



xoserve, GTs, shippers and other interested parties

Promoting choice and value for all customers

Date: 11 April 2008

Dear Colleague

User Pays arrangements

Ofgem recently received a number of complaints from shippers about xoserve and the new User Pays arrangements. More specifically, they expressed concerns about the costs and governance process of the new arrangements, and asked Ofgem to veto the charging methodology that determines User Pays charges as set out in the Agency Charging Statement (ACS) and defer the direction of Standard Special Condition A15¹.

Having considered carefully the issues raised by shippers we did not see any statutory grounds on which we should veto the charging methodology or to defer the implementation of SSC A15. We subsequently approved the methodology as set out in a letter published on 28 March 2008², and directed the licence amendment on 31 March 2008, which has the effect of implementing the new funding arrangements for xoserve. For the avoidance of doubt, we would like to clarify that our letter of the 28 March gives our implicit approval to the form of the ACS.

To reflect the modifications to SSC A15, on 7 April 2008 the Authority directed that the modification proposal UNC188: '*Introduction into the UNC of the Agency Charging Statement ("User Pays")*' be made. The modification gives full effect to, and recognition to the ACS within the Unified Network Code.

While the 28 March letter details our rationale for our approval of the charging methodology, this letter seeks to address the issues raised by shippers regarding the costs and governance process of User Pays services, while highlighting the initiatives recently announced by xoserve to meet some of these concerns.

We would also like to take this opportunity to express our own disappointment at the way xoserve carried out the consultation process and conducted itself during the process and our agreement and sympathy with the level of dissatisfaction that this has produced amongst shippers. We therefore expect xoserve to learn the lessons from this episode, make improvements to its processes and deliver on its aim to be more customer focused and commercially minded.

¹ SCA15: Agency

² *Approval of Agency Charging Statement*, Ofgem

<http://www.ofgem.gov.uk/Networks/GasDistr/GasDistrPol/Documents1/Xoserve%20Charging%20Statement%20Decision%20ltr.pdf>

We may want to draw upon these events as part of our ongoing Governance Review where we are actively considering what measures we could take to improve the operational performance and the customer focus of all the businesses that administer arrangements under the various Industry Codes.

Background

The concept of a transporter agency was an important aspect of the industry restructuring that occurred as part of the Distribution Network sales process in 2005. The purpose of the agency is to provide a common system and service interface between transporters and the industry, to mitigate against possible cost and competition impacts following DN sales. xoserve currently fulfils this agency role and is responsible for a variety of functions such as invoicing shippers for use of the transportation system, and managing the change of supplier process. xoserve currently provides services on behalf of the GDNs and NGG NTS in accordance with the terms of the Agency Services Agreement.

Gas Distribution Price Control Review (GDPCR)

As part of the recent Gas Distribution Price Control Review³ (GDPCR), we decided to change the funding arrangements for xoserve. Under the new arrangements the services provided by xoserve are classified as either being core services funded through the price control, or User Pays service funded directly by the user of the service. We considered that these funding arrangements would have the following benefits:

- it gives GDNs and NGG NTS (xoserve) an incentive to find out what services users require and to offer new and improved services to earn additional revenue;
- it gives users an incentive to manage the costs they impose on xoserve because they would pay directly for the services they request / use. Before these arrangements, for example, parties such as traders that were not required to pay transportation charges and who therefore do not contribute to xoserve's costs, could make use of these services for free; and
- it encourages efficiency within xoserve. Their cost forecasts include a significant amount of expenditure on an upgrade of UK-Link. User pays would help xoserve understand what total additional system capacity customers are willing to pay for and will help them to make sure that the incremental capacity of these new systems is given to those who value it most.

Shipper concerns

In accordance with the proposed drafting of SSC A15, on 31 January 2008 xoserve published for consultation a draft Agency Charging Statement (ACS) containing a charging methodology. In the main shippers did not consider that the proposed ACS fully met the requirements of the proposed licence condition.

xoserve then submitted a consultation report and a revised ACS to the Authority for approval. In advance of our decision on whether or not to approve the methodology, we received concerns from shippers on the User Pays arrangements. In particular, shippers expressed their dissatisfaction with the level of costs that xoserve had derived for the new systems and with the lack of a formal governance process to deal with the new arrangements.

With regards to the costs of User Pays services, shippers were especially concerned about the cost of Internet Access to Data (IAD) and the cost of implementing the User Pays arrangements.

³ Gas Distribution Price Control Review – Final Proposals, December 2007

Internet Access to Data service costs

Shippers voiced concern at xoserve's proposal in its draft ACS to charge £40 a month per Internet Access to Data (IAD) account. The view was that such a sum would have resulted in a recovery of annual revenue equivalent to almost three times the amount removed from the GTs under the GDPCR. Following these representations and updated information from shippers about their estimated level of future demand xoserve reduced this charge to £16 in the revised ACS. We are satisfied that this charge is now broadly cost reflective. It is derived by dividing the costs attributed to the IAD service totalling £2.2m by the number of accounts. To ensure that all User Pays charges continue to remain cost reflective we have asked xoserve to review charges no later than 1 October 2008, as we set out in the 28 March 2008 letter.

We also note that IAD services are contestable and the User Pays arrangements support a shipper's right to choose an alternative service provider. While currently xoserve is the sole provider of IAD services in gas, it is not a natural monopoly and its future revenues are not guaranteed. With prices now unbundled shippers will be able to make an informed decision about whether the IAD service provided by xoserve represents good value and, if they think it does not, to go elsewhere for this service.

User Pays revenue

Looking at the amount of revenue to be recovered from the costs associated with implementing User Pays services, concern was voiced that the additional £500,000 xoserve would be collecting represented an excessive amount, and as such should require re-consultation of the ACS.

The process for informing users of the £500,000 should have been handled better by xoserve, as borne out by the fact that shippers were first made aware of the increase only following Ofgem's receipt of the revised ACS. There is clearly significant room for improvement within xoserve in communicating with shippers (xoserve's customers) more effectively on the User Pays costs and we expect the organisation to take steps to address this criticism.

Nonetheless, we are satisfied that the derivation of the new value, to approximately £3.5m is appropriate. In arriving at the revised revenue figure, xoserve uplifted for inflation to 2008/09 prices the £3m removed from the price control and allocated to User Pays items. This when taken together with the 6% margin plus a few other minor adjustments – some of which were positive and some negative - increased the total amount to approximately £3.5m.

While we have not audited the derivation of the £3m figure, the cost allocation methodology appears reasonable in principle and the 6% margin not excessive. xoserve identified these costs through their cost allocation methodology which is an activity based methodology. We are therefore satisfied that the additional £500,000 worth of revenue is justified, and that re-consultation of the ACS would be unnecessary.

In approving the charging methodology, we recognised the level of concern regarding the transparency and level of detail contained in the methodology and therefore set out in the 28 March letter a number of actions that we would expect xoserve to undertake by 1 October 2008 to address these matters.

User pays governance issues

The second major issue that shippers had was with the lack of a formal governance process regarding the User Pays contract between shippers and xoserve. In particular, shippers were concerned that the contract terms gave xoserve autonomy over future changes to the

terms of the contract. There was also, understandably, much grievance over xoserve's threat to withdraw services immediately from shippers that did not sign the contracts by 31 March particularly given that xoserve is, at present, the only provider of these services on which shippers rely.

We sympathise with the significant levels of dissatisfaction expressed by some shippers around how xoserve managed the contract negotiations. We consider this to be a very poor start to a process which is aimed at making xoserve more customer focused and commercially minded.

However, we are encouraged by xoserve's recent announcements to address some of the concerns of shippers in response to customer feedback. In a letter sent to shippers on 31 March xoserve stated that it would not be withdrawing services, at least not immediately from shippers that had not yet signed the contract.

xoserve also announced on 28 March 2008⁴ that it would develop and implement a revised mechanism to support user involvement with the contract change process, which is intended to include a dispute resolution mechanism through mediation. This will have the effect of extending the scope of the dispute resolution to changes to the contract in addition to application of the contract. It is xoserve's intention to implement the changes as soon as possible after 1 April 2008. xoserve has also made a commitment to establish a User Pays Group meeting and we would like to encourage all users to actively engage in the process.

While the manner in which xoserve has conducted itself has made the transition to the new User Pays arrangements less than smooth, we take comfort that xoserve has appeared to have learned some valuable lessons in terms of customer service as evidenced by the initiatives recently announced. However, we would expect xoserve to use this as a springboard to reconsider carefully how it conducts its business and what further changes would be required, or face the risk of losing it. For example, we have already stated in the 28 March 2008 charging methodology approval letter that we expect an improvement in the level of detail and transparency contained within the methodology. No doubt the establishment of a regular User Pays User Group meeting will enable shippers to actively engage in the process, but we would also welcome feedback from shippers should they have particular concerns that xoserve are not meeting its promises.

Please feel free to contact Jonathon Dixon on 020 7901 7354 or Indra Thillainathan on 020 7901 7294 if you would like to discuss this letter further.

Yours sincerely,

Steve Smith
Managing Directors of Networks

⁴ Framework Contract for the Provision of Non-Code User Pays Services published on www.gasgovernance.com