues going forward. We have processes in place to ensure appropriate use of systems and no discrimination between users. We have committed through the Work Group to make these visible to the industry. We have provided Ofgem with full visibility of our costs and revenues through the BPQ process. It is not clear what further ambiguity or issues exist.

**Question 2: If we adopt a core services plus user pays approach (Option 2), how should we define core services and user pays services?**

The Work Group has considered the criteria for identifying candidate user pays services and suggested the following:

- The key stakeholders are Users and
- Users have discretion on either whether or how to use the service and
- The cost of the service line is usage dependent.

In addition the Work Group has recognised that materiality criteria need to be applied.

For each candidate service line that meets these criteria, it would be prudent to confirm that the costs and benefits identified in the impact assessment still suggest that for the particular service line under consideration there is likely to be an overall gain by the user paying directly for the service.

A one-off exercise needs to be carried out for existing services. For new services, the above criteria can be applied, but the option of funding them through allowances should also be available. Without this option, it is likely that sub-optimal arrangements could be introduced.

**Question 3: What costs/benefits would your organisation incur in the event that we adopt Option 2?**

Option 2 would incur additional administration and systems costs. There will be upfront costs to establish the framework, charging methodology etc as well as ongoing costs to administer the process. The magnitude of these costs will be dependent on the proportion of services that are user pays and the nature of the regime. It will be important to have a clear set of assumptions on these issues before an attempt is made to collect cost and benefit information from the various stakeholders.

Option 2 increases the revenue risk for xserve and the likelihood of stranding costs, particularly where fixed costs are recovered with a usage based charge. It would be reasonable to assume that this would be reflected in the margin applied to the charges to shippers. We believe it is more appropriate that only avoidable costs are recovered through user pays.

There is the potential for demand for services to be lower than under the current regime, which would allow costs to be reduced. Conversely, where volumes are in excess of the forecast, xserve and the GTs will gain additional income. In both cases, it is assumed the a proportion of the benefit will flow through to consumers in the next price control period.

Option 2 would provide stronger market signals as to the value of a service and inform users' desire to fund change.

**Question 4: What questions do we need to ask GTs, xserve and shippers in order to accurately quantify the costs associated with Option 2.**

It will be essential to identify the benefits, in terms of how the changes to incentives could vary the behaviour of stakeholders. Users need to be asked how their usage of existing services will vary

and what new services they will be requesting which cannot be requested under current arrangements. Similarly, GTs need to be asked about the relative priority they will place on additional revenue from new services against the delivery of existing services where they have obligations.

We will be expecting to provide cost information, both in terms of the administration costs and the impact on existing service costs. In addition, we will assume that the impact assessment will need to take account of the additional risk on our business and the effect this may have on charge levels.

### **User Funding of Change**

Where developments to the commercial regime have been agreed within the appropriate governance framework, it is important that a lack of clarity on funding arrangements does not frustrate the implementation of the development. Currently, the costs for this type of change are borne by all stakeholders. It is assumed that GTs are funded for such change.

Where users are seeking a change and GTs do not intend to make the change without the costs being recovered from users, i.e. Class 3 UNC modification, the experience to date is that the process does not work effectively. Indeed, there have been no such changes implemented since 1996. Where users are required to fund changes, the experience of the last ten years is that governance to ensure appropriate funding is essential if commercial developments are not to be frustrated.

If no allowance has been made for GTs to fund the change from allowed transportation revenue, then an alternative approach is required. Possible options are:

- i) For changes which could be specifically defined, but only subsequent to a price control review, a discrete revenue adjustor could be used. This would require a change's outputs and costs to have been forecast, and arrangements put in place to allow stakeholders appropriate review. Full allowance would be dependent on timely delivery of the change within budget (similar to the TIRG mechanism already used by Ofgem for specific unanticipated transmission investment). In this instance the incremental costs would be shared in the same manner as transportation costs.
- ii) Similar to the previous option, but levy an additional charge on users to fund the change. This charge could be one-off or based on a measure of usage of the change. A new methodology to share the charges or set usage rates would be required. The obligation to pay the charges would need to be established in new contracting arrangements. Note: If the charging methodology was portfolio based, the share of costs would be very similar to using the transportation charging methodology.
- iii) Utilise arrangements similar to those for Income Adjusting Events.

Without a funding option of this nature, it is unclear how GTs could be considered to be able to fully finance the activities which are the subject of obligations on them.