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Dear Joanna,

**xoserve's response to Ofgem's GDPCR Initial Proposals Document, ref 125/07**

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

**Operating Cost Savings**

The basis of the proposed xoserve savings in operating costs is flawed due to invalid assumptions regarding the comparability of xoserve and the GDNs' activities. The consultants' reports do not justify these proposed savings and demonstrate a lack of understanding of the xoserve business and the differences to GDNs, which are understandably the focus of their attention. We have provided detailed responses to Ofgem on these issues that demonstrate the inappropriateness of the comparisons made.

**User Pays**

Under the current regulatory and funding arrangements, xoserve provides additional services to users and works with users to ensure services are used efficiently and at minimum cost. It is unclear how the proposed funding arrangements for xoserve's existing services will significantly improve these incentives, sufficient to justify the additional cost and risk associated with the arrangements.

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 or opportunities missed through lack of clarity of funding and governance arrangements will be significant. It will be critical to ensure that the governance arrangements are consistent with the

funding arrangements and we are very happy to work with the industry, including Ofgem, to develop arrangements that mitigate this risk.

### **UK Link Replacement Funding**

We understand the concerns over sharing any additional benefit gained from assets funded by price control allowances and, given their likely materiality in relation to UK Link, support the proposals to consider these ex post.

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 or the attached responses to the consultation questions please do not hesitate to contact either 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**  
**Initial Proposals Document**  
**xserve Ltd Response to Consultation**

**Section 3 – Operating Expenditure Analysis**

**Question 1:** Do you agree with our approach for setting opex allowances and the proposed allowances we have derived using that approach?

We do not support the approach for setting operating cost allowances or the proposed allowances relating to xserve activities. The proposed xserve savings are based on inappropriate comparisons with GDNs that do not take account of the different nature of the xserve and GDN businesses. xserve was established to undertake a common set of shipper facing services on behalf of GTs, i.e. they would not be undertaken by GTs. Therefore, almost by definition, xserve is undertaking a completely different set of activities to GTs that could be expected to have different cost profiles.

We understand the desire following network sales to benchmark between GDNs but see no rationale for including xserve within the benchmarking pool. We note that xserve has not been included in the consultant reports for individual GDNs, recognising the different nature of the businesses, but the consultant report for xserve includes ourselves and the four GDN groupings. This is an inconsistent and inappropriate approach.

We are happy to be benchmarked against externally validated benchmarks or other companies that are more comparable with xserve. We are confident that such an exercise would demonstrate that xserve performs above benchmark.

IS

The proposed savings in IS expenditure are derived from a comparison with just one GDN. The GDN utilises a different set of systems that are used for different purposes and with different service levels, and has a completely different profile of commercial change and programme of infrastructure replacement.

Any changes in cost profile forecast by the single comparator GDN cannot be translated to xserve in a simplistic manner without an understanding of the underlying activities of the two companies. Specific events reduce the comparator GDN costs that don't apply to xserve, e.g. FOMSA. Because the cost profile is driven largely by events rather than underlying productivity improvements, a simple change in the base year for the comparison reduces the savings from £6.6m to £1.4m, even if the two companies' activities could be considered comparable.

We are confident that a benchmarking exercise that takes account of the nature of our business, the service levels required, the volume of transactions and the age profile of the systems involved would show that our cost forecasts are fully efficient. In the absence of such an exercise, there are no rational grounds to propose reductions in our IS costs.

Property

The LECG report points out that xserve's overall property costs and rental costs are at benchmark when compared with externally validated benchmarks, yet a 38% reduction in our property costs is being proposed. This reduction is all in facilities management costs – from £10.8m to £4.4m, a 60% reduction.

The basis for this reduction is a comparison of xserve's and the GDNs' facilities costs. As mentioned above, the comparison is not made in the GDNs' own consultant reports, presumably recognising the different nature of the businesses. The comparison is made between xserve's single office location and a mixture of office and industrial locations for the GDNs. Also, the variability in the GDN comparators brings into question the consistency of the basis on which they were derived.

No recognition is made of the high occupancy achieved by xoserve, which is over 200% efficient when compared with externally validated benchmarks. Inevitably this high occupancy will increase facilities managements costs per square foot.

The comparison is further invalidated by extrapolating the results to the two data centres used by xoserve, which have completely different facilities management requirements to either the office or industrial accommodation used in the comparator set.

Given that overall property costs and rental costs are at benchmark and the inappropriate nature of the comparisons with GDNs, there is strong evidence to suggest that the benchmarking exercise for facilities management costs is invalid. There are no grounds to reduce xoserve's property costs without a more robust benchmarking exercise against externally validated benchmarks.

## Section 8 – Other Issues

**Question 1:** Do you agree with our proposed approach to the funding of xoserve?

xoserve believes that there is potential merit in user pays, but that the scope and manner of its implementation contemplated in the Initial proposals and, more importantly, in discussions with Ofgem, would mean that the significant benefits that could be delivered through a well thought through user pays framework with associated licence changes will not be realised.

The implementation of user pays as envisaged is likely to have either no effect or a tendency to reduce demand for the affected services. Considering the nature of the candidate user pay services, it is most unlikely that their usage will be material in informing the scope and scale of the replacement UK Link system. The existing framework enables xoserve to offer additional services to requesting users, user pays as envisaged would not increase xoserve or GDNs' incentives to introduce new services. The Impact Assessment relies heavily on these points.

If user pays has no material effect on demand, the benefit of the additional complexity is questionable, (although if certain xoserve charges were disaggregated, some shippers would gain a marginal benefit due to their relative usage of user pays services being lower than their supply point share). If demand is depressed, then in theory, in the long term, user pays should generate market signals regarding the value of those services and ultimately whether they are required. However the medium term effect would be to put at risk the recovery of fixed costs that the GTs must incur in order to discharge their licence obligations. Unless the GTs' obligations were amended in the light of market signals or their fixed costs to meet these obligations covered by allowed costs, they would risk stranded costs. This would point to a need for a charging model that promoted user commitment and covered the fixed costs or increased unit charges for the delivery of services to factor in the risk of declining demand. In any event, introducing user pays would mean additional complexity in the transportation charging framework, imposing costs on industry participants.

Although user pays for a small range of existing GT-obligated services appears to xoserve to deliver little benefit in its own right, throughout the GDPCR process, xoserve has been receptive to the concept of user pays, in the expectation that the "big prize" would be a framework that facilitated funding for more significant changes, beyond the current services, e.g. for significant changes to the "baseline" services at the time of the planned UK Link system replacement. Discussions with Ofgem suggest that funding of additional core functionality in UK Link Replacement is not necessarily part of user pays. xoserve is concerned that there may therefore be no viable mechanism to fund enhanced services in UK Link Replacement. Ofgem has made it clear that more significant changes to the transportation regime would most likely be paid for by GTs from their allowed revenue. In light of this, i.e. without a "bigger prize" envisaged as the end game, xoserve does not support the user pays proposals.

The following outlines why, in xoserve's view, the current framework is, for relatively minor customer-specific requirements, adequate to achieve the objectives of user pays without the need to introduce user pays for a small range of existing services:

The regulatory framework established at the time of GDN sales created an incentive for and removed a barrier to the delivery of additional services by xoserve. The Initial Proposals do not

make it clear how increasing the funding risk of an element of the revenue from existing GT-licence-obligated services would increase the incentive on xoserve to deliver additional services.

Since its establishment there are many instances, albeit low financial value, where xoserve has been able to fulfil shipper requests for additional services. Under the current framework a range of parties has benefited: shippers, as they have received a service that they value, xoserve by generating additional income and GTs through some reduction in ASA charges, reflective of the more efficient use of xoserve's fixed costs of assets used to deliver regulated services. The "industry" has benefited through an overall improvement in efficiency, as a number of the services that xoserve has been able to deliver may otherwise have required more protracted negotiation with GTs for the shipper to benefit and may even have had to go down the UNC modification route. xoserve is not able to quantify the benefit to gas consumers, but presumably the shippers who have procured the services have done so in order to improve their service or reduce costs, that should benefit consumers. Additionally, as discussed below, for more significant income from assets utilised to deliver regulated services, it may be appropriate to define an ex post arrangement to share the GTs' benefits from ASA cost reductions, provided that such an arrangement does not remove xoserve's and GTs' existing incentives to deliver new services.

Ofgem is understandably concerned that where additional services are delivered by xoserve, any additional revenue should not mean that GTs are double-remunerated for the use of assets, such as the UK Link system, that are used to deliver regulated services. xoserve recognises that this is an important principle, but we believe that the implementation of "user pays" in the manner proposed may stifle innovation and the ability of xoserve to meet customer requests. The financial value of additional services delivered by xoserve has to date been low. To the extent that assets such as UK Link have been used in their delivery, xoserve has reduced its charges to GTs through the ASA. The benefit has therefore flowed back to GTs, albeit that the additional revenue to date has been well below the de minimis threshold. Should more significant revenue streams be generated in this way, xoserve's view is that through appropriate reporting, transparency could be given to these revenues such that if the quantum were above de minimis, a mechanism could be developed such that the value could be taken into account ex post. In order to maintain an incentive for xoserve to deliver such value-enhancing services, the ex post consideration of value to GTs should be on a basis that shares the benefit between them and their customers. Introducing user pays for a limited range of existing services does not move this situation forward.

Should user pays proposals progress, it will be critical to ensure that the governance arrangements are consistent with the funding arrangements. The Initial Proposals expect the GDNs, xoserve and the industry to work together in coming up with suitable arrangements. xoserve would be happy to support the development of these arrangements but believe that under the arrangements envisaged, the primary considerations should be between GTs and Ofgem to ensure that the framework appropriately covers GTs' costs in delivering their licence obligations.

**Question 2:** How should we address any benefits arising to xoserve from redundancy created from the replacement of UK Link?

We support the Initial Proposals view to address any benefits ex post. The reasons for this support are due to the nature and materiality of any benefit.

The implication of the question is that xoserve will build-in redundancy to the replacement of UK-Link. This is not the case. The base assumption is that the replacement of UK Link will be designed to be consistent with the key features outlined to the Industry Dialogue Workgroup with sufficient, and no more, capacity to meet the forecast demands on the system. This is the most cost efficient approach rather than adding capacity in a piecemeal manner. As part of the design process, we will take account of potential industry trends but no additional cost has been included in our forecasts.

During the life of the system it may be possible to deliver additional services. The price of these services will be based on additional costs incurred in developing and operating the services plus an evaluation of the value of using assets funded by price control allowances. This value could be considered to be the benefit gained. At this stage, the materiality of these benefits is uncertain and difficult to forecast, although experience to date would suggest that they are not going to be

significant. For these reasons, we support the Initial Proposals view to address any benefits ex post.

**Question 3:** Do you agree with our approach of modifying SSC A15 to facilitate governance arrangements for user-pays?

SSC A15 defines the current scope of agency services and so it would seem logical for the same condition to define the core and user-pays subsets of the services, although other licence conditions may also require amendment.

We are not clear what further modifications are envisaged to facilitate governance arrangements but we are very willing to work with others to help develop appropriate arrangements. It is vital that this is resolved at the earliest opportunity in order to mitigate any risk of inconsistencies between governance and funding.

**Question 4:** Do you think that the existing arrangements are adequate to ensure enforcement of the range of services and outputs delivered by xserve in light of these proposals.

The feedback we receive suggests that the industry currently believes that the arrangements are working well and that there is no drive from shippers or anyone else to change these arrangements. The obligations are on the GDNs to deliver the services. As owners as well as parties to the ASA, GDNs are in a strong position to resolve any failure to deliver.