



OFGEM: REVIEW OF XOSERVE FUNDING, GOVERNANCE AND OWNERSHIP

August 2011

Final report

FOR PUBLICATION

Submitted by:

Cambridge Economic Policy Associates Ltd



CONTENTS

Executive Summary	i
Background	i
Services provided.....	i
Future challenges for the gas industry.....	ii
Meeting current and future industry requirements.....	iii
The role of funding, governance and ownership.....	iii
Options for change	iv
Evaluation.....	v
Recommendation	vi
1. Introduction	1
1.1. Objectives of the review	1
1.2. What is meant by funding, governance and ownership and why are they important?	2
1.3. Approach to the review	3
1.4. Structure of the report	4
2. Overview of Xoserve’s governance and funding arrangements	5
2.1. What is Xoserve and what does it do?.....	5
2.2. The ownership and contractual relationships between GT and Xoserve	7
2.3. Regulatory governance.....	9
2.4. Funding	10
2.5. Summary	11
3. Our understanding of GT Agent services and governance arrangements	12
3.1. Introduction.....	12
3.2. Segmentation of IT services provided by Xoserve.....	12
3.3. Rationale for a single entity	14
3.4. Incentives on industry participants	15
3.5. Role of industry participants in the governance of central agency services.....	16
3.6. Summary	18
4. Industry change and the future role of GT Agent services	19
4.1. Introduction.....	19
4.2. GT Agent services in RIIO-GD1 and RIIO-T1.....	19

4.3.	Support services for Independent Gas Transporters	20
4.4.	Smart meter rollout.....	20
4.5.	Strategic change to gas markets from Europe.....	24
4.6.	Summary	25
5.	Identifying and understanding issues	26
5.1.	Key messages arising from customer / stakeholder feedback.....	26
5.2.	Issues with funding, governance and ownership	29
5.3.	Conclusions	32
5.4.	Options for change.....	33
6.	UNC 334 Review of GT Agent Services	35
6.1.	Introduction.....	35
6.2.	Incremental change options	35
6.3.	Fundamental change options.....	36
6.4.	Other options considered.....	36
6.5.	Recommendations	37
7.	Options for change	38
7.1.	Changes within the current ownership and governance framework.....	38
7.2.	Changes to ownership and regulatory governance	47
7.3.	Summary	50
8.	Evaluation of options	53
8.1.	Optimising the existing regulatory and ownership framework (Option A).....	53
8.2.	Changes to ownership and regulatory obligations.....	63
9.	Conclusions and recommendations	70
9.1.	Industry requirements and the role of funding, governance and ownership.....	70
9.2.	Options.....	71
9.3.	Recommendation.....	73
	Annex A: Terms of reference.....	74
	Annex B: Questionnaire feedback.....	79
	Annex C: Xoserve services.....	85
	Annex D: Independent gas transporters	91

EXECUTIVE SUMMARY

Background

CEPA has been appointed by Ofgem (the GB gas and electricity markets regulator) to undertake a review of the funding, ownership and governance arrangements for Xoserve. The study will support a future consultation on these arrangements by Ofgem on these issues as part of the RII0-GD1 price review process.

Xoserve is a limited company founded in May 2005 following the restructuring of the gas distribution sector and National Grid's sale of four of the gas distribution networks (GDNs) to three new owners (Scotia gas networks, Northern Gas Networks and Wales and West Utilities). Its business is to act as the Gas Transporters' (GT) Agent, primarily in the supply of many of the core information system services required for the gas industry to operate, both in terms of *network* and *market* operations. The range of centralised gas transportation services provided by the GT Agent is defined in the GTs' Uniform Network Code (UNC) and licences.

Ofgem's terms of reference ask us to consider specifically whether Xoserve's current *funding*, *governance* and *ownership* arrangements have ensured regulatory objectives, of least cost provision of services, quality of services and responsiveness to requests from Suppliers / Shippers. As such, this is more of an appraisal of the parameters within which Xoserve operates, rather than Xoserve's performance itself - a detailed operational review of Xoserve being outside of our terms of reference.

Funding refers to the way in which Xoserve is remunerated for the services it provides. Xoserve currently receives most of its income through a regulatory allowance paid to its GT owners for the services provided by Xoserve, which is then passed through to Xoserve. Industry *governance* relates to how entities within the wider gas sector are regulated. When Xoserve was established, regulatory requirements prescribed the relationship between Xoserve and the GTs. In particular, certain of the GTs responsibilities are provided by Xoserve through an Agency Service Agreement (ASA). From a business economics perspective, these create a highly *contractual* relationship between Xoserve and the GTs, which on balance make Xoserve appear and operate more like an IT outsource service provider than a customer facing subsidiary. Strictly interpreted, *ownership* involves who holds the equity of a company. However, whilst our terms of reference refer specifically to ownership, we have interpreted them as to include wider corporate governance arrangements, such as *control*.

We have been asked to identify and appraise other options, particularly those observed elsewhere in the energy sector, involving changes to the above, that could promote better provision of Xoserve's services.

Services provided

Xoserve provides services on behalf of the GDNs and National Grid Gas (NGG) National Transmission System (NTS) primarily in accordance with the terms of the ASA. The ASA details the

services to be provided by Xoserve and the service standards to be achieved. It also sets out the arrangements by which Xoserve charges GTs for its services.

At the previous Gas Distribution Price Control Review (GDPCR) Ofgem changed the funding arrangements for Xoserve introducing a Core Services and User Pays approach. Under this approach regulated services provided by Xoserve were classified as:

- *Core services* - regulated services that it was deemed appropriate to fund using price control allowed revenues. The costs associated with these services are spread across all customers through gas transportation charges.
- *User Pays services* – regulated services that is was deemed appropriate to fund using charges levied directly upon user (s) requesting the service. Revenue from delivery of User Pays services is treated as excluded from GTs price controls.¹

Both Core and User Pays services support the fulfilment of a number of the GT’s licence and UNC obligations; specifically:

- *Supply Point Administration* – this includes the registration of new meters and change of supplier registration;
- *Balancing and Settlement* – managing the flows of data to meters to provide invoices for billing shippers and energy balancing;
- *Capacity Management* – systems to allow shippers to book capacity on the distribution and transmission network; and
- *Energy consumption data services* – demand estimation/forecasting.

Although the business activities set out above differ in their nature, they *all* rely on the availability of timely and accurate data provision. The arrangements that have been developed would suggest that the provision of all of these IT services: (a) can be undertaken by a single entity (hence the “common agent”); and (b) the IT services provided are different from and separable from the business processes they support in terms of the entity that delivers them (the establishment of Xoserve as a separate legal entity and the ability to outsource specific identifiable IT services through the ASAs).

Future challenges for the gas industry

In future, the gas industry faces a number of changes from the need to adapt to a low carbon economy to delivering security of supply. Part of the challenge is moving towards new energy systems and business models than can support smart metering and strategic changes in gas markets and transportation systems. Xoserve has an important role to play in delivering these changes and supporting the new market structures and arrangements. The gas industry therefore requires a funding and governance framework for central systems and services that can support changes

¹ User Pays services are contracted bilaterally and through the UNC.

outlined but which are also flexible to accommodate changes and uncertainty of the future role of the GTs and their agent Xoserve.

Meeting current and future industry requirements

We have not been asked to review Xoserve's performance per se; however, we have needed to assess whether current arrangements have either supported or hindered the achievement or not of regulatory objectives. In the absence of a full review, we have relied on customer feedback provided to us both by Xoserve from its own surveys and that gathered through a limited survey that we have conducted of stakeholder views, including but not limited to Suppliers and Shippers.

From a contractual stand-point, as pointed out to us by Xoserve's management, Xoserve has fulfilled its obligations under the ASA, both within the regulatory allowance and to the required standards, as for evidenced, for instance, by Xoserve's own key performance indicators for 2010/11. This overall message is generally supported by the feedback that we received from stakeholders during the process of completing our review. Throughout our consultations we have consistently been told that on a day-to-day basis Xoserve is delivering its services and that its staff are professional and well qualified. Xoserve's management also set out the steps that have been recently taken to engage with Suppliers and Shippers in order to help identify and address any concerns that they might have.

Whilst in general there has been a degree of satisfaction with the services provided by Xoserve, our stakeholder consultations also identified concerns not just with User Pays services but also with Core services. Whilst not always fully articulated by stakeholders, their concerns seem to be based largely on a perception of, first, *poor responsiveness* to requests made by Shipper – particularly for services driven by change within the sector and which perhaps are more challenging or requiring a greater degree of resource or more innovative approach. Second, there was a degree of unease and even suspicion, regarding a general *lack of transparency* in the general arrangements, particularly as regards how charges for services are derived and their consequent value for money and how strategic decisions affecting the industry are taken. These views would appear to be consistent with views provided to Ofgem prior to it commissioning this review.

The role of funding, governance and ownership

We believe that the arrangements put in place for Xoserve's funding and governance, in particular, help explain these observations. Or put another way, what is observed is to a large extent a natural consequence of what has been put in place.

Although suppliers of business process outsourcing are typically not owned by their clients, for the most part Xoserve does act as the provider of outsourced IT services to the GTs who, in the main, are its arm's length, contractual customers to whom it is answerable. Whilst this relationship dictates much of Xoserve's business, in addition it has sought to develop direct relationships with Shippers and establish itself as the client interface (even for ASA provided service), rather than the GTs.

We consider that the restrictions created by the ASA arrangements, the ambiguity that exists as regards customer relationships and the indirectness of payment flows, all contribute to the observed lack of transparency and service responsiveness. Indeed, irrespective of the efforts made by Xoserve's management in improving customer management, these arrangements and structures are likely to increasingly militate against success as Shipper and Supplier demands continue to increase as a result of changes within the sector.

Such problems are compounded by Xoserve's regulatory funding arrangements which are more suitable to a large capital network operator, rather than an IT services provider. A more flexible means of funding would be more consistent with the investment requirements of such systems.

Perhaps to a lesser degree, Xoserve's ownership and corporate governance regime have not been appropriately focused to address these problems and have thus also contributed to the observed problems. Whilst there is a logic to current ownership arrangements and Xoserve's board fulfil their fiduciary obligations, there is little evidence of a corporate ambition beyond meeting the requirements of the ASA. The absence of ownership or control adds to the perceived lack of transparency on the part of other stakeholders.

Options for change

Although the industry has proposed a number of changes (focused predominantly on change management and industry governance) to help address the issues identified, we believe that these are unlikely to be sufficient to address the problems identified and therefore more radical options should also be included in a detailed consultation exercise.

Having considered carefully the analysis in this report, there seem to us to be three credible options that could be considered further.

The first (Option A) would involve optimising the current arrangements through reforming industry governance (change management) *alongside* the funding framework. We would suggest that funding issues are best addressed through a more negotiated, rolling form of settlement rather than the regulatory arrangements that exist at present.² This will allow a greater degree of flexibility to meet industry requirements, as well as improving visibility as to how the funding requirement is established. Ofgem will still need to be prepared to step in – if required – to protect final consumer interests or to drive strategic industry change.

Where the existing regulatory and contractual framework for GT Agent services remains in place (as envisaged for Option A), it would be the GTs rather than Xoserve who would need to lead the negotiated settlement with industry participants.

The second approach (Option B) would be to remove the contractual arrangement (i.e. ASAs) between Xoserve and the GTs, making Xoserve a fully “empowered”, direct customer-facing

² This might be achieved either through extending User Pays or a formal negotiated process with a rolling budget funded through an identified /specific revenue term in the GTs principal revenue formula.

subsidiary, with a separate licence. In this case an empowered Xoserve would lead a negotiated settlement and budget with industry participants.

A third, more radical change (Option C), involves a cooperative approach where there is joint industry ownership and control of Xoserve. This would involve a step change in the way the gas industry delivers and governs central systems and services, with funding provided by Xoserve's shareholders/stakeholders according to recharge arrangements.

Evaluation

As regards Option A, we do not believe that the ASA arrangements remain fit for purpose if a more responsive Xoserve is desired. This leaves the two alternatives. A minimum means of achieving a more responsive Xoserve would be to move relevant licence obligations from the GTs to Xoserve, which will help empower it as a more customer facing subsidiary (i.e. Option B). The alternative is a more cooperative body (Option C) which would require collective engagement and accountability for Xoserve across industry stakeholder groups.

The benefits of Option B, as compared with the current arrangements, is Xoserve's role in the gas sector and its accountability to different industry participant groups would be made clearer and more flexible by removing the ASAs. There are risks with this model; considerable behavioural change would be required from GTs, Xoserve and other industry participants. While the principles of negotiated settlement in the context of Xoserve's business are in our view sound, the model is also largely untested in the regulated GB energy sector.

In contrast, cooperative ownership and governance would align industry incentives and interests, and potentially avoid the complexity of regulatory funding, obligations and governance under Option B. There is also precedent in other parts of the energy industry of a "cooperative" model having been a relative success. However, of all the available options a cooperative model may require greatest upheaval of the current arrangements.

There are costs and risks either way. With both Options (B and C) there is a risk that with the industry undergoing a period of change on many other fronts, radical changes to Xoserve funding, governance and ownership act to undermine the capacity for Xoserve to respond quickly to required changes rather than promoting responsiveness as intended. There are implementation challenges with either approach.

Ultimately, the optimal arrangements would, in our view, seem to rely on answers to a number of high-level, but fundamental questions, which can only be addressed through further consultation with different industry stakeholder groups:

- First, are the activities and systems managed by Xoserve separable from gas transportation businesses? If complete functional separation were considered challenging, or indeed impossible, then a fully licensed, empowered GT Agent subsidiary model might on balance provide the optimal arrangements for the future (on the basis of being the most practicable option for addressing identified issues).

- Second, following from the first question, are the activities performed by Xoserve “cooperative” in nature. With UNC administration under separate governance from Xoserve, is a shared ownership / interest model in this context appropriate? If the answer is yes, and Xoserve’s systems and services are separable from the GTs business, then a cooperative model could provide the optimal arrangements.
- The next question is what appetite is there amongst industry participants outside the GTs to assume a greater role, responsibility and therefore *accountability* for Xoserve and its activities?³ Xoserve provides critical industry services, and will have a role to play in facilitating smart metering. A cooperative body would require Shippers, for example, to invest resource and potentially their own capital into the business as part of their collective industry responsibility for the services provided.
- Finally, are the systems and services provided by Xoserve of such criticality to the industry during a period of already significant change in the energy sector, that fundamental change to Xoserve funding, governance and ownership raises too great a risk? If the answer in this case is yes, then Option A would need further consideration, recognising there will be limits of what can and might be achieved.

Recommendation

We believe that the precise arrangements need to be determined by an industry Consultation which further explores the respective costs and benefits of each option and industry participants views on the consultation questions outlined above.

³ Indeed, is the desire and envisaged role in Xoserve corporate governance and ownership the same across different industry participant groups?

1. INTRODUCTION

CEPA has been appointed by Ofgem (the GB gas and electricity markets regulator) to undertake a review of the funding, ownership and governance arrangements for Xoserve. The study will support a future consultation on these arrangements by Ofgem on these issues as part of the RII0-GD1 price review process.

Xoserve is a limited company founded in May 2005 following the restructuring of the gas distribution sector and National Grid's sale of four of the gas distribution networks (GDNs) to three new owners (Scotia gas networks, Northern Gas Networks and Wales and West Utilities).

As we explore further in the rest of our report, at its heart, Xoserve's business is primarily the supply of many of the core information system services required for the gas industry to operate, both in terms of network and market operations. Based on these resources, Xoserve is also able to provide ancillary services such as invoicing to gas Shippers on behalf of Great Britain's (GB) principal Gas Transporters (GTs). The GTs are responsible for transporting gas through the eight distribution networks in GB and the National Transmission System (NTS). Xoserve's owners include the major gas distribution network companies and National Grid's gas transmission network business.

Xoserve is the vehicle through which several of the GT's obligations are fulfilled; specifically:

- *Supply Point Administration* – this includes the registration of new meters and change of supplier registration;
- *Balancing and Settlement* – managing the flows of data to meters to provide invoices for billing shippers and energy balancing;
- *Capacity Management* – systems to allow shippers to book capacity on the distribution and transmission network; and
- *Energy consumption data services* – demand estimation/forecasting.

These services – so-called GT Agent services – are all delivered through the management and operation of a number of major information systems. An integral part of the management of these systems, is undertaking changes and upgrades, made necessary by industry reforms and modifications to the Uniform Network Code (UNC), the main industry code for the gas industry.

1.1. Objectives of the review

Ofgem's terms of reference ask us to consider specifically whether Xoserve's current *funding, governance* and *ownership* arrangements have ensured regulatory objectives, of least cost provision of services, quality of services and responsiveness to requests from Suppliers / Shippers. As such, this is more of an appraisal of the parameters within which Xoserve operates, rather than Xoserve's performance itself - a detailed operational review of Xoserve being outside of our terms of reference.

Irrespective of how existing arrangements may have been and may even continue to be, fit for purpose, we are required to identify and evaluate alternative options to the current arrangements, drawing on lessons from other sectors and what changes these models might infer for Xoserve's existing funding, governance and ownership..

We have been asked to identify the impact that industry changes, such as smart meter rollout, will have on the nature GT Agent services required and how these services and Xoserve's role in the GB gas industry might need to change, and hence the funding, governance and ownership arrangements that might be required to accommodate these changes. As regards the broader landscape of data services in the gas and electricity industries, this includes the respective roles of Xoserve, Elexon and the Data and Communications Company (DCC). We are not, however, required to undertake a detailed consideration of the broader landscape of data services in the gas industry post- smart metering or the estimation of the future efficient costs of Xoserve. Our full terms of reference can be found at Annex A.

In addressing these terms of reference, and thinking about options for change, we are looking for evidence to suggest that change is indeed needed and that any changes are appropriate given the objectives set out. However, given the relatively limited nature of the review, we recognise that much of the evidence provided is through the views expressed by stakeholders, together with Xoserve's customer feed-back records and our interpretation of such information.

1.2. What is meant by funding, governance and ownership and why are they important?

In considering funding, governance and ownership issues as they relate to Xoserve, it is important to set out our understanding of these terms and their application in the regulated gas industry in which they operate.

1.2.1. Funding and industry governance

To a degree, there is a strong overlap between funding and industry governance.

Funding

Funding refers to the way in which Xoserve is remunerated for the services it provides. This is separate from financing which refers to how Xoserve finances its capital and operational expenditures. In the context of the regulated gas sector, as will be explained in detail in Section 2, Xoserve currently receives most of its income from its GT owners and customers. GTs recover allowed revenue for certain services through network charges to Shippers, and then remunerate Xoserve for provided those services under an Agency Services Agreement (ASA).

Industry governance

Industry governance relates to how entities within the wider gas sector are regulated. As regards Xoserve this includes the basis on which and how frequently regulatory allowances for the services provided by Xoserve are established and who is involved in determining that level.

Moreover, when Xoserve was established, regulatory requirements also prescribed the relationship between Xoserve and the GTs. In particular, certain of the GTs responsibilities are provided by Xoserve through a series of service agreements, which as we will discuss provide an explanation as to why Xoserve operates in the way it does.

From this perspective, we are interested in whether or not existing industry governance arrangements are appropriate given Xoserve's operational requirements, especially the price control process and the contractual arrangements through which Xoserve delivers its services.

1.2.2. Ownership

Strictly interpreted, ownership involves who holds the equity of a company. However, whilst our terms of reference refer specifically to ownership, we have interpreted them as to include wider corporate governance arrangements, such as *control*.

In the case of Xoserve, the question to be addressed is one of whether its structure, ownership and corporate governance arrangements, including Board membership, are appropriate to the role that it is expected to undertake by the industry as a whole.

We go on to explore these issues further in the later sections of our report.

1.3. Approach to the review

Our approach to the review has been based upon an initial consultation exercise with a selection of industry stakeholders in order to identify any issues; including Xoserve, the GTs, shippers, suppliers and other relevant stakeholders (including independent Gas Transporters (iGTs)). We would like to thank both Xoserve, who have been responsive and open to our different requests and to other respondents and industry stakeholders who met with us over the course of the project and who provided useful and informative responses to our questionnaire. A summary of the responses received are provided in Annex B.

Our first key output from this, has been to identify specific issues and concerns in the way in which Xoserve operates and the services it provides and the extent to which these may be caused by the current funding, governance and ownership of GT Agent services. It should be noted that Ofgem has commissioned this review following concerns raised by the Shipper community.

The second output has been to develop appropriate options which we believe might address the issues identified, which might include, but not necessarily be limited to, changing current funding, governance and ownership arrangements; but only so much as such options might have reasonable prospects of addressing the issues identified and lead to benefits compared to any costs that arise (i.e. the advantages outweigh the disadvantages).

We have therefore considered a range of options for changing GT Agent funding, governance and ownership, from those which would both complement the current arrangements and lead only to incremental change, through to those that would revise substantial aspects of the current arrangements. In reaching our conclusions on possible changes to the current arrangements, we

have, however, been mindful of implementation issues, unintended consequences and the specific issues raised by industry stakeholders.

We have reviewed the identified options in more detail against a set of criteria developed for the project. These criteria are, in no particular order:

- the *efficient* provision of services provided by Xoserve;
- the provision of good *quality* of service;
- *responsiveness* of customers' needs;
- the ability to *accommodate future industry changes*; and
- the ease of implementation.

Finally, as part of our overall conclusions to the review, we have set out a recommendation of what would, in our view, achieve the optimal “package of changes” to the current framework of gas central agency service funding, governance and ownership.

1.4. Structure of the report

The remainder of the report is structured as follows:

- Section 2 provides an overview of the relationships between GTs, Xoserve and Shippers.
- Section 3 provides a detailed analysis of the services provided by Xoserve.
- Section 4 considers industry change and the future role of gas central services.
- Section 5 summarises findings of the UNC 334 Review Group.
- Section 6 provides our assessment of the issues.
- Section 7 sets out incremental change options.
- Section 8 outlines change options to regulatory, corporate governance and ownership.
- Section 9 provides our review conclusions and recommendations.
- Annex A provides our terms of reference.
- Annex B summarises responses to the stakeholder questionnaire.⁴
- Annex C provides more detail on Xoserve's services.
- Annex D considers iGT incorporation within a single service provider.

⁴ The views of individual respondents have been kept anonymous.

2. OVERVIEW OF XOSERVE'S GOVERNANCE AND FUNDING ARRANGEMENTS

In this section, we examine how Xoserve fits within the architecture of the gas industry, specifically its relationship to its owners, the GTs and to Shippers, and the different governance and funding arrangements that currently operate (“the current regulatory and commercial framework for gas common services and systems”).

2.1. What is Xoserve and what does it do?

Following completion of distribution network sales in 2005, the GTs were provided with a licence obligation (Standard Special Condition (SSC) A15) to appoint an agency (the “GT Agent”) for the common provision of certain services and systems. This obligation was satisfied through the creation and appointment of Xoserve as the GT Agent in 2005.

Xoserve is jointly owned by the GTs, with National Grid’s transmission business holding a stake of 11 per cent, National Grid Gas (NGG) distribution 45 per cent, Scotia gas networks 24 per cent, Northern Gas Networks 10 per cent and Wales and West 10 per cent. The balance of shares reflects the size of the GTs (i.e. the volume of services each GT takes from Xoserve) the level of exposure and liability of each GT company in the event of service failure and the respective requirement to finance Xoserve’s activities. The ultimate parent company of Xoserve is National Grid plc which remains its majority owner.

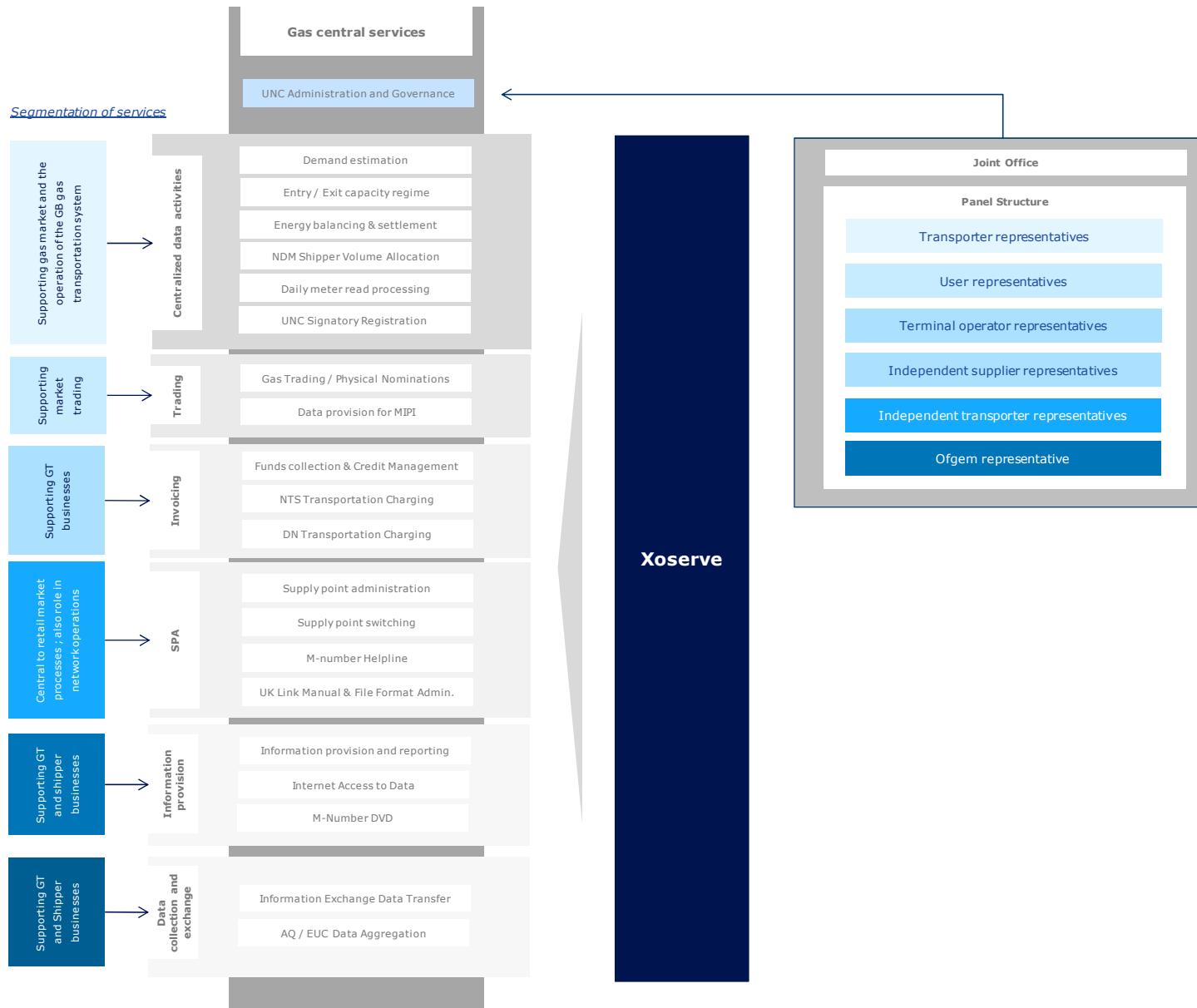
Xoserve operates information systems and support centres to deliver common services and systems. The range of centralised gas transportation services provided by the GT Agent is defined in the GTs’ Uniform Network Code (UNC) and licences. With the exception of the Gemini system (which is owned by National Grid’s transmission business and supports gas nominations, balancing and capacity booking) Xoserve is also owner of these systems. An important part of the business is *managing change* to those systems, driven by industry reforms and modifications to the Uniform Network Code (UNC), the main code in the gas industry.

Many of these services and functions support the gas transportation businesses. Other functions, however, support “market facilitation and operation”. What they have in common is a reliance on core IT service provision. There are reasons (including economies of scope) as to why these activities are undertaken by a single entity.

Unlike in the electricity sector, in the gas sector the *administration* of the commercial gas transportation and market code system is currently separate from the *operational* activities performed by Xoserve. It is the Joint Office of Gas Transporters which administers the UNC, while Xoserve performs many of the activities and processes that *support* this commercial code of practice. Xoserve helps to discharge certain activities and processes governed by the code, but is currently not part of the regime of change governance. This role is performed by the GTs whose licence obligation it is to provide certain services and systems.

Figure 2.1 sets out the different types of activity supported by Xoserve, differentiating between the role of Xoserve and that of the Joint Office, which is responsible for the UNC.

Figure 3.1: Types of activities supported by the services provided by Xoserve

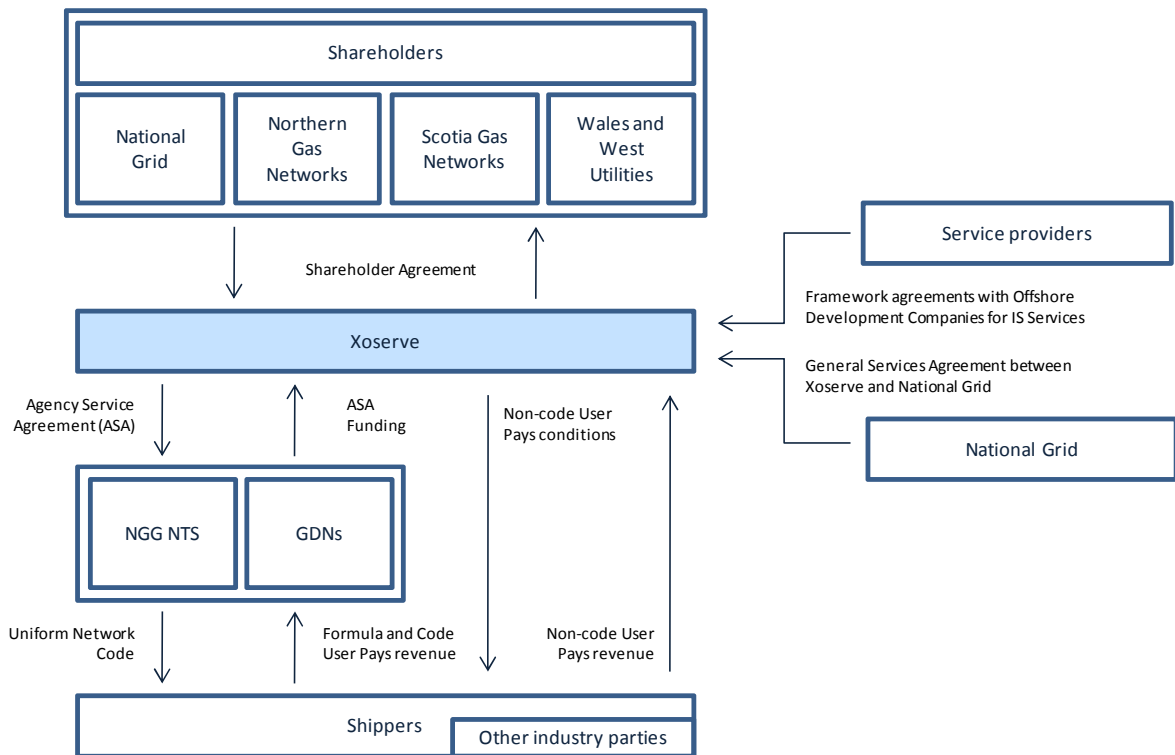


As we explore further in the rest of our report, at its heart, Xoserve’s core business is one of being an information service provider that that supports change management within the gas sector, although the company also operates a number of other services, including operational research and a customer service centre. It should also be noted that Xoserve sub-contracts certain support services to off-shore IT service providers.

2.2. The ownership and contractual relationships between GT and Xoserve

Figure 2.2 provides an overview of the ownership as well as contractual arrangements through which Xoserve operates. It shows the shareholder agreement between Xoserve and all of its shareholders, the General Services Agreement between Xoserve and National Grid and the framework agreements with offshore development companies for provision of certain information system services.

Figure 2.2: Xoserve contractual structure



Source: Xoserve / CEPA

As set out, a key part of industry governance is the licence obligation that GTs have in place an Agency Services Agreement (ASA) with an entity – i.e. Xoserve – to provide common services and systems. The requirements of the GT Agent role (as set out in ASA) are based on the GT’s

regulatory obligations as defined in the UNC and GTs licences. These are termed “Core Services” and “Code User Pays Services” (User Pays Services for which GTs have UNC responsibilities).

Through the establishment of the GT Agent role; it would appear that the different GTs have essentially *outsourced* the provision of the services that such licence obligations require them to provide, to Xoserve. It is not a typical IT outsourcing arrangement, in that Xoserve is owned by and therefore is a subsidiary of, the entities that it provides services to; it has its own identifiable brand and owns several of the IT systems it operates. However, for the most part the Shippers to whom Xoserve provides services are in fact the customers of the GTs, who remunerate the GTs through use of system and other charges, who in turn remunerate Xoserve through the ASAs.

From a business economics perspective, this highly *contractual* relationship between Xoserve and the GTs, established through the ASAs which dictate much of what Xoserve does, which on balance make Xoserve appear and operate more like an IT outsource service provider than a customer facing subsidiary⁵. Details of the different contractual relationships between Xoserve, the GTs and Shippers are set out in Table 2.1, which also sets out the funding mechanisms related to each.

Table 2.1: *Contracts and funding arrangements*

Contract	Services	Funding
Agency Services Agreement with GTs (<i>contract between GTs and Xoserve</i>)	Core Services for which GTs have UNC responsibilities and regulatory licence obligations	Xoserve is funded by GTs through their allowed revenues set under periodic Price Control Reviews
	User Pays Services for which GTs have UNC responsibilities	Charges are cost reflective and based on the utilisation of the service. For the purposes of GTs’ Price Controls, these services are treated as excluded services.
Framework Contracts with Shippers (<i>contract between Xoserve and shippers</i>)	User Pays Services for which GTs have regulatory licence obligations	
Other bilateral contractual arrangements (<i>contract between shippers and Xoserve</i>)	Services are individually tailored to meet specific customer requirements and are outside the scope of GTs’ UNC responsibilities and regulatory licence obligations	Xoserve receives payment directly from those parties that request the services

Source: Xoserve / CEPA

As shown in Table 2.1, Xoserve provides certain services directly to Shippers outside of the ASA. These account for only a small proportion of the services provided and therefore have little impact on the relationship as described above. Framework agreements between Xoserve and Shippers apply for services for which GTs have regulatory licence obligations to deliver, but which sit outside GT UNC responsibilities (these services are known as non-code User Pays Services).

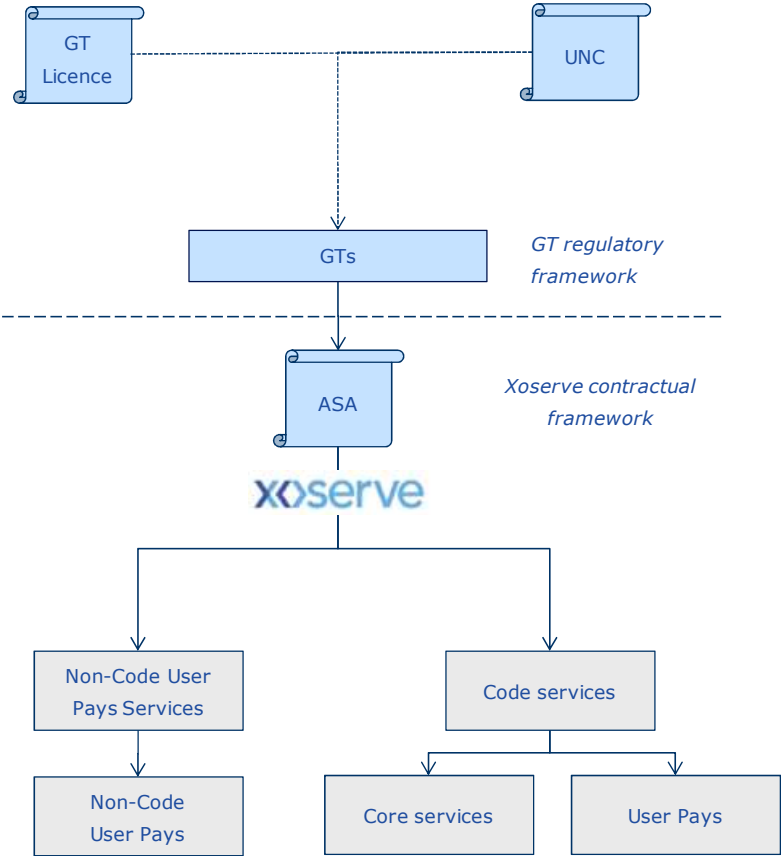
⁵ Companies such as Accenture and IBM are also providers of so-called IT business process outsourced (BPO) services.

The company also provides certain services through additional bilateral contractual arrangements. These bilateral agreements are used for specific customer service requirements which are also outside the scope of GTs UNC responsibilities and their regulatory licence obligations and are also provided directly to Shipper customers and not under the terms of the ASA through which Xoserve provides services on behalf of the GTs.

2.3. Regulatory governance

As described above, GT Agent services are those services provided by Xoserve in its capacity as the GTs’ Agent, which are provided under the ASA. As described above, this defines the scope and definition of Xoserve’s GT Agent services. From a regulatory governance perspective, Xoserve discharges certain of the GTs’ service obligations as defined by their regulatory licences and the UNC. Figure 2.3 illustrates this combination of contractual and regulatory governance framework and flows for agent services.

Figure 2.3: GT Agent services – current governance framework



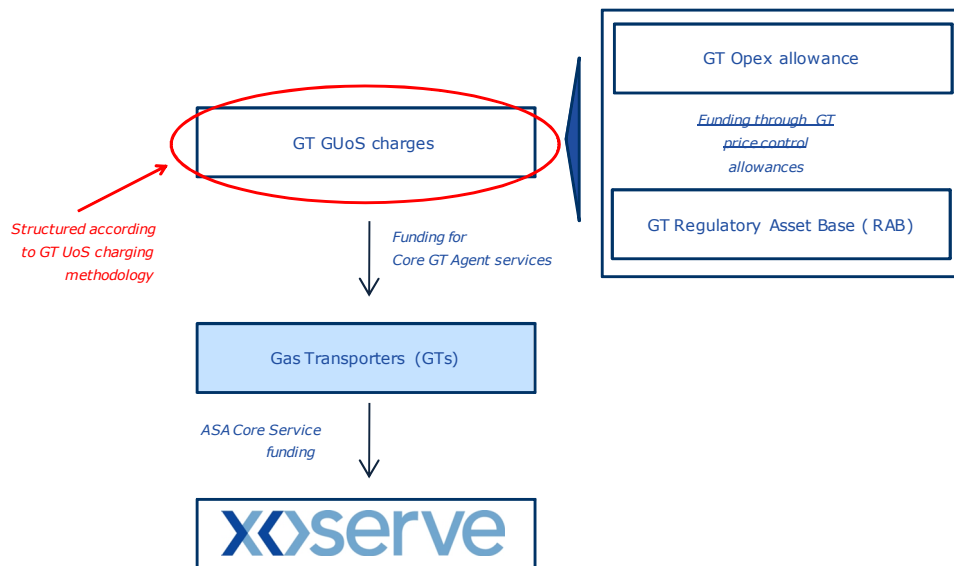
Source: Xoserve / CEPA

The section which follow consider the funding arrangements for these services.

2.4. Funding

The amount payable for Core Services under the ASA is determined by the regulatory allowance that the GTs are able to charge Shippers under the Use of System framework, as illustrated in Figure 2.4. This revenue is allocated to allow Xoserve to provide its Core Services for which GTs have UNC responsibilities and regulatory licence obligations.⁶

Figure 2.4: Xoserve funding arrangements



Source: CEPA

In addition to the revenues received from the GTs price controls, as shown in Table 2.1 above, Xoserve earns additional revenues for providing services which are beyond the scope of Core Services established at the price review. These services are known as “User Pays”.⁷

The funding framework of User Pays services was implemented at the previous Gas Distribution Price Control Review (GDPCR) with the objective of ensuring users of Xoserve services were aware of the costs they impose on Xoserve when requesting new functions. In theory, User Pays ensures that only functions which are valued by industry participants are implemented and provides an incentive for Xoserve and its owners to earn additional revenue and profits from central agency services (User Pays services are treated as excluded services).

SSC A15⁸ of the GT licence requires the GTs to publish an Agency Charging Statement (ACS) which sets out the scope of agency services, the methodology for deriving User Pays charges and the

⁶ See: Uniform Network Code: Transportation Principal Document Section V paragraph 6 which can be found on the Joint Office of Gas Transporters website [here](#).

⁷ The User Pays arrangements are implemented in the Gas Transporter Licence through the Standard Special Condition A15 (Agency).

⁸ A copy of the SSC A15 can be found on the Ofgem website [here](#).

charges themselves. Any amendments to the ACS must be approved by the Gas and Electricity Markets Authority (GEMA) referred to as the Authority.

As illustrated by Figure 2.3, User Pays services are differentiated by services for which GTs have UNC responsibilities (Code User Pays services) and User Pays services for which GTs have regulatory licence obligations (Non-Code User Pays services):

- Code User Pays services are managed through the ASA contractual mechanism; while
- Non-Code User Pays services are managed through framework contracts with shippers.

The ACS provides Shipper customers with detail of the charging methodology and the level of charges for each of the User Pays services.

According to the ACS, Xoserve uses the Activity Cost Base (ACB) methodology to set the User Pays charges in line with Special Condition A15(3)(ii) of the Gas Transporters' licence. Xoserve does this by developing an estimate of the costs of providing each of its services (including administration costs and a margin of 6%); and then dividing the cost by the forecast demand in order to establish the price after adjusting for any over or under recovery in the previous year.

The charging methodology seeks to ensure that User Pays charges reflect the costs of providing services, and so that they do not unduly discriminate between any of the different Users. There are defined industry governance processes to determine whether or not services are User Pays services, the parties who are to fund the investment and the charges for use of the implemented service.

2.5. Summary

In this section we have reviewed the establishment of Xoserve limited and the prevailing regulatory, contractual structures and funding arrangements that apply to its business.

In establishing these arrangements, the ASA and shared GT ownership of Xoserve, would appear to have been based on a recognition of the GTs common interest in directing and managing Xoserve since each of the gas network businesses has regulatory obligations covering activities that are sub-contracted to Xoserve as their appointed agent. The corporate governance and ownership arrangements of Xoserve provide the GTs with the means to manage risk of failure to discharge their regulatory obligations.

A fundamental point to note, however, is that for the most part Xoserve provides its services through arrangements in which it acts very much like an outsourcer, rather than a direct customer facing subsidiary of the GTs. From a *contractual perspective*, in most part the GTs are Xoserve's customers, with in turn, the Shippers being the customers of the GTs.

3. OUR UNDERSTANDING OF GT AGENT SERVICES AND GOVERNANCE ARRANGEMENTS

3.1. Introduction

Whereas in the previous section we set out the framework within which Xoserve operates, in this section we set out our understanding of GT Agent services and how industry governance arrangements operate in practice.

We begin by analysing the services provided by Xoserve in greater detail. We then consider the rationale for such services being provided by a single agency and how they differ from the other activities undertaken by the GTs. We then consider who is benefiting from the provision of the services provided by Xoserve, given contractual arrangements. Finally, we examine the role of different industry participants in the governance of Xoserve, including the determination of industry service requirements and the funding of those services.

3.2. Segmentation of IT services provided by Xoserve

In this subsection, we consider the nature of the services provided by Xoserve and the key industry functions supported. As a provider of IT services which underpin many aspects of the operation of the GB gas industry, Xoserve typically provides data and other information which the industry participants require to make decisions, although it does provide a few ancillary services itself, such as the provision of a call centre and invoicing services, most of which are based upon the data that it collects.

The range of services provided by Xoserve are central to the economic and efficient operation of the gas transportation system; but equally they are important to the commercial operation of the GB gas wholesale and retail markets (particularly settlements/energy allocation and supplier registration).

Annex C describes services provided by Xoserve in detail, together with the industry functions they support. In this section, we summarise Xoserve's role as it relates to different activities undertaken in the gas sector.

3.2.1. Gas transportation

It is clear that many of the services provided under the GT Agent functions are critical to the operations of the gas transportation businesses. For example:

- NTS and GDN transportation billing is clearly an activity that even without a single agency is central to the running of network businesses.
- Equally there are operational activities of the GT Agent related to balancing that support activities performed by the transmission system operator (SO).

- Xoserve provides consumption, interruption and trading data to NTS on each business day to support the SO role.
- The role Xoserve performs in the operation of the NTS entry / exit capacity regime also follows from core network services.

3.2.2. Trading

Other major functions and activities provided by Xoserve support “market facilitation” and “market operations”. For example, provision of the centralised data activities for settlement processes including demand estimation, annual quantity, allocation and reconciliation; and provision of the private data network to manage the flow of information between parties within the gas industry.

3.2.3. Other activities

Other agency activities are also a critical part of running a gas networks business. For example, gas meter supply points are effectively the connection points to the GDN operators’ existing networks. Maintaining a register of and administering supply points is therefore important to their network management activities. GTs utilise the data and information in the supply point register to manage the day to day operation of their businesses. Equally, supply point/meter registration is also a central and critical part of gas retail and supplier switching processes.

3.2.4. Key IT systems

The major IT systems involved in service provision are as follows:

- The Gemini application supports gas management, energy balancing and associated invoicing processes on behalf of National Grid Transmission and the Shipper Community. For example, it supports gas nominations and exit capacity booking. National Grid is the owner of Gemini system whilst Xoserve has taken on full responsibility as system manager and system operator.
- The UK Link system carries the GT supply point register that holds a record of the contractual relationship between the registered Shipper at each supply point and the relevant GT, along with a set of supply point attributes. This information enables retail customers to switch between suppliers. The UK Link system also stores and processes meter reads, energy consumption and tariff information, and is used by both the gas transporters and the gas Shipper community. The system is owned by Xoserve.
- Xoserve is also responsible for the management and delivery of the information system ConQuest – an e-based query management system used by shippers, gas transporters and Xoserve. The system supports Xoserve’s management of gas industry participant queries regarding standards of services and data and is owned by the company.

3.3. Rationale for a single entity

Although the business activities set out above differ in their nature, they *all* rely on the availability of timely and accurate data provision. The arrangements that have been developed would suggest that the provision of all of these IT services: (a) can be undertaken by a single entity (hence the “common agent”); and (b) the IT services provided are different from and separable from the activities they support in terms of the entity that delivers them (the establishment of Xoserve as a separate legal entity and the ability to outsource specific identifiable IT services through the ASAs).

3.3.1. Commonality of services

As regards the GT Agent services that are provided through an ASA between Xoserve and the GTs, there would appear to be clear economies of scale and scope:

- suppliers and shippers are provided with a single point of contact with GTs;
- there are consistent processes across the GDNs; and
- duplication of systems of systems is avoided.

Many of the functions performed by Xoserve are in some way linked to the operation either of a gas transmission or distribution system. They are therefore “suited” to a central service provider responsible to the GTs. This particularly applies to certain balancing activities and transportation billing and invoicing.

Whilst the GTs have outsourced the provision of the IT and related aspects of their licensed service obligations to Xoserve; the provision of specific aspects of these services is contestable, in the sense that they can be further outsourced to other service providers. Indeed, Xoserve already operates its own framework agreements with offshore development companies. We understand nearly two-thirds of its cost base is provided through outsourced service provider contracts.

As evidenced by DNO arrangements for meter point registration activities in electricity distribution, and the service provider arrangements in place for electricity settlement activities through Elexon, the services currently performed by Xoserve could potentially be split further along the lines of:

- customer services;
- information system services; and
- data storage and systems.

While arrangements in the electricity sector illustrate that not all the activities currently performed by Xoserve need *necessarily* be provided by a single central agent, the current central provision of agency services in gas means benefits of economies scale and scope can be realised within the industry.

3.3.2. Distinctiveness of services

The services provided by Xoserve differ in several ways from the network and other activities that they support. As regards gas transportation, IT service provision:

- is less capital intensive, systems have shorter asset lives and different project management and planning requirements, particularly as regards shorter planning horizons; and
- is arguably more customer focused activities affecting *both* the operation of the transportation system but also wholesale and retail markets.

Moreover, whilst expenditure on these services may be small relative to the Regulatory Asset Base (RAB) of the NTS and distribution system, they are critical to industry operations. In other words, their importance is significantly disproportionate to their cost.

However, implementing and updating the central systems that support gas retail competition and system operation is no small undertaking. The sector's service and system requirements are dependent on industry decisions on system operation and market design. In GB gas these are principally managed through the UNC. In the future, other industry codes such as the Smart Energy Code (SEC) may affect requirements from central systems.

The legacy systems designed at the GB gas sector's liberalisation, add additional complexity to the operational management and investment cycles of Xoserve services.

Therefore, while many different system solutions and service models are in theory available, the planning and restructuring processes to implement them will always be complicated, dependent on the requirements of many different industry participants and reliant on the future flexibility of existing legacy information system infrastructure.

3.4. Incentives on industry participants

The current funding arrangements for Xoserve's services place incentives on different industry participant groups.

Core Services are funded through the GTs price control allowances; the GTs submit a business plan at the beginning of the price review process and Ofgem sets an ex-ante allowance for the duration of the price control period (historically five-years). There is then an incentive on the GTs to control Xoserve's costs over the course of the price control period as any savings are retained as profit, or indeed losses against the settlement avoided. Costs are targeted on network users through the structure of gas network use of system charges.

Incentives on industry participants under User Pays are slightly different. There is an incentive for the GTs to earn additional revenues as these service are treated as excluded services from their price controls. For this reason, Xoserve charges a margin on the costs it incurs in delivering User Pays services. The margin that Xoserve charges in respect of User Pays services reflects a level of return that is considered appropriate to the degree of business risk inherent in their provision.

There is also an incentive on the users of User Pays services (like any contractual arrangement) to consider the cost they impose on Xoserve.

3.5. Role of industry participants in the governance of central agency services

Having considered the beneficiaries and users of GT Agent services, in this section we consider the role of industry participant groups in the governance and funding of those services.

3.5.1. Role of corporate governance in Core Xoserve activities

Xoserve as the outsourced service provider to the GTs exists primarily to discharge certain obligations on behalf of its contractual customers the GTs. The corporate governance arrangements for Xoserve might reasonably be expected to focus on ensuring:

- service quality and performance standards are achieved by the business in order that GT licence obligations continue to be discharged by their agent;
- financial targets for GT Agent services set at the price control determination are met by Xoserve's management; and
- principal business risks and uncertainties that face the business are managed effectively and are subject to appropriate corporate oversight.

The principal risks for Xoserve's *owners* (i.e. the GTs) are the failure to meet their licence and UNC obligations within allowed revenues:

- At the time of the price review, the key issue for the GTs (as with other parts of their regulated business) is engaging with the regulator over the *amount of funding* provided through the price control to manage the support central systems and services.
- Over the course of the price control period, the key issue for the Xoserve Board is ensuring strategic investment in information systems is delivered, performance of Xoserve management, staff and general delivery of services is monitored.
- For example, Xoserve's Board and management monitor Shipper customer satisfaction targets (as illustrated in Xoserve's recent Shipper eNews letter⁹) and the financial targets set at the price control review.

3.5.2. Role of industry governance in Core Xoserve activities

Network users, GTs and the industry regulator through UNC governance arrangements set the commercial framework for the GB gas market and transportation system. The ASA (and its contract managers) manages the *operational* and contractual relationship between Xoserve and the GTs.

⁹ http://www.xoserve.com/docs/e-News_Issue11.pdf

While network users are part of the governance framework of the UNC, they play little or no part in the contractual management of Xoserve and its day to day delivery of its activities.

Historically, network users have instead input into the funding of network and market IT services through the price review process, with consultations held by Ofgem at different stages of the ex-ante determination of service requirements and funding.

Project Nexus has however, involved a slightly different process. The text box below summarises some of the key features of Nexus.

Case Study 1: Project Nexus

- Project Nexus is Xoserve's vehicle for industry engagement to gather and define strategic service requirements for the medium to longer term.
- The first phase of Project Nexus identified the topics to be considered. The project has now developed to a Requirements Definition phase.
- The Project Nexus Requirements outputs will in future need to be converted into UNC modifications and funded through the GT price control allowances.
- The Project Nexus UNC workstream (PNUNC) is a group formally constituted under UNC governance and accountable to the UNC Panel.
- Xoserve's PNUNC board has ultimately been responsible for sign-off of the requirements and brief developed over the project to date.
- The Project Nexus Advisory Group (PNAG) was also established to promote Project Nexus and to provide advice and support to Xoserve during the requirements definition phase.
- The Advisory Group is constituted from a broad cross-section of industry participants with Xoserve responsible for chairing the meetings.

3.5.3. Role of industry governance in User Pays services

As summarised below, Code User Pays services are handled through industry governance arrangements under the UNC.

Case Study 2: UNC Code Governance and User Pays

- The UNC Panel comprises a Chairman and deputy Chairman appointed by the GTs, five voting representative for the GTs and five voting user representatives.
- There are also a number of non-voting representatives from iGTs and independent suppliers and a representative from Ofgem – Xoserve is a not a party to the UNC panel.
- The ACS provides users with detail of the charging methodology and the level of charges for each of the User Pays services (as defined during industry dialogue at the inception of User Pays).
- The ACS is updated whenever revisions are made to service charges or the services offered under the User Pays framework change.
- For UNC Modifications, User Pays (and consequent cost sharing through the ACS between stakeholders) is part of the UNC modification process.
- A “User” proposes an amendment to services under the UNC and the industry then enters into a debate about funding shares for proposed change.
- Xoserve generates the information needed to support the debate on the level and structure of User Pays charges (where they are not already a part of the ACS).

As discussed previously, framework contractual arrangements are in place with Shippers for Non-Code User Pays services. The contract and conditions for Non-Code User Pays services have been drafted with regard to the provisions of the ACS and the proposed SSC A15 to reflect the requirements for the charges for User Pays services, so far as reasonably practicable, to be cost reflective and to not unduly discriminate or prefer any person. Change management is brought into force through a contractual mechanism.

3.6. Summary

In this section we have set out our understanding of the detail of GT Agent services and how industry governance arrangements operate in practice.

We have considered the rationale for such services being provided by a single agency and how they differ from the other activities undertaken by the GTs. We have also considered who is benefiting from the provision of the services provided by Xoserve given contractual arrangements and the role of different industry participants in the governance of Xoserve.

In the section which follows, we consider industry changes affecting Xoserve’s business and the UNC review of the funding and governance of GT Agent services.

4. INDUSTRY CHANGE AND THE FUTURE ROLE OF GT AGENT SERVICES

4.1. Introduction

The gas industry faces a number of changes, most importantly the need to adapt to a low carbon economy whilst delivering security of supply. Challenges to be addressed in the near future include the future development of European gas markets within the framework of the ‘Third Package’ and the roll-out of smart metering for the gas market. In this section we consider how these might affect the context within which Xoserve operates and its future role in the gas industry.

4.2. GT Agent services in RIIO-GD1 and RIIO-T1

Last year, Ofgem announced a new approach to network regulation: RIIO (Revenue = Incentives + Innovation + Outputs). The first price control reviews that will implement this new model of regulation are RIIO-T1 and RIIO-GD1, which will cover transmission and gas distribution respectively. Part of the new regulatory framework is to look at new business models, deliverables and outputs to support sustainability and security of supply objectives in the gas sector.

Within this context, the GTs and their central agent Xoserve are developing their business plans for the forthcoming eight year price control. Xoserve has begun to develop a “strawman” of the likely set of outputs that it should plan to be capable of supporting over the duration of the GT price control review period. The existing strawman for the purposes of price control business planning has been tested with stakeholders and developed to reflect:

- The feedback that Xoserve has received to date through its Project Nexus industry consultation and engagement on future service requirements.
- The implications of the initial and future role and responsibilities of the DCC as set out in the conclusions to the Smart Metering Prospectus (see below).¹⁰

The strawman has informed the preparation of Xoserve’s business plan for the provision of GT Agent services in RIIO-T1 and RIIO-GD1

As stated in the introduction, it is not part of our terms of reference to consider the scope or nature of GT Agency services in the forthcoming GT price control period. However, what is clear from the initial stage of the price review process and industry business planning is that some core agency services currently offered by Xoserve are expected to be subject to change over in the medium to longer term. There are states of the world in which:

- the essential scope and nature of Xoserve services would remain largely unchanged in the next GT price control period; however
- similarly there are also scenarios where Xoserve could do less or indeed more to support the transition to smart metering systems (for example).

¹⁰ Xoserve (2011): ‘GT Agent Services 2013-2021’

Roll-out of smart meters, in particular, is likely to have a profound impact on GB's gas market, and the GT's central IT services. For example, smart metering may in future precipitate changes to balancing and settlement arrangements in the gas sector.

Other issues could also affect the activities and future roles which the GTs, Xoserve and other industry stakeholders might be required to discharge.

For example, the gas industry continues to discuss whether arrangements might be put in place to facilitate independent Gas Transporter (iGT) participation in Uniform Network Code (UNC) agency services. There are also a host reforms to gas markets and transmission emerging from the European Union (EU) Third Package agreement.

The sections which follow, consider the changes arising from these areas and the possible implications for the GTs and their central agent Xoserve.

4.3. Support services for Independent Gas Transporters

iGTs develop, own, operate and maintain local gas transportation networks generally built to serve new housing developments. There are now around one million supply points that are served and managed by iGTs (this compares to around 22m supply points managed by Xoserve).

One of the considerations in the establishment of the GT Agent at the time of the GDN network sales was whether the new arrangements might facilitate a single service provider for all gas transporters, including iGTs.

Under current industry arrangements, the iGTs operate their own billing and registration processes (outside of the UNC and the GT Common Agent ASA). The feedback we have received from the stakeholder questionnaire (see Annex B) is that shippers face additional cost and complexity from having to deal with individual iGT systems and processes. This can increase the costs of serving iGT network customers. The iGTs are also growing in market share, and therefore providing their own systems may not be sustainable when smart meters are introduced.

There have therefore been discussions between industry parties as to the viability of iGTs services being delivered by Xoserve using common UNC standards. This alternative model would involve the migration of iGT's activities and systems and we understand may also create a new funding requirement to support a transition.

Industry and service level governance issues would also need to be considered as part of any transition. For example, the requirement for iGTs to become a more integrated part of UNC arrangements were a common service provider adopted.

4.4. Smart meter rollout

The Smart Meter Implementation Programme (SMIP) published its response to Prospectus consultation in March 2011.¹¹ The Government's response (and its supporting documents) set out

¹¹ DECC/Ofgem (2011): 'Smart metering implementation programme: Response to Prospectus consultation'

conclusions on the policy design for the implementation of smart metering including new obligations on suppliers to deliver the rollout, technical specifications for smart metering and the arrangements for managing smart meter data.

New obligations will be placed on industry participants to deliver this policy design. To deliver the rollout, energy suppliers will be required to procure and install smart meters for their customers. Suppliers will also need to install smart metering equipment that meets the required technical specifications and standards.

Data and communications in the domestic sector will be managed centrally by a new licensed DCC regulated in a similar way to other monopoly service providers in the energy sector. Unlike in the domestic sector, use of DCC services will not be mandated for the non-domestic sector.

The implementation of smart metering programme has three key phases:

- **Phase 1 (Policy Design)** (completed in 2011 Q1) reached policy conclusions and developed plans for the implementation of smart metering. These were set out in the Government’s response to Prospectus.
- The objective of **Phase 2 (Foundation)** (Q2 2011 to 2014 Q1) is to create a framework and build a state of consumer, business, market and regulatory readiness such that mass rollout can be commenced.
- **Phase 3 (Mass Rollout)** will start from Q2 2014 onwards with the objective to achieve the mass rollout of smart meters to the programme timescales. This phase will also see the DCC take on new functions in the form of meter registration services (see below).

Some of the key milestones specifically related to the management of smart meter data and communications are summarised in the table below.

Table 4.1: SMIP data and communications milestones

Activity	Milestone
DCC licence application process commences	Q2 2012
DCC licence awarded	Q4 2012
DCC service providers appointed	Q4 2012
Start of mass rollout	Q2 2014
Design DCC’s meter point / registration activities	No specific milestone
Transfer of meter point / registration activities to DCC	2016/17

Source: DECC¹²

¹² http://www.decc.gov.uk/en/content/cms/consultations/smart_mtr_imp/smart_mtr_imp.aspx

Both the installation of smart meters and the establishment of DCC will have a profound impact on the energy sector. Energy use, energy allocation and billing processes may in future change with improvements in data quality and access provided by:

- smart meters; and
- the communications and data retrieval services of DCC.

Energy suppliers will need to ensure their systems interface with DCC. Smart meter systems and processes will also need to operate and interface with other industry services and processes, including network transportation services. GT services will need to facilitate the transfer and use of the large volumes of data from smart meters.

Government proposals for smart meter communications and data management will therefore also have implications for Xoserve's business.

The Government's decision includes transfer of meter point / supplier registration (currently an activity undertaken by Xoserve) to DCC within 2-3 years of DCC providing its initial services. There are therefore timing related issues and uncertainties related to the DCC's establishment that need to be managed by the GTs and their agent Xoserve:

- Gas networks price controls will enter an eight year tariff cycle from 2013. Other parts of the industry are currently working to different business and industry change cycles.
- DCC is expected to only be established in Q4 2012. The transfer of meter registration service obligations is therefore only likely to occur by 2016/17.

The exact role and system required to support the GTs role in the DCC set up has yet to be established. There are scenarios where Xoserve and the GTs could leverage their existing systems within the DCC set up. For example, Xoserve could feasibly become a service provider to the DCC for certain data management services.

There are also scenarios (mainly in longer term) where other functions Xoserve currently performs could move to DCC. Feasibly Xoserve could perform fewer activities following the establishment of DCC and smart meter mass rollout.

Box 4.1 outlines the Government's conclusions on smart meter data and communications management and key aspects of the likely role of the DCC.

Box 4.1: DCC scope of services

DCC will be created as a new licensed entity, responsible for the procurement and contract management of data and communications services that will underpin the end-to-end smart metering system. The Government will run a competitive application process for the DCC licence. The Central Communications and Data Management supporting document¹³ states:

“the scope of DCC should be developed in a phased manner. When DCC starts providing its services, the scope should cover secure communications, access control, translation, scheduled data retrieval and initial smart grid functions.”

The supporting document goes on to note that:

“meter point / supplier registration of all metering points should also be transferred to DCC. DCC's registration services should cover domestic and non-domestic meters, including those connected to independent networks ... It is considered that registration can be transferred to DCC within 2-3 years of DCC providing its initial services, during which period existing registration system operators will be required to grant DCC access to the existing registration systems to verify whether a party is authorised to access a specified meter.”

As regards data functions:

“Further analysis is required before the Government can decide whether data processing, aggregation and storage functions should at some point also be transferred to DCC ... The impact of these issues will be assessed prior to reaching a position on whether DCC should provide these services.”

The Government also noted the interactions with iGTs:

“Currently there are inconsistencies between the registration systems used by independent gas transporters and xoserve (the registration agent for gas transporters) ... Government concurs with stakeholders that the arrangements for smart metering must be designed to enable consumers on independent networks to access the same benefits from smart metering ... Accordingly, consideration should be given as to any necessary changes that would enable DCC's access control arrangements to operate equally, regardless of the network on which the consumer is located.”

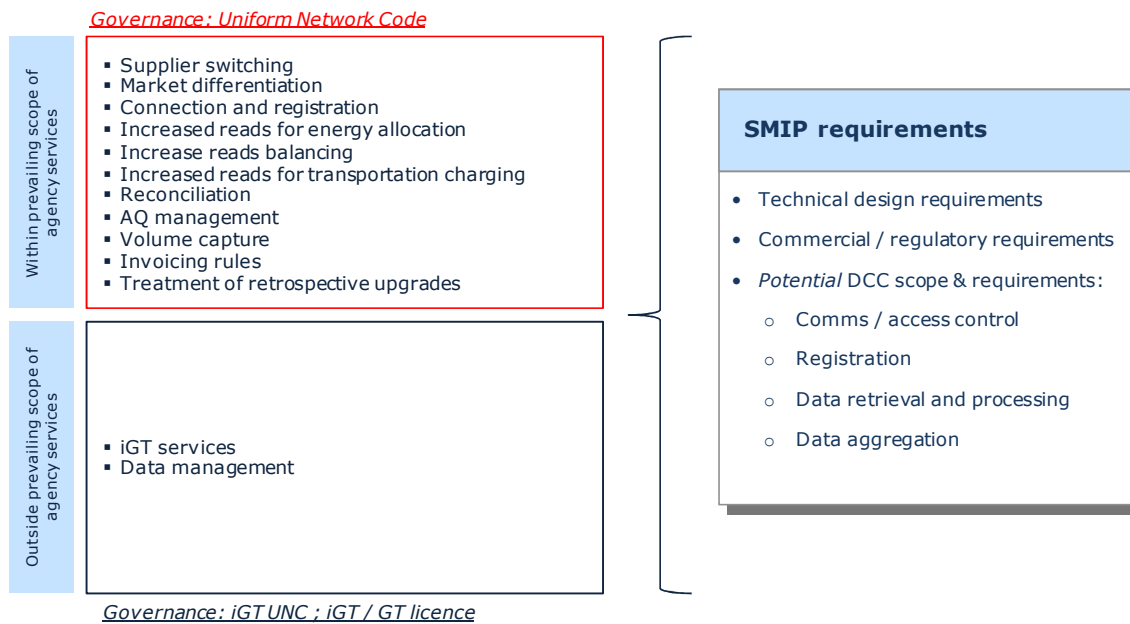
Industry working groups, such as the Project Nexus UNC Workstream (PNUNC), have helped to define potential system requirements arising from smart meters and establishment of DCC, although the industry has yet to reach any formal conclusions on requirements.¹⁴

As highlighted by Figure 2.7, information system requirements have an external dependency on future market design and smart meter requirements resulting from the SMIP but these design requirements are being brought forward under a separate industry governance framework from Project Nexus.

¹³ DECC/Ofgem (2011): ‘Smart metering implementation programme: Central Communications and Data Management’

¹⁴ See Project Nexus (2010): ‘Development of Requirements Project Brief’

Figure 2.7: Project Nexus topics and industry requirements



Source: Xoserve / CEPA

Other industry parties, including gas suppliers and shippers, will need to operate their own new systems and processes and manage their integration with DCC. They may also require changes from GT Agent IT services, data and information to support their migration to new commercial business models and industry processes.

For example, respondents to our stakeholder questionnaire highlighted the need for:

- early reforms to critical gas balancing settlement arrangements, such as the Annual Quantity (AQ) review process; and
- individual meter point reconciliation, with some shippers requiring daily allocation based on daily reads, whilst others indicating a requirement for monthly reconciliation and readings.

The GTs and Xoserve may be required to evolve their systems and processes to support many of these industry changes. Smart metering will also introduce new governance arrangements for the gas sector. The Smart Energy Code (SEC) may place new (or revised) obligations on industry parties (including GTs) that will need to be managed through changes to industry funding arrangements to support these obligations and services.

4.5. Strategic change to gas markets from Europe

Xoserve operates an information system service known as Gemini. The information system allows gas shippers to carry out gas nominations, energy balancing and exit capacity booking. The scope and nature of support to the Gemini system is expected to be impacted by changes in the scope and nature of capacity and energy balancing products and services in response to EU market developments emerging from the Third Package.

As with smart metering, European market developments potentially raise additional requirements over the forthcoming business planning and investment period of central agency services.

4.6. Summary

The gas industry faces a number of changes from the need to adapt to a low carbon economy while delivering security of supply. Part of the challenge is moving towards new energy systems and business models that can support smart metering and strategic changes in gas markets and transportation systems. The central service provider to the gas sector has an important role to play in delivering these changes and supporting the new market structures and arrangements. The gas industry therefore requires a funding and governance framework for central systems and services that can support changes outlined but which are also flexible to accommodate changes and uncertainty of the future role of the GTs and their agent Xoserve.

5. IDENTIFYING AND UNDERSTANDING ISSUES

In this section we set out our views on the extent to which we believe Xoserve's current funding, governance and ownership arrangements have either supported or hindered Xoserve, in its role of providing central IT and other services to the gas industry.

As we have not undertaken a full operational review of Xoserve; however, our views are largely informed by the information provided to us by Xoserve and the feedback that we have received from stakeholders in response to a questionnaire that we circulated to obtain perspective from different industry stakeholders.

The key information provided to us by Xoserve, relate to its performance against a series of Key Performance Indicators (KPIs) covering both Core and User Pays services. It should be noted, however, that Xoserve's management also provided us with their views on a range of issues. We then separately consider the key themes emerging in the feedback provided by industry stakeholders.

Following this review, we have sought to identify what appear to be any key issues emerging, both related to current industry requirements, but also to future ones. Having identified such "symptoms", we have then sought to deduce what the "causes" of such problems might be and how current funding, governance and ownership arrangements for GT Agent services may have contributed.

Some of the issues that are stated in the first part of the analysis have been raised by stakeholders before, in particular in the response of various stakeholders to Ofgem's Open letter consultation on Gas Distribution Price Control Review 2 (GDPCR2) – the way forward and Xoserve's Review of Stakeholder Analysis. What we believe to be new, but which we recognise requires further analysis and debate, is our interpretation of how existing funding, governance and ownership arrangements have contributed to the issues raised by stakeholders.

5.1. Key messages arising from customer / stakeholder feedback

As set out, the key sources of feedback on Xoserve's performance are Xoserve's own customer feedback and that provided by our questionnaire. We begin by setting out what both sources regard as being favourable under both Core and User Pays arrangements before turning to some of the issues our stakeholder survey identified.

5.1.1. Positive feedback

Key Performance Indicators

The ASA details the Core and User Pays services that Xoserve is required to provide to the GTs and ultimately network users. Xoserve's ability to deliver these services is measured primarily through its performance against a series of KPIs. In addition we understand that Xoserve also measures annually the availability of its systems and measures the level of satisfaction of its customers.

Although Xoserve has been forthcoming with our requests for information, it has not been within the scope of our terms of reference to undertake a detailed operational review of Xoserve. For this we have had to rely on Xoserve's customer service feed-back and our own questionnaire. Key points from the former are:

- Xoserve's performance against the Service Agreement KPIs for 2010/11 suggests that Xoserve delivered all of its Priority 1 and 2 services to the required standard in the last financial year, and did the same for its Priority 3 and 4 services in all but a few isolated cases.¹⁵
- The availability of Xoserve's systems was also equal to or greater than the expected level for all its systems in 2010/11 (except for its Conquest system that was available for a less than expected but greater than minimum level).
- The level of Shipper satisfaction with Xoserve has been increasing: in all but one of the months over the last financial year Xoserve achieved a Shipper satisfaction score in excess of the 70% target, increasing from 70% to 75% in March 2011.

The message arising from these performance indicators, albeit from a limited information set, is that Xoserve delivered its services to the required standard levels in 2010/11.

Stakeholder feedback

This overall message is generally supported by the feedback that we received from stakeholders during the process of completing our review. Throughout our consultations we have consistently been told that on a day-to-day basis Xoserve is delivering its services and that its staff are professional and well qualified.

We also received relatively consistent feedback from stakeholders that the GB gas industry values a central service provider and the services delivered had been relatively reliable for customers.

The day to day discharge of UNC obligations also generally obtains good customer feedback.

Some stakeholder groups also suggested services had been very cost effective. For example, it was noted that Xoserve cost per supply point was approximately £1.50-£1.75 per supply point per annum, which is seen as being good value for money.

A number of respondents also noted that given the right framework to operate within, Xoserve was very capable of providing an efficient, customer-facing service. Project Nexus was highlighted as an example of Xoserve working effectively with different industry stakeholder groups.

5.1.2. Stakeholder concerns

However, our stakeholder consultations also identified concerns with the delivery of basic Core and as well as User Pays services set out in the ASA.

¹⁵ There were three instances of failure to meet Priority 3 and Priority 4 KPIs during 2010/11.

Whilst not always fully articulated by stakeholders, their concerns seem to be based largely on a perception of *poor responsiveness* to requests made by Shippers, together with concerns regarding a general *lack of transparency* in arrangements, particularly as regards how charges for services are derived.

Poor responsiveness

In addition to the services detailed in the ASA, the establishment of the User Pays framework was designed as a mechanism through which Xoserve could respond to users' needs by providing additional services and modifications – the User Pays for Change arrangements.

When the User Pays arrangements were introduced in 2008, it was intended that these would grow over time and provide the Shippers an opportunity to work together with Xoserve to deliver industry change in an efficient manner. The information and feedback that has been made available to us while completing the review suggests that this has not happened.

The User Pays for Change market has failed to develop as expected since the introduction of these arrangements. Stakeholders pointed to the following in support of this:

- Xoserve is not seen as communicating as well as it might with stakeholders when dealing with change management requirements; moreover, the process of attempting to deliver change through Xoserve is considered to be too long.
- The costs quoted by Xoserve to deliver change are considered to be too high; stakeholders find it difficult to reconcile to estimates provided by other IT service providers for similar services.
- Stakeholders also felt that there is not enough prioritisation within Xoserve's current change management programme. GTs are perceived as being too involved with proposed modifications which are not necessarily of relevance to them, and are seen as being an obstacle to change.

There is a perception on the part of some *network users* that Xoserve sees itself purely as a GT Agent, rather than an industry service provider. In their view, this creates a cultural problem within Xoserve, and contribute to a lower degree of responsiveness to requests from Shippers compared to the GTs. But over and above this, respondents stated consistently that the failure of these services to develop is because Xoserve lacks the *capacity* to respond to and manage industry change. In addition, some stakeholders have suggested that Xoserve may currently be underfunded, which is contributing to capacity problems.

Transparency

The other major issue consistently cited by respondents was a lack of transparency as regards different aspects of Xoserve's operations. Several examples of this were suggested:

- Whilst network users have oversight over changes to central agent services through UNC Modification processes, currently they have less operational oversight over the implementation and costing of these services.
- Shippers voiced the concern that since the introduction of the User Pays arrangements, a number of services that were previously offered under Core services (and were thus funded by Use of System charges) would appear now to be offered as User Pays services, without proper explanation.
- Without having more visibility of Xoserve's costs and more oversight of Xoserve's activities, suppliers have found it difficult to reconcile how their Use of System charges fund Xoserve's services. This has created a lack of confidence amongst some stakeholders in Xoserve's performance and also contributed to additional concerns regarding the value for money provided by Xoserve.
- Though some network users have acknowledged that they have not always managed to articulate the specific problems that they want Xoserve to address in a clear manner, there was a general view that current change management processes sometimes lack transparency in terms of why Xoserve has taken the actions it has.

Linked to the transparency issue, a number of respondents have suggested that the current arrangements give rise to incentives that they do not believe to be in their interests. Shippers have raised issues with the current ownership and funding arrangements of Xoserve and the incentives that they create for the GTs to focus on pushing Xoserve to meet licence obligations at least cost, rather than attempting to promote innovation and deliver improved services.

5.2. Issues with funding, governance and ownership

In the second half of this section we consider how Xoserve's existing funding, governance and ownership arrangements may have contributed to the issues discussed above, specifically its ability to meet the needs of industry change, where service responsiveness is critical.

As stated in the introduction to the section, this analysis is naturally more subjective, particularly given the lack of quantitative evidence available. That said, the impression gained from our discussions with all stakeholders, including Xoserve, is one of a service provider that performs perfectly adequately as regards the provision of established functions, but one which is challenged when it comes to having to deliver outside these parameters, notwithstanding the fact that there are examples, such as Project Nexus, where it is seen, at least in part, to have risen to the challenge. There are aspects of the approach taken in Project Nexus, for example, that stakeholders have liked and support, although we have not been close enough to these process to be able to say they have necessarily amounted to a full success.

A lack of transparency in operations and particularly in service costings, combined with a lack of responsiveness to customer requirements, as regards speed, competitiveness and flexibility, seem to be the dominant themes otherwise encountered.

In the analysis below, we attempt to provide reasons as to why Xoserve's funding, ownership and governance arrangements may have contributed to these observations, both singularly and collectively.

5.2.1. Governance arrangements

We believe that a key contributor to both the transparency and responsiveness issues identified is the ASA / outsourced arrangement under which Xoserve operates. Whilst being a perfectly logical outcome of the governance arrangements set in place in 2005, this:

- Focuses Xoserve's Board and management on working to the GTs which are its contractual client and does not work to promote a more active engagement by its owners in Xoserve's business beyond delivering core contracted requirements.
- In any event, provides for a very restrictive contractual arrangement which hinders a more flexible approach to Shipper requirements, especially where new investment is required (Project Nexus perhaps provides an example of how more responsive Xoserve can be when considering change somewhat outside from such a constraint).¹⁶

Indeed, our understanding is that the GTs' influence is felt more through their role as counterparties to the service level agreements, rather than through direct management control of Xoserve.

In some ways, whilst operating under its own brand in providing services (which is perhaps atypical for an outsourced entity) and being set up as a stand-alone subsidiary, separate from the GTs other businesses, Xoserve does look like an empowered entity, but at the end of the day it operates largely as a contractor. Arguably, existing but especially new, industry requirements require a more empowered Xoserve than the current contractual arrangements provide for. Rather than the current convoluted contractual relationships, this might suggest a full empowered subsidiary, with more independent management in which there is a direct customer relationship between Xoserve and Shippers.

As regards transparency, whilst we recognise the responsibility for license obligations currently sits with the GTs, it is also arguable that a lack of stakeholder involvement and / or representation in Xoserve's decision making processes has reduced the transparency of its operations and reduced stakeholder confidence that it aims to be responsive to their needs. There is therefore potentially a case for both moving license obligations to Xoserve and in addition potentially improving the visibility of Xoserve's activities through greater representation by other industry stakeholders.

Such a higher degree of involvement could likely achieve a greater degree of customer buy-in to required future investments, in terms of both specification and cost as would appear to be the case with Project Nexus.

¹⁶ As outlined in Section 3, Project Nexus is Xoserve's primary industry engagement vehicle for gathering stakeholder requirements for change to GT Agent services in the medium to longer term. Xoserve is soliciting requirements from the industry rather than having to react to UNC modification proposals.

5.2.2. Funding arrangements

The governance issues identified above are further compounded by funding arrangements. The regulatory model influences funding in three main ways. The first is through the contractual mechanism described above which arguably weakens the responsiveness of Xoserve to Shipper requirements. The second concerns the appropriateness of a five year, soon to be eight year, regulatory settlement for what is largely the provision of IT services, rather than capital intensive network services. The third relates to the charging mechanism itself.

Contractual mechanism

Whilst being understandable from the way in which Xoserve was established, the more it is desired for Xoserve to be responsive to Shipper demands, the more unwieldy the current arrangements are. Ideally the customers paying for the service would pay the service provider directly. An implication of the current funding arrangements is more of a cost centre than a revenue generator; and that the absence of a link between the provision of services and direct payment from customers for such a major part of Xoserve's activities, is likely to act so as to blur the customer responsiveness incentives that would normally influence the behaviour of other information systems service providers.

As identified by several Shippers, funding of Xoserve through price control allowances also creates a direct incentive for the GTs to focus on controlling Xoserve's costs rather than on developing Xoserve's ability to respond to industry change

Periodicity and focus of the price control

The setting of funding for the lengthy price control period is not consistent with Xoserve's planning needs as a business. This is likely to have reduced the flexibility of Xoserve to respond to the diverse range of industry requirements.

In other words, the use of a regulatory model – which was by and large designed to create and incentive for network operators to drive out cost from capital intensive businesses – is inappropriate to business functions which are less capital intensive – although still requiring material investment – and which need to be more nimble in terms of investment cycles and service development. We would argue, that as far as possible, arrangements need to be designed in such a way as to align with and underpin the desired nature of the business services.

Charging methodology

In addition to this high level point, we would also suggest the following as regards establishing Xoserve's costs and charges:

- The funding of Xoserve largely through transporter charges also adds to a lack of *transparency* as well as blurring of incentives. A more explicit allocation of funding for all central services might, in our view, improve the flow of information between the parties involved in the

transaction and might create the potential for improved efficiency, innovation and release of industry funding.

- Linked to the point above, separation of Core and User Pays funding mechanisms have also created concerns over the transparency of Xoserve's funding arrangements. The differentiation has created a superficial and at times unhelpful differentiation.
- As regards User Pays for Change services, there is no evidence to suggest that the GTs (as Xoserve's owners) have been incentivised to provide additional services to generate additional revenues (a point likely to be linked to the objectives of Xoserve's owners – see below).

5.2.3. Ownership arrangements

As a wholly owned subsidiary of the GTs, whilst we have no doubts that Xoserve operates in a manner consistent with meeting its obligations under the ASA, we believe that there are legitimate questions to ask as to whether this provides for the degree of corporate ambition ideally required to meet the needs of the industry in future, especially the high expectations for smart metering to achieve a more efficient use of energy. A combination of such ownership arrangements, together its funding mechanism, would appear have led to a narrow focus on equipping Xoserve to deliver the GTs licence obligations, rather than a broader range of commercial services demanded by the industry. This may also be because there is a lack of incentive for the GTs to invest in Xoserve's asset base and service offering.

A further part of its owners perceived lack of ambition for Xoserve, may be the small scale of Xoserve relative to the other costs involved in the GTs' operations.

Taken together, it would seem inappropriate to place the full responsibility for any actual or perceived failures on Xoserve's management if its owners do not both empower and resource them to respond to customer requirements.

We would argue that a greater degree of engagement from Xoserve's owners, combined with changes to governance and funding arrangements might encourage greater responsiveness to customer requirements. Over and above this, there is also a question of whether broadening Xoserve's ownership to other industry participants, which might also assist in improving both responsiveness and transparency through the creation of more of a cooperative industry body. This would also broaden accountability for Xoserve across the industry.

5.3. Conclusions

The picture that emerges from our appraisal of Xoserve's current performance suggests Xoserve is generally meeting its quality of service targets in the delivery of its day-to-day activities, but that it is not managing the delivery of industry change as effectively as stakeholders might hope. We would not expect this conclusion to come as a surprise, as we have had quite consistent feedback from

stakeholders on these points while completing our review and many of the points raised have already been identified in previous consultation exercises.

Stakeholders highlighted to us that given the right framework to operate within, Xoserve is capable of providing an efficient and customer-facing service. The relatively favourable perception of Xoserve's stakeholder engagement through the governance of Project Nexus also illustrates that the company can and does work effectively with the gas industry to deliver change when provided within the right framework.

This supports the hypothesis that the issues identified above are driven by funding, governance and ownership of GT Agent services.

Many of the stakeholders we interviewed during the process of our review also noted that while Xoserve costs might only be a small part of the overall GT revenue allowance, future funding and the outputs provided by Xoserve are among the most important issues for them in the RIIO-T1 and RIIO-GD1 price review process (at least on the gas side). This is linked to the major changes in the industry arising from security of supply and sustainability objectives.

The funding, governance and ownership arrangements for agency services have therefore arguably for the most part, been adequate to support GT requirements for a stable, low risk delivery model for centralised agency services and information system infrastructure. The performance indicators show that Xoserve achieves this objective well, and at a relatively efficient cost for the industry.

However, as a provider of critical business services in an industry undergoing a major degree of transformation this does not appear to be sufficient any longer given the needs facing the industry. Xoserve may be small in scale, but it undertakes vital functions.

Whilst there has probably always been criticisms of a lack of transparency in what Xoserve does, we have also found consistent criticisms of responsiveness of Xoserve to its customers requirements, where more is expected than a delivery of GT license obligations at least cost. Whilst User Pays was supposed to create an incentive, it does not appear to have achieved the desired objective.

At a corporate level, the current funding and governance arrangements – specifically the de facto contractual outsourcing structure under which Xoserve operates, leads to it being managed and governed by the GTs largely as a “cost” centre as opposed to revenue generator, albeit it one requiring a degree of investment in information systems technology and possibly personnel to realise the potential benefits available. Whilst perfectly logical from the way in which it was established, driven by the licence obligations that currently sit squarely with its GT owners, it is not clear that this remains fits for purpose, with a consequent need for alternative arrangements that might address responsiveness and transparency concerns.

5.4. Options for change

Given the problems identified above, we have sought to consider a number of options as regards funding, governance and ownership which we believe should be considered in addressing them. These relate to a number of recommendations made by the gas industry through the UNC334

review of GT Agent Services, which effectively seek to work within the existing arrangements. We have then sought to propose what we see as being more radical options including profound structural changes to funding, governance and ownership. The UNC 334 group did not recommend such options as they were deemed to be outside the scope of the review.

6. UNC 334 REVIEW OF GT AGENT SERVICES

6.1. Introduction

The gas industry recently undertook its own review of central system funding and governance arrangements (UNC Review Proposal Reference Number 334).¹⁷ The review has been undertaken through the UNC with the aim to:

- assess the current funding framework for central systems;
- identify areas of good practice; and
- identify those areas that may require improvement.

This section briefly summarises the areas the Review Group considered (incremental and wider industry change options) following by the groups conclusions.

6.2. Incremental change options

The Review Group has considered incremental changes to the existing funding and governance framework, including the creation of an account management framework within Xoserve and coordination of industry change processes and programmes. Table 6.1 summarises some of the incremental changes which the industry has considered.

Table 6.1: UNC 334 Review Group – incremental options

Sub-options	Description
Oversight committee	New committee with a focus on timely delivery and cost efficiency of User pays modifications. The group would have permanent members comprised of shippers and transporters.
Early engagement	Increased engagement between Xoserve and stakeholders prior to the formal raising of a UNC Modification proposal. This may involve formalising existing informal arrangements.
Early estimates of costs	Xoserve to provide a rough cost matrix for early assessment of costs for a solution. Joint Office to provide estimated costs for secretarial services associated with taking forward modification proposals.
UNC representation	Xoserve representation at the UNC panel so they have early sight of any prospective User pays modifications and can provide advice on operational implications.

Source: CEPA / UNC review group

¹⁷ <http://www.gasgovernance.co.uk/0334>

6.3. Fundamental change options

The Review Group also considered fundamental changes that would require changes to GT licences and the funding and corporate governance of Xoserve. Table 6.1 summarises the options which the group has considered.

Table 6.2: UNC 334 Review Group – wider industry change options

Sub-options	Description
Board composition	Alter Xoserve’s current board composition to include Shipper representatives, either as executive or non-executive directors.
Tendering	Introduce Tender process: central system activities would be defined as discrete activities and would be tendered for provision by third parties. Xoserve would act as the agent to ensure that the service is provided effectively and cost efficiently.
Financial separation	Xoserve would have separate funding arrangements (PCR) but would still be owned by the transporters.
Xoserve ownership change	Xoserve would be owned by Shippers and Transporters. Would require separate board and governance structure to direct strategies. Board would be comprised of owners.

Source: CEPA / UNC review group

Table 6.2 shows that many of these wider industry change options would require changes outside of the UNC process, including licence changes and changes to Xoserve’s corporate structure and ownership. The group noted in its final report that development of more fundamental change options was outside the scope of the UNC.

6.4. Other options considered

The Review Group also considered a number of charging options for User Pays services to identify if there is an opportunity to standardise the approach to allocating User Pays charges. These are summarised in Table 6.3 below.

Table 6.3: UNC 334 Review Group – funding options for user pays services

Sub-options	Description
Apportionment of costs by Market share	For example, by number Supply points or energy use/throughput.
Only those who wish to use the service pay	As stated.
Bundling up the analysis and development costs	Industry would be invoiced at regular intervals. Would require an allocation methodology and regular reporting to and monitoring by the industry.
An upfront central change fund	Would require a cost allocation process. Approval of draw down of funds required.

Source: CEPA / UNC review group

The Review Group also considered an additional funding mechanism for the pass through of system change costs. The proposed key features included:

- Cost would be included in allowed revenue in the following Formula Year.
- The costs would be charged through use of system charges.
- Ofgem direction on Modification Proposal would also be used to determine expenditure qualification for inclusion in the pass-through item.
- The funding mechanism would also requires an allocation methodology.

6.5. Recommendations

The Review Group considered a number of incremental changes and funding reform options that could improve the current UNC processes.

A number of the actions referred to in the Review Group 334 action plan will require modifications to be raised to take these recommendations forward.

The Review Group was unable to reach a consensus on the wider industry change reforms as the group considered these to be outside the scope of UNC and was therefore unable to offer any recommendations on the issues.

7. OPTIONS FOR CHANGE

In this section we consider options for reforming the funding, governance and ownership framework of Xoserve and GT Agent services.

First we consider changes consistent with the types of changes proposed by UNC334. These changes can broadly be characterised as *incremental changes* to the *status quo* arrangements, whereby regulatory licence and UNC obligations for common services and systems continue to sit with the GTs. Xoserve would continue to be owned by the GTs and operated as an outsourced function from the GTs core network businesses, managed contractually through an ASA. These changes include reform of industry change management, GT Agent funding and potentially Xoserve's board composition.

As such, the changes seek to “optimise” the existing regulatory framework for central systems and services delivery. Collectively, we describe the changes as “Option A” as they retain the existing regulatory and contractual governance framework.

We then turn to consideration of more fundamental changes around ownership and corporate control of Xoserve and the delivery of central services and systems (through changes to ownership regulatory governance and obligations).

The first change involves removing the contractual arrangement (i.e. ASAs) between Xoserve and the GTs. This would involve making Xoserve a fully “empowered”, direct customer-facing subsidiary, with separate licensed activities but still under GT ownership (“Option B”). The second involves a more “cooperative” approach along the lines of the Meter Registration Agreement Company (MRASCo) or Elexon in electricity, where there is joint industry ownership and control of Xoserve (“Option C”).

We present all of these changes and options as illustrations.

The detailed practicality of particular options would require further development and industry consultation. At this point their aim is to stimulate debate on alternative arrangements that might better meet the needs of the industry.

7.1. Changes within the current ownership and governance framework

7.1.1. Reform of change management

Changes to industry governance would aim to provide wider industry participant insight into the operational management and change of GT Agent services. The objective would be to provide wider transparency of GT Agent activities. For example, this could include procedural changes to allow users and Xoserve to engage more effectively in long term business planning and solution development or a formalised user engagement process and industry forum, created as an enduring activity of the GTs Agent.

There are a number of incremental “tweaks” to the UNC modification process which the industry has considered to help facilitate the GTs’ and their Agent’s engagement with users in managing change to industry systems and services. For example, the previous section set out some of the proposals the UNC 334 Review Group specifically considered for reforming the change management and governance processes of GT Agent services.

While the 334 Review Group proposals provide far from radical changes to the existing industry governance arrangements of GT Agent services, they illustrate that the industry (who have of course been closest to GT Agent services and their governance in the current price control / funding period) have independently started to consider how many of the issues identified in the previous sections might be addressed going forward. For this reason they require careful consideration, both as standalone change options, and in combination with more fundamental change options, for example, to GT Agent funding.

A more fundamental industry governance option that could capture many of the 334 Group proposals presented in Section 6, might be to formalise GT Agent user engagement through a process similar to that followed by Xoserve for Project Nexus. For example, a GT Agent User Requirements Group could be combined with the proposed UNC Modification Oversight Committee. The group would have cross-industry representation and a mandate to focus on short, medium *and* longer term gas centralised services and systems developments. Text Box 7.1 (overleaf) considers a straw-man.

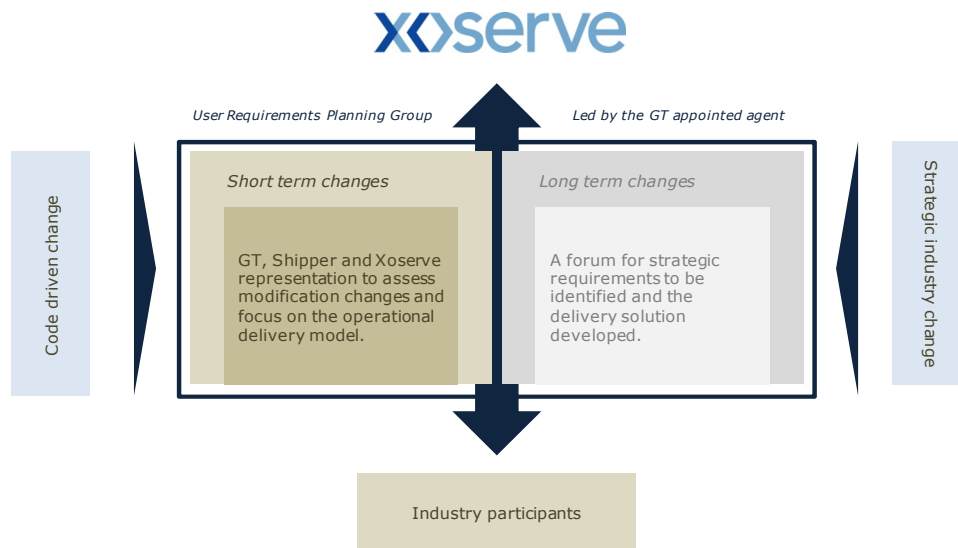
Changes to *industry governance* processes would need to operate alongside the contractual relationship between the GTs and Xoserve under the ASA. The GTs would retain regulatory obligations for central systems and services under the UNC and their licences, and therefore corporate control of Xoserve and contractual control through the ASA.

The main change to the current arrangements would be through UNC processes or the creation of an enduring forum for the GT Agent to formerly engage with industry participants. This would create a more “empowered” and “independent” GT Agent role.

These reforms would clearly be strengthened by a funding stream to support change development and flexible funding arrangements which could allow the definition of industry requirements to be linked to the release of GT Agent funding through negotiated settlement. We discuss how the changes to industry governance might be linked to changes in the GT Agent funding mechanism in the sections which follow.

Text Box 7.1: User Requirements Planning Group

- Xoserve would be empowered to lead (on behalf of the GTs) a User Requirements Planning Group responsible for planning / management of short and longer term changes to GT Agent services.
- The group would be mandated to ensure users can actively engage in costing and modification development processes, alongside delivery of more strategic change.



- The User Requirements Planning Group would have a very clear delineation of industry participant roles and responsibilities (and agreed governance arrangements).
- With appropriate empowerment of the planning group and governance arrangements, the group would help set and agree strategic priorities and timelines for delivery of change.
- The group would have permanent members that are also involved in change management in other areas of the industry (UNC; price controls etc.)
- As the relationship between the GTs and Xoserve would continue through the contractual relationship of the ASA the GTs would need a key role in the group.
- Indeed, while Xoserve might be the “chair” for the group providing operational insight, negotiations might principally be between the GTs and their customers; shippers.
- In this case Xoserve would operate as the facilitator of the process as opposed to operating relatively independently of the GTs.

7.1.2. Extended User Pays

One option to develop a more flexible funding framework could be to retain the User Pays funding mechanism but alter the services funded as Core and User Pays services:

- More *existing* services would be provided under User Pays to reflect more closely functions considered to support “market operation” (with wider stakeholder interest).

- Core services would cover those services which relate to network operation, for example, invoicing of shippers for network charges.

The main change from the current arrangements is more essential, non-discretionary services, would be covered by User Pays. Users would need to come together collectively in specifying user requirements for non-discretionary services. As currently with User Pays arrangements, Ofgem would play no role in determining the funding of services classified User Pays.

Funding flexibility would be achieved through treatment of a larger proportion of GT Agent activities as excluded services from the price controls. The emphasis (coupled with more empowered industry change governance) would also be to rely on User Pays as the funding mechanism for managing changes in services and delivery of new incremental system capacity.

The expansion of User Pays would thus provide the uncertainty mechanism for the industry to collectively manage major changes to central systems and processes. Rather than issues having to be addressed through an ex ante price control mechanism, industry participants would be responsible for collectively agreeing a funding settlement through User Pays arrangements.

Extending User Pays has similar objectives as the use of Long Run Incremental Cost (LRIC) pricing models. Both seek to place incentives on the users of infrastructure services to internalise the costs of ‘incremental’ capacity or service levels and also consumer / user engagement in the choices that are made by the regulated utility and/or service provider.

A complication perhaps is that Users Pays sits outside the GTs price controls and so (as with User Pays currently) there is a need for associated protections to ensure cost reflective pricing. LRIC models (as they have applied in other contexts) generally retain a form of regulated price or revenue cap for the service provider.

7.1.3. Negotiated settlement

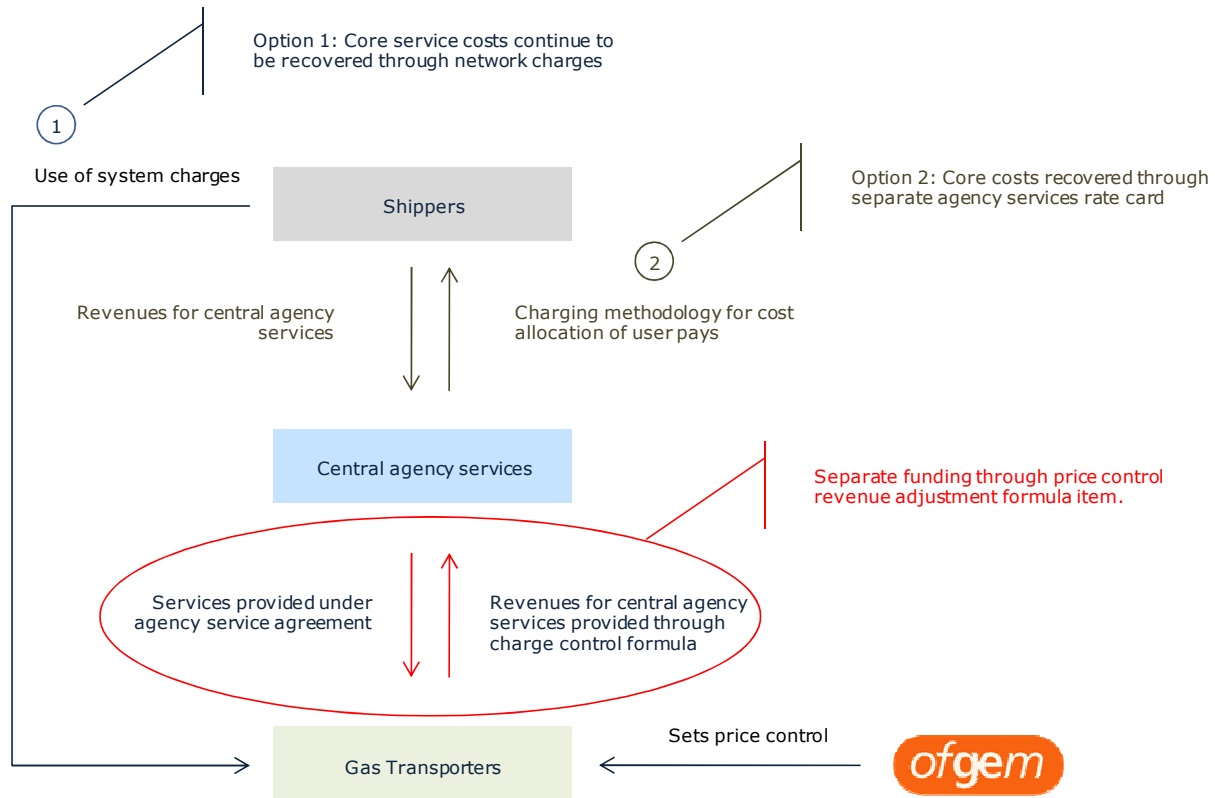
An alternative, all be it similar, model to extending User Pays, could involve negotiated funding arrangements for GT Agent services as part of GTs *price control allowances* (i.e. funding as price control services rather than excluded services as under User Pays). Expenditure on GT Agent services would be determined jointly by industry participants and funded through an identified /specific revenue term in the GTs principal revenue formula.

For capex, industry participants would first be involved in defining requirements and outputs and the development of functionality / optionality of information systems. The objective being to support industry “buy-in” to the data and information system solutions.

Fixed ex-ante allowances could be set by industry participants for costs that are relatively certain over the planning period – for example, overheads or baseline system requirements. These would be rolling operational budgets also agreed by industry participants, but used manage day to day delivery and change development. All new services / systems changes would also be managed flexibly through governance arrangements triggered by different industry participant groups.

As is illustrated by Figure 7.1, GT Agent costs could continue to be recovered through the GTs use of system charges. Alternatively, costs could be recovered separately through a central agency rate card / cost allocation methodology (like there are separate network charges for connections and use of the network system).

Figure 7.1: Illustration of the change to GT Agent funding option



There would be no change to the ownership arrangements of the GT Agent. Obligations to deliver central systems and services would remain with the GTs. The main refinement to the current arrangements would come through the increased opportunity for stakeholders to engage in the process of completing the funding settlement.

This would enable stakeholders to determine jointly with the GTs and Xoserve, outputs and requirements through the “central service provider” price control revenue item. This flexible funding mechanism and governance would be more aligned to the activities and planning cycle of an information systems and services business. The text box sets out some of the sub-options; their practicality would require further consideration.

Text Box 7.2: Negotiated settlement

- Xoserve, GTs and users of central agency services would initially be responsible for defining the future requirements from industry services over the business planning period.
- These activities would be supported by a change governance fund provided either under an ex-ante revenue allowance or triggered for more specific projects.
- A formal review process could be held once initial industry planning has agreed definitions of requirements – this would involve more of a standard role for Ofgem in the funding process.
- Alternatively release of funding could be subject to a price control pass-through with users of central agency services agreeing the release of funding – through a negotiated settlement.
- Xoserve would lead the process for negotiating with customers while Ofgem would determine any disputes over funding requirements.
- Ofgem would only intervene in the interests of protecting consumers – for example, where there are significant costs being proposed by industry participants.
- Profitability of central agency services would be linked to the costs and outputs delivered through the governance processes and GT licences.
- Other examples of negotiated settlements include the public contest method in Argentina, US federal energy regulation, oil and gas pipelines in Canada and Constructive Engagement in UK airports.
- In Argentina negotiated settlements were used to decide upon extensions to the transmission network using a voting system by transmission users.

There are various examples of ‘revenue drivers’ and ‘pass-through’ formulas having been used in a price control context to provide flexibility around the funding of uncertain outputs and requirements. During our stakeholder consultation, a number of industry participants noted the NTS licence (Special Condition C8 (g)) already has a logging-up facility for unforeseen UNC driven change. Provided a similar term were included in all GT licences, then GT Agent negotiated settlement costs could be funded by a similar type of mechanism.

Text Box 7.2 also highlights different options for the role of the regulator in the settlement of funding the GT Agent:

- One option would be for Ofgem to operate with a relatively “light touch” only intervening where it considered there to be impacts it considered to be significantly detrimental to consumers (a “consumer protection role”).
- Alternatively, the role could be more narrowly defined in an arbitration activity (a “regulatory arbiter role”). In this case, Ofgem would be required to intervene if asked to provide directions on particular aspects of the funding settlement.

An example of an arbitration role in determining infrastructure funding is provided by the Arbiter position in the now defunct London Underground Public Private Partnership (PPP) contracts (the role and its objectives are summarised in the text box below).

Text Box 7.3: Role of the London Underground PPP Arbiter

- As part of the PPP Structure, the Greater London Authority Act 1999 created the position of the London Underground PPP Arbiter.
- His roles and responsibilities as set out in the Act were to offer guidance to the PPP parties (acting jointly or alone) in any matters relating to the PPP contracts that are referred to him.
- He could also make determinations on matters specified within the PPP contracts where either party referred a matter to him.
- These matters included the right to determine the Infrastructure Service Charge (ISC) in the event that the parties were unable to reach agreement.
- The Arbiters role differed substantially from a traditional utility regulator. The Arbiter was not a party to the contract although he had clear statutory roles and responsibilities.
- The scope of this role was also narrower. Unlike a traditional regulator he had no direct role in defining and enforcing the level and quality of service.
- The role was to provide guidance and / or resolve disputes between the parties (where asked to by one of the PPP parties) about the appropriate level of the ISC.

Amongst the key features of the PPP Arbiter role (compared to standard economic regulators in UK infrastructure sectors) was that the PPP Arbiter was not required to monitor or enforce service delivery. The PPP Arbiter was also not required to set the outputs delivered by the service providers in the PPP Agreements (these were set by London Underground).

Another difference between the London Underground PPP Agreements (a contract) and standard network company licence mechanisms was the greater ability to modify network company licences.¹⁸ The PPP Agreement only envisaged changes at the time of Periodic Review (every 7 ½ years), and even then relating more to requirements and pricing than to contractual structure.

With regulatory obligations remaining with GTs, a licence structure would continue as the regulatory mechanism (although the relationship between Xoserve and the GTs would continue through an ASA (i.e. contractual mechanism)). This suggests the *ideal* and *envisaged* role of the regulator in a GT Agent negotiated settlement would be to approve modifications to GT licences, to act as custodian of the rules and procedures of negotiated settlement and responsibility for approving funding settlements agreed through industry governance processes.

The regulator's *intervention role* would thus be limited to actions considered to protect consumer interests. For example, at the extreme, were significant expenditure on upgrades to systems and services considered to be detrimental to the consumer interest, Ofgem would retain the right (under the negotiated settlement procedures) to review the business plan, or alternatively to ask for services to be market testing through an alternative service provider route.

¹⁸ Chris Bolt (2007): 'Regulating by contract and licence: the relationship between regulatory form and its effectiveness'

There may need to be a greater regulatory role in the funding settlement for more strategic investment changes, similar to Ofgem’s role in Significant Code Reviews to drive through changes to energy sector commercial arrangements. Industry participants might be expected to develop and specify requirements and to manage the funding settlement, but there would be a more proactive role of the regulator and/or Government in driving the specification of technical requirements and the process leading to the final funding settlement. This, however, would be the exception rather the rule, with in general Ofgem’s interventional role limited to gross inefficiency abuse.

7.1.4. User non-executive board member

This option would introduce changes to Xoserve’s corporate governance to provide more user representation in the company mainly through altering Xoserve’s Board composition to include user representatives. A similar approach is followed in the UK water sector, whereby Ofwat specify that independent non-executive representation is required to be provided at the board level as part of financial ring fencing conditions. Ofgem has proposed similar provisions.¹⁹

The option of altering Xoserve’s current Board structure to include user representatives in a non-executive capacity has been proposed by industry participants as part of the UNC 334 Review Group process. Table 7.1 sets out how the non-executives might be elected and the responsibilities they might be tasked with by the industry.

Table 7.1: Options for reform of GT Agent corporate governance

Sub-options	Description
User representatives as non-executive directors	Non-executive board members could be elected using a similar process to the shipper representative on the UNC panel.
	Non-executive board members would be tasked with constructively challenging management and their development of strategy.

Any such corporate change proposal would need to be supported with a clear rationale for why customers should/need to be involved/represented at Xoserve Board level (an issue we return to in our evaluation below). As context, the case study text box below, provides a short description of the general expected role of non-executive board members and the reason why they are currently a part of boards of England and Wales water and sewage companies.

The key point highlighted by the case study is that non-executives are generally appointed to *prevent* activities and outcomes as opposed to *driving strategy* and *decision making*. In the case of non-executive directors in the England and Wales water and sewage companies, the role is to ensure that ring-fenced activities and customer interests are respected and protected. Ofgem has similarly proposed ‘sufficiently independent directors’ (SIDs) in the energy sector on the basis they can contribute to good governance particularly in the promotion of licence compliance.

¹⁹ <http://www.ofgem.gov.uk/Networks/Policy/Documents1/Ring%20Fence%20Mods%20Consultation.pdf>

Text Box 7.4: Role of non-executive board members

The “Combined Code,” overseen by the Financial Reporting Council, is a set of principles of good governance for companies in the UK. The Financial Services Authority’s Listing Rules backed by the Financial Services and Markets Act 2000 requires publicly listed companies to disclose their compliance with it on a “comply or explain” basis.

Provision B.1.2 of the code requires that:

“Except for smaller companies, at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent. A smaller company should have at least two independent non-executive directors.”

The aim of these arrangements is for no small group to dominate board-level decision making. This outcome is attractive to regulators wishing to curb influence from owners that might stray from licence condition requirements.

While not directly referenced in licences, consultation documents on amendments make it clear that Ofwat’s governance requirements (Condition P) on its licensees is influenced by the Combined Code. In particular this includes the requirement that owners ensure that the licensee’s Board contains a minimum of two (or three in some cases) independent non-executive directors with relevant experience of the areas of the licensed activities and how customers’ interests can be respected and protected. Not all licences require that these non-executives are also independent.

7.1.5. Contested GT Agent role

A more radical option that might fall within the current arrangements would be to *require by licence* that the GT Agent role be regularly “market tested” in its entirety as an industry IT business process outsourcer. We have not considered this option further, as any proposal to pursue such a course of action might be best determined only after a full operational review of Xoserve that established that it was not providing value for money. However, this radical alternative might be considered further were current regulatory arrangements considered appropriate but the other changes presented in this section deemed insufficient to address identified issues.

7.1.6. Summary

In this section we have set out a number of changes for reforming the funding and industry change governance framework of central systems and services provided by the GTs appointed agent Xoserve. They focus on “optimising” the current arrangements by developing a funding framework tailored to Xoserve’s business activities and drawing on governance architecture that has been successfully applied for Project Nexus.

The User Pays route provides more funding accountability and flexibility by treating more GT Agent service as excluded from GT price controls. There would be *no role for Ofgem* in the settlement in this case. An alternative, all be it similar, model to User Pays, could involve negotiated funding arrangements for GT Agent services as part of *GTs price control allowances*. This might be linked to more formalised user engagement during service and systems requirements definition. In this case,

Ofgem’s role would approve funding but in general, the regulatory interventional role would be limited to actions considered to protect consumer interests.

We also presented the option of changing Xoserve’s board composition to include user representation in a non-executive capacity and a more radical option of requiring by licence that the GT Agent role be regularly “market tested” in its entirety by the GTs as an industry IT business process function related to their core businesses.

7.2. Changes to ownership and regulatory governance

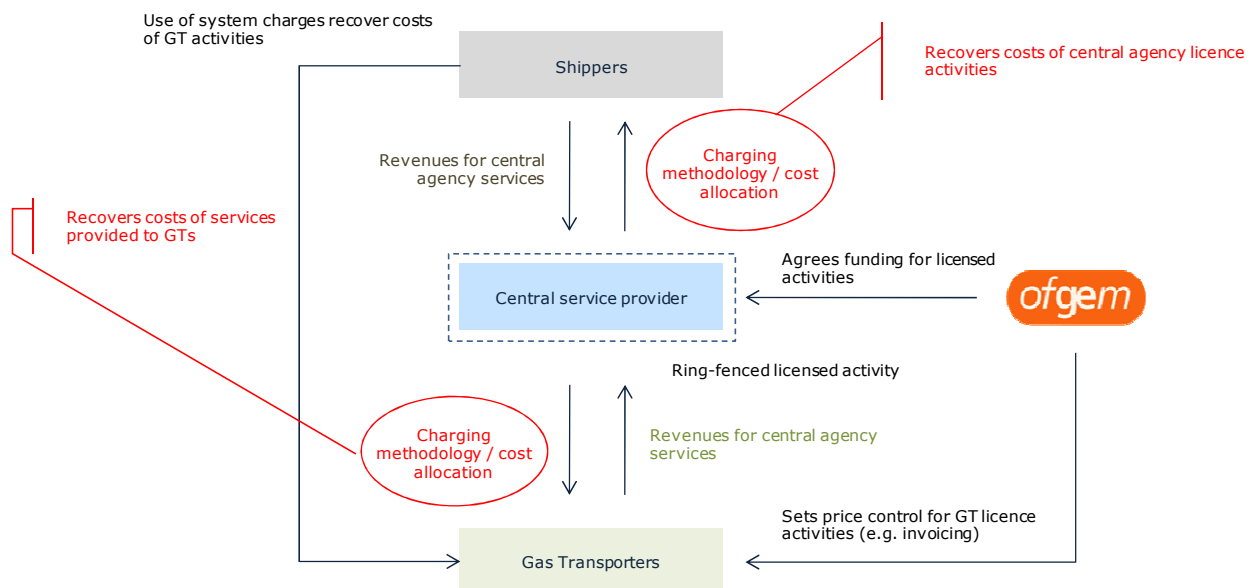
7.2.1. Separate licence, customer facing GT subsidiary (Option B)

Whilst Xoserve is currently a wholly owned subsidiary of the GTs, one option might involve making Xoserve a more empowered subsidiary. As before, the company would continue to be owned by the GTs who would therefore retain corporate control of the business. The central systems and functions provided by Xoserve, however, would be delivered through a separate licensed activity. The licence would specify the services that it would provide to industry participants.

Xoserve currently performs a number of functions that are central to the GTs operation of their businesses (for example, invoicing). Certain service obligations (given their criticality to GT cost recovery) might therefore be expected to be retained as part of the GT licences. These services could continue to be managed through a service agreement between Xoserve and the GTs.

Rather than services predominantly being funded through the GTs network use of system charges (as currently), a separate rate card / charging methodology for allocating central service costs would be developed and enforced. Figure 7.2 illustrates funding flows under this option. A single methodology would need to apply to all users of the central services and systems that is cost reflective, and avoids cross-subsidy between different activities.

Figure 7.2: Funding flows (separate licence mechanism)



Activity based costing (similar to User Pays currently) could be applied to develop the charging statement / cost allocation method for the central systems and services. Consistent with the findings of the Code Governance review, this could sit within the UNC to allow users to influence the allocation of costs as well as the services provided.

As illustrated in Figure 7.2, services that support GT activities could still ultimately be funded through network use of system charges although the GTs would be charged by Xoserve according to its agreed charging methodology. Central services provided to shippers would be funded more directly through the Xoserve's cost recovery mechanism. Alternatively all central systems and services could be funded directly by Shippers with GTs required to draw upon the services and systems supported by the funding settlement.

We envisage a negotiated settlement mechanism (as discussed within Option A) would be adopted to set prices. However, in this scenario Xoserve would be empowered to lead the negotiated settlement rather than the GTs as a separate licensed entity. As with a GT led negotiated settlement, envisaged Ofgem's role would be to develop and approve modifications to the licence, act as custodian of the rules and procedures of negotiated settlement and responsibility for approving funding settlements that had been agreed through the industry governance processes.

An example of a proposed licensed activity for central industry services in the energy sector, is the funding and governance model being proposed by the UK Government for the DCC. The Box 7.5 sets out some of the key features of the business model.

Text Box 7.5: Data Communications Company (DCC) commercial/regulatory framework

- DCC will be responsible for managing the procurement and contract management of smart metering data and communications services.
- A new licence will be granted for the central procurement and contract management activities through a competitive licence applications process.
- DCC is expected to be established as a commercial business, accountable and financially incentivised to achieve service standards.
- An appropriate performance incentive mechanism is expected to be developed to drive economic and efficient outcomes.
- DCC's right to recover its own internal costs and allowed profit margin, as well as the contracted costs of its service providers, are expected to exist in the context of this incentive mechanism.
- DCC's costs will be recovered through service charges to users. Service charges will comprise a mix of standard and variable charges designed to reflect different types of service.
- For example, DCC may levy volume charges (related to the volume of data transferred). General charges might contribute to other administration and general costs incurred by DCC.

The proposed business model for DCC is that it will contract with service providers rather than providing the services itself. The gas central service provider licence would allow Xoserve to provide the services (i.e. it would not be a contracting body as is proposed for the DCC) although the

negotiated settlement regime could allow the users of the company's different services to request or investigate alternative outsourced tendering routes. For example, as was discussed by the UNC 334 Review Group, central system activities would be defined as discrete activities and would be tendered for provision by third parties. Xoserve would in this case act as the purchaser of such services and would ensure that such services were provided effectively and cost efficiently.

7.2.2. Cooperative body (Option C)

A more fundamental “cooperative” governance and ownership model would be the establishment of a fully cooperative not-for-profit central systems and services body, similar to the Meter Registration Agreement Service Company (MRASCo) or Elexon in the electricity sector.

A model similar to Elexon might involve nominal ownership of Xoserve by the GTs but a separate board of directors. The board for the “Uniform Network Code Company” (UNCCo) would include members across industry participant groups.

Alternatively a model similar to MRASCo could be applied 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 a central gas agency service provider.

Under either approach, funding of central systems and functions would be according to recharging arrangements from the stakeholder group who benefits from those services:

- GTs would set a budget for the central functions they solely require from the service provider (for example, invoicing services). Funding of GT driven services could come from network price control allowances as currently.
- Shippers and suppliers would establish a budget to fund functions they require from the central service provider. Funding would be recharged to stakeholders through a formula (for example, like the BSC funding formula).

As a cooperative company, Xoserve would be a not for profit organisation with a budget, business plan and change management procedure set through stakeholder agreement.

As context, Box 7.7 below summarises the funding, governance and ownership structure of the MRASCo and Elexon in the GB electricity sector.

Text Box 7.7: Funding, governance and ownership of MRASCo and Elexon

MRASCo

Ofgem's electricity distribution licence standard terms (SC37) require licensees to jointly establish and maintain a data transfer service. The Meter Registration Agreement Service Company (MRASCo) performs this role, administering and undertaking development activities for the Master Registration Agreement (MRA). The MRA is a multi-party agreement between the licensed electricity distribution network operators (DNOs), suppliers, the BSC agent and MRASCo setting out terms for Meter Point Administration Services and procedures for any change of supplier.

MRASCo is a not-for-profit joint-venture company jointly owned by each party to the MRA (each party one owning one share). An annual budget is approved by the MRA Forum, comprising all parties to the MRA. Two thirds of costs are recovered from suppliers weighted by number of registered meter points; and one third of costs from distribution businesses, split equally between businesses with over 750,000 connections and scaled in proportion to connections for smaller businesses. The directors of MRASCo are the members of the MRA Executive Committee (MEC), which has one member elected by distribution companies, two by suppliers and one appointed by the BSC Agent. The Board appoints the secretariat, acting in support of the MEC. Delivery of MRASCo services are currently provided under a service agreement with Gemserv.

Elexon (BSCCo)

Elexon administers the BSC for GB and in this way is different to Xoserve which is purely a IT service provider to the gas industry. However, the GB electricity industry also relies on Elexon to procure and manage service contracts with third parties, such as IT service providers, which run activities such as settlements. As signatories to the BSC, BSC members are responsible for funding Elexon according to an agreed formula (as discussed previously). Although National Grid Electricity Transmission (NGET) is the sole shareholder in Elexon, NGET does not operate as a normal owner as it bears no liability for Elexon's activities and operates as a passive shareholder.

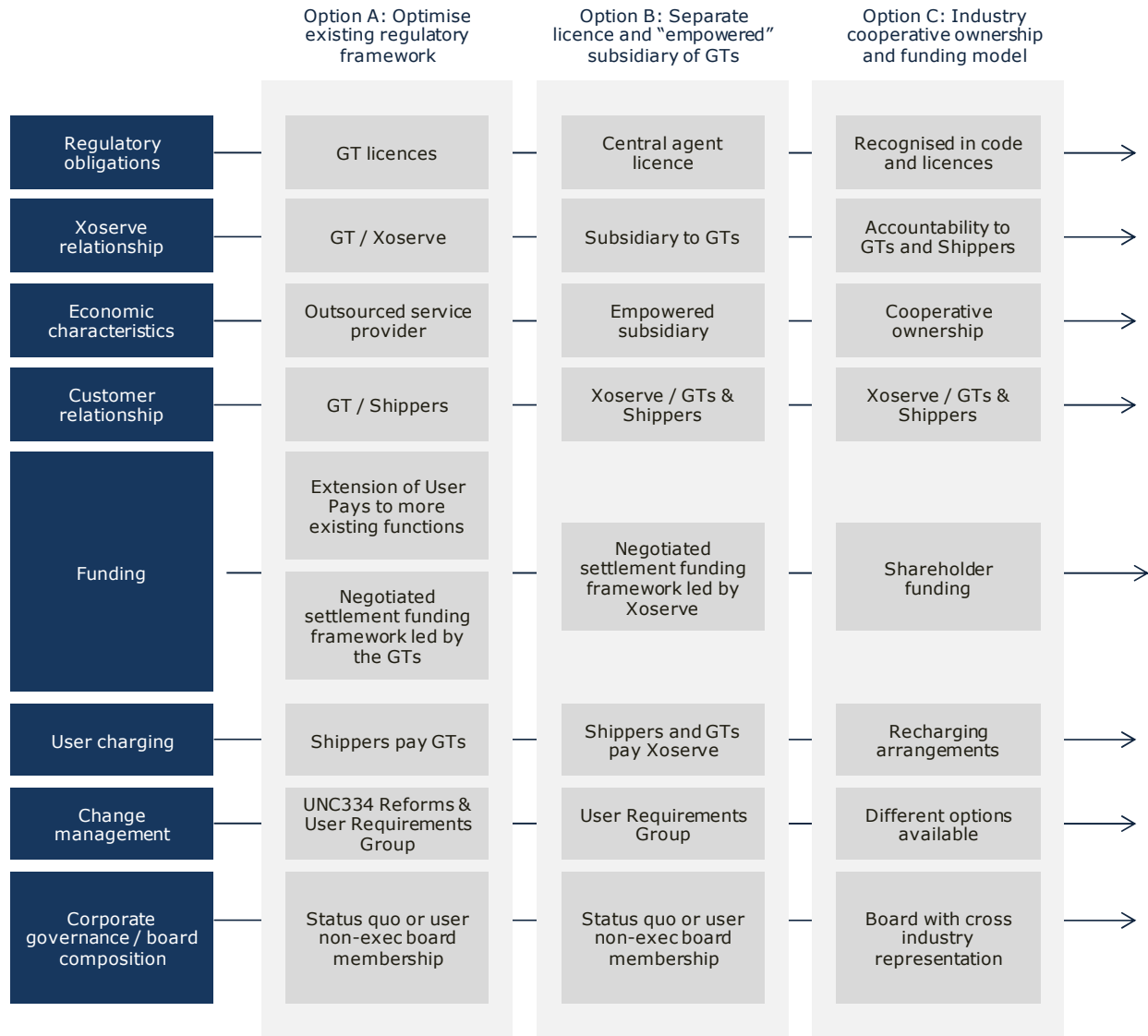
Elexon is independently managed and has a separate Board of Directors consisting of the Chairman, two Industry Panel Members and two other Non-Executive Directors.

7.3. Summary

In this section we have set out a number of options for reforming the funding, governance and ownership arrangements of the central systems and services provider to the gas industry Xoserve. These options would involve a step change in the way the gas industry delivers and governs central services in most cases requiring significant behavioural change from industry participants and structural changes to the commercial and regulatory framework.

Figure 7.3 illustrates the different change options which have been outlined and how different aspects of each option might overlap.

Figure 7.3: Summary of change options



In summary, Figure 7.3 illustrates three “strawmen” options.

The first (Option A) involves optimising the current arrangements through reforming change management *alongside* the funding framework. For example, through extending User Pays or introducing a more negotiated form of price control funding settlement. This includes the option of user representation on Xoserve’s Board (in a non-executive capacity).

The second approach (Option B) is based on removing the contractual arrangement (i.e. ASAs) between Xoserve and the GTs. This involves making Xoserve a fully “empowered”, direct customer-facing subsidiary, still under GT ownership but with a separate licence for the activities it performs. A negotiated settlement would set regulated prices, with Xoserve in this case empowered to lead the funding settlement with industry participants.

A third, more radical change option (Option C), involves a cooperative model where there is joint industry ownership and control of Xoserve. This would involve a major step change in the way the gas industry delivers and governs central systems and services. Xoserve funding would be provided by its shareholders according to agreed recharge arrangements.

The section which follows evaluates, and considers the implementation risks and complications, with each of these options.

8. EVALUATION OF OPTIONS

In this section we evaluate the options presented in the previous section. First, we evaluate changes that could be implemented within the current arrangements. For example, reforming the change management and funding of GT Agent service. We then evaluate the option of removing the contractual arrangement (i.e. ASAs) between Xoserve and the GTs and establishing a separate licence for Xoserve's activities. Finally, we evaluate more cooperative ownership structures similar to Elexon or the MRASCo in the electricity sector.

8.1. Optimising the existing regulatory and ownership framework (Option A)

A number of changes to industry governance and change management have already been brought forward by industry participants through UNC processes (UNC334 group). These refinements have the potential to improve change processes and to some extent transparency and operational oversight over GTs and Xoserve's management and responsiveness to change.

While incremental refinements may be beneficial in the short term, and for this reason we expect would be supported by industry participants, on a standalone basis, it is our view these changes are unlikely to address the wider, more strategic issues we have identified with GT Agent services. In particular, to provide a fit-for-purpose Xoserve that can cope with the rapid change expected in the next few years in the gas industry.

This conclusion is supported by the observation that Xoserve already invests significant effort in working with industry participants:

- While changes to governance have the capacity to support these efforts, ultimately changes that relate to licence or UNC obligations will always require agreement from the parties ultimately responsible, and liable, for the performance and discharge of central agency service obligations in the gas sector – i.e. the GTs.
- Changes to *change management* do not change the governing contractual relationship between Xoserve and the GTs which drives the strategic direction, and operational delivery of the business. Xoserve can and does engage with Shippers, but ultimately its responsibility is to its shareholders and contractual customers, the GTs.

The options UNC334 considered around change development funding also highlight wider issues around strategic changes affecting the gas sector as identified in Section 4. Interdependencies between Xoserve and the SMIP mean that there needs to be a high level of confidence in Xoserve and the GTs to deliver required changes to systems and services on time and to specification (as set out in our terms of reference).

Ultimately while the *manifestation* of many of the issues identified in Section 4 are observed at an operational level, their cause is more strategic, related to corporate structure, incentives and the contractual relationship between GTs and Xoserve. With Xoserve's business entering a period of change (away from its steady state) this suggests to us that more radical options should at least be

considered in a detailed consultation exercise, recognising there are also risks with moving away from current arrangements as we discuss below.

We evaluate more specific changes proposed under Option A in the sub-sections which follow. As outlined in the previous section, these changes would require major reform of the *funding* framework of GT Agent services.

8.1.1. Change management / User Requirements Planning Group

Our concerns with a narrow focus on change management and industry governance (independent of funding) are outlined above. Of course change governance/project management is critical as a means to manage change and establish broader strategic priorities.

However, independent of more radical changes, we consider there to be the potential for conflicting objectives of Xoserve's role and accountability to different industry participants within, for example, a User Requirements Planning Group. A contractual model to facilitate discharge of GT regulatory obligations may not work vis-à-vis a more empowered GT Agent governance role.²⁰

In terms of the ease of implementation, clearly changes to UNC processes or the establishment of an industry planning group would appear to provide some potential "easy wins" for the industry, given the main implementation steps are likely to include:

- industry working groups to develop the procedures and governance frameworks associated with a GT Agent User Requirements Definition Group;
- potential changes to GT licences and the ASA to obligate GTs and Xoserve participation in User Requirements Definition Group; and
- greater resources across industry participant groups, particularly Xoserve, to support the enhanced industry governance processes.

However, there are implementation and transition risks, including the potential for the changes simply to lead to increased bureaucracy and costs for industry participants. There might also be the risk Xoserve was not able to provide adequate information, particularly costs of implementing change, to enable the working group to be effective.

8.1.2. Extended User Pays

User Pays may offer the potential for more flexible funding of central systems and services by their increasing treatment as excluded services (as budgets could be agreed incrementally). The model may also offer more transparency around what industry participants have funded as part of baseline requirements. Experience to date would seem to suggest that User Pays model can be an effective incentive mechanism for industry participants to consider the costs they impose on Xoserve. Against

²⁰ For example, should all industry participants have a key role in GT Agent operations when GTs retain ultimate accountability under their discharge of licence obligations?

this, there have been criticisms over the time taken to develop costings as well as the transparency of the cost estimates.

There are, however, a number of risks associated with extending and placing greater reliance on the User Pays funding approach. For example:

- GTs would be reliant on the release of funding from users to meet certain licence and UNC obligations. They would have less control and certainty over funding than currently but would continue to bear similar regulatory and commercial risks.
- User Pays principles have been applied to incremental changes but not major capex or complex investments. Unless users fund investment upfront, the model may create a financing requirement independent of GTs price controls.
- From Xoserve's perspective, there is the risk of insufficient use of the investments to provide payback of the costs. Particularly with capex, there is a risk of eventual cost recovery unlike a price control where a RAB provides for cost recovery.
- Questions such as "Who takes responsibility for longer term funding?" and "How might development activities or anticipatory investment be handled?" are likely to be particularly important for delivery of strategic change under the User Pays model.
- As with User Pays currently, there is also a risk that rather than promoting more consensual funding of services and change development, the industry instead focuses mainly on cost targeting issues ("who pays under User Pays").²¹
- As mentioned above, there is also a perception from industry that current User Pays has not worked effectively (for example, related to timeliness to develop costings and transparency of cost estimates). Simply extending User Pays may not resolve such problems.

The process of identifying what could be reclassified as User Pays may be challenging in itself if it is not clear who is expected to benefit from a function, i.e. shippers or transporters. Some functions are likely to service both shippers and transporters; therefore defining who should pay for these services may be difficult (how transporters would fund certain functions through the price controls may also be difficult if an eight-year ex ante allowance is set). When the current framework was developed these issues were avoided by classifying the majority of existing services provided by the GT Agent as Core and incremental changes classified as User Pays.

Implementation would of course be simpler than more fundamental changes:

- We expect some changes to the UNC and the GT licences would be required to change the balance of services funded through User Pays.

²¹ As has been discussed at the UNC 334 Review Group, one option for addressing concerns around cost targeting for different services, might be to standardise the approach to allocating User Pays charges. For example, Elexon's funding model in electricity illustrates a model of cost allocation based on the principle/concept of market share.

- An industry working group would need to identify which services should be separated from GT price control funding and treated as User Pays.
- Extension of the User Pays model may also require changes to industry governance to be brought into force (for example, some forms of change management).

The main implementation risks include:

- The risk (as currently with User Pays) that industry participants focus on cost targeting rather than the delivery of service and system changes.
- The risk that critical changes to industry systems and services might get delayed through lack of clarity on funding.
- From Xoserve’s perspective, extending the User Pays framework might not provide the required user commitment to avoid the risk of eventual cost recovery for strategic capex.

With an extended User Pays model, stakeholders would need to be comfortable with retention of the current regulatory and contractual framework, but reduced Ofgem participation and *governance* over the funding settlement of GT Agent activities and services.

8.1.3. Negotiated settlement

The risk with a negotiated settlement approach is the potential for disputes over both the *level* and *allocation* of funding of Xoserve’s central services and systems. Rather than Ofgem having the envisaged “light-touch” consumer protection role in the negotiated settlement, it might instead be asked to constantly arbitrate on the detail of costs and services provided (i.e. drawn into a more traditional regulatory role).

While there are examples internationally of user negotiated funding settlements, the model is largely untested in the regulated GB energy sector. It would require significant change in behaviour from the GTs and Xoserve and engagement from Shippers.²² It may also require Ofgem to initiate and be involved in strategic change; the type of change in systems and services which are likely to be the most difficult for the regulator to assess.

How to incentivise the GT Agent, its owners and users may also be a challenge to resolve. For example: how might the quality of service and efficient delivery of change vis-à-vis efficient management of central agency expenditure be measured?²³ An advantage of the current funding model (including User Pays principles) is that the incentives on different industry parties are relatively clear (see Section 3.5). Benefits to different parties under a negotiated a settlement, independent of the industry regulator, would need to be equally clear.

²² For example, in terms of costing of options and business plans and information provision to Shippers.

²³ This is challenging for a core networks business with clear outputs but potentially more challenging for an information system operation and management business.

However, in our view, it is through a negotiated industry settlement that a more accountable and flexible funding model for Xoserve's activities can and should ultimately be achieved.

In the *envisaged* model, this is through the market discovery role of user engagement in the negotiated funding settlement (particularly for capex) and a flexible funding mechanism appropriate for a data and information systems application business (i.e. rolling operational budgets for shorter business planning periods and change management). Similarly, provided the rules and procedures of the negotiated settlement were to work as intended, there is also the potential to avoid unduly burdensome regulatory processes whilst continuing to protect the interests of consumers.²⁴

A negotiated settlement would also provide the industry's uncertainty mechanism for managing future flexibility and adaptability as Xoserve's role in the gas industry changes. The *process* would provide the vehicle for developing change with greater industry responsibility and involvement in determining their future requirements from Xoserve

Clearly there are implementation challenges:

- Industry working groups would need to develop the rules, practices and procedures associated with a negotiated funding settlement.
- We expect there would need to be major changes to the UNC and the GT licences to define the obligations and roles of different parties in a negotiated settlement.
- A key issue that would also need to be resolved is how costs would be targeted on industry participant groups ("who pays").
- GT Agent funding solely through use of system charges might be considered undesirable if the incentive on users to assess the costs and benefits of different proposals were removed.
- Were costs recovered through a separate GT Agent rate card (rather than use of system charges) then a methodology would need to be developed.

There is also the same issue as raised with changes to industry governance about the ability to access many of the benefits of a negotiated settlement approach where the relationship between Xoserve and the GTs continues to be managed contractually through an ASA. A more empowered agent role in a negotiated settlement does not feel wholly consistent with GT responsibility for service delivery and an ASA arrangement. This suggests a negotiated settlement could only be achieved within the status quo arrangements provided the GTs (rather than Xoserve) were to lead the negotiated settlement with their customers.

Even then, the governing contractual relationship between Xoserve and GTs would remain in place.

8.1.4. User non-executive board member

The advantages the UNC 334 Review Group highlighted with this reform option include:

²⁴ Noting the points raised above about disputes over the level and allocation of funding.

- improved customer focus;
- improved *board level* access to customers views and experiences of services provided;
- improved transparency and strategic oversight of Xoserve; and
- benefits from Xoserve access to wider industry experience /requirements.

While there are precedents of non-executive board members performing roles in regulated companies (as has been proposed for GB energy network companies) we question the rationale of such a role in the context of Xoserve's business *currently*.

As they stand, the prevailing outsourcing arrangements promote engagement by Xoserve's owners predominately in an oversight capacity of the key contractual arrangements in place which allow the GTs' to meet their licence requirements (namely the ASA). The company (and Board) is constrained by the contractual interface between Xoserve (as outsourced data and IS service provider) and the GTs. While the Board may engage in strategy and actively monitor performance (through the company's key performance indicators) its role and objectives are defined by the contractual framework for central systems and services.

As the GTs have highlighted through the UNC 334 Review Group, and in responses to our stakeholder questionnaire, change management is also not usually a topic for board consideration. These issues are managed by the GTs and Xoserve through the ASA. Given the stated objectives and role of Xoserve's Board it is not clear what the responsibilities of a user non-executive would be – the Xoserve Board are the custodians of the efficient delivery of the ASA process and discharge of the GTs licence obligations.

There is also a risk that it would be challenging to find a non-executive director that represented the interests of users as a whole. The I&C Shippers, for example, frequently have different strategic objectives from the larger domestic shippers.

The main implementation risk (within the current regulatory governance and ownership model) is clearly one of conflicting objectives whereby delivery and governance of central systems and services is managed primarily through the contractual relationship between Xoserve and the GTs rather than the company operating as a fully empowered subsidiary.

Changes to corporate governance and in particular the role of a user representative non-executive may have greater relevance if the role of the Xoserve Board were strengthened as part of greater "corporatisation" and "empowerment" of the GT Agent role (an issue we return to as part of the full subsidiary with licence option below). In this case a user representative to constructively challenge and contribute to the development of strategy within the business might support transparency and the responsiveness of the business to customer needs.

The main implementation issues include changes to GT licences and the UNC to require user non-executive membership of the Xoserve Board. The shipper community would need to develop a nomination process to agree their representative (s) on the Xoserve Board. New board members may also require changes to how Xoserve operates and reports to its Board going forward.

8.1.5. Conclusion

In this section we have considered options which on a standalone basis can broadly be characterised as *incremental changes* to the current arrangements. Taken together, however, they would require considerable *behavioural* change from GTs, Xoserve and other industry participants leaving existing *contractual* (i.e. ASAs) and regulatory (i.e. GT obligations) frameworks unchanged.

We note the following key points.

We do not consider the governance change options address the cause of the issues identified under the current arrangements, namely the contractual relationship between Xoserve and the GTs. An eight-year ex ante funding mechanism structured to support capex intensive network businesses is in our view also inappropriate for the activities managed by Xoserve.

In our view, a negotiated settlement would be a more suitable funding mechanism for providing flexibility and adaptability as Xoserve's role in the gas industry changes; the market discovery role from user engagement and the more direct contractual interface with users, the vehicle for developing change and greater industry responsibility and involvement in establishing industry requirements from Xoserve.²⁵

Extending User Pays provides one option of achieving this. However, there is a perception from industry that current User Pays has not worked effectively.

A *regulated* negotiated settlement where GT Agent activities are funded through *price controlled revenues* might provide more certainty over future funding of critical services and still reduce the role of the regulator in the process. More flexible rolling opex budgets agreed by industry participants would provide future funding flexibility.

However, such an approach could only be achieved within the *status quo* arrangements provided the GTs (rather than Xoserve) were to lead the negotiated settlement with their customers. We envisage significant challenges with this approach where the existing contractual relationship between Xoserve and GTs remains in place.

Xoserve should *either* operate as an outsourced function (with GTs responsible for customer relationships and determination of industry requirements and funding) *or* an empowered agent operating on behalf of the GTs through industry governance processes.

In the section which follows, therefore, we evaluate the more fundamental changes to regulatory obligations and ultimately ownership and corporate control of Xoserve outlined in the previous section. These might help facilitate a more empowered Xoserve that could lead a funding settlement or requirements definition process with industry participants.

²⁵ For example, GTs and Xoserve would be able to enter into dialogue with DCC and industry participants for funding to support its role in the SMIP. The negotiated settlement would also provide a mechanism for shippers and suppliers to enter into dialogue with GTs and Xoserve over requirements that support their transition to new smart meter systems and processes.

Table 8.1 summarises our evaluation based on the review evaluation criteria. We score the options on a tick scale system of 1-5, where 5 is best. We also show our assessment of the materiality of the implementation issues / next steps.

How the options evaluated in this section might facilitate iGTs incorporation within the current regulatory and contractual arrangements is considered in Annex D.

Table 8.1: Evaluation of changes to optimise the existing arrangements (Option A)

Criteria	Optimise existing arrangements (Option A)			
	Change management / industry planning group	Funding		Non-executive board member
		User pays	Negotiated settlement	
Efficient provision of services	Some of the proposed changes might add cost and bureaucracy without obvious benefits.	Maintains incentives on users to consider costs they impose on Xoserve.	Negotiated settlement to help users assess costs. Regulator role in protecting consumers.	In theory benefits through Xoserve having wider stakeholder representation on the board.
	✓	✓✓✓	✓✓✓	
Provision of good quality of service	Would support Xoserve's existing customer service performance and management of change.	Offers the opportunity for wider engagement with industry participants.	Offers the opportunity for wider engagement with industry participants.	It is unclear to us the rationale for a non-executive role within current the ownership / contractual structure.
	✓✓	✓✓	✓✓	
Responsiveness to customers' needs	ASA contracting model would continue to dominate the delivery model of GT Agent services. May not reduce "inflexibility".	Wider industry participant role in establishing requirements and settlement of funding.	Wider industry participant role in establishing requirements and settlement of funding.	✓✓
	✓	✓	✓✓	
Transparency and engagement	May help to provide more user operational insight into central systems and services.	Requires GTs and Xoserve to consult with stakeholders (similar to objectives of RIIO).	Requires GTs and Xoserve to consult with stakeholders (similar to objectives of RIIO).	May help to provide greater transparency of Xoserve activities.
	✓	✓✓	✓✓	
Accommodate future industry changes	Engagement similar to Project Nexus could support better long term industry planning.	The model has yet to be tested for capex in systems infrastructure.	Might facilitate market discovery process and identify industry requirements. Price control provides funding certainty.	In theory benefits although note points above.
	✓✓	?	✓✓	

Criteria		Optimise existing arrangements (Option A)			
		Change management / industry planning group	Funding		Non-executive board member
			User pays	Negotiated settlement	
Ease of implementation / transition issues	Separation of services	Services continue to be provided through a single agency model.	Industry participants would need to identify which services are User Pays.	Services continue to be provided through a single agency model.	Services continue to be provided through a single agency model.
	Changes to regulatory framework	Some changes to UNC and GT licences.	Some changes to reflect changes to UNC governance and services treated as User Pays.	Major changes to define rules, practices and procedures with a negotiated settlement.	Some changes to UNC and GT licences.
	Resources	Working groups during establishment and greater enduring industry resource.	Would depend on whether reforms to UNC governance adopted at the same time and may require greater industry resource to agree User Pays funding.	Working groups to develop rules/practices. Industry responsibility for running the process.	Shippers would need to elect a representative.

8.2. Changes to ownership and regulatory obligations

8.2.1. Separate licence, customer facing GT subsidiary (Option B)

The main benefits of this model, as compared with the current arrangements, is Xoserve's role in the gas sector and its accountability to different industry participant groups would be made clearer and more flexible by removing the ASAs.

As an empowered subsidiary of the GTs with a licence for providing central systems and services, the customer interface between Xoserve, GTs and shippers would be defined through the separate licence, with Xoserve directly responsible and accountable for the customer interface. The flow of funding to support the central systems and services would also be more direct to the service provider (i.e. Xoserve).

A full subsidiary responsible for the contractual interface with shippers would also allow the benefits of a negotiated settlement to be accessed more easily. Xoserve as an empowered subsidiary, rather than outsourced function, would be responsible for running the negotiated settlement with the users of its services; both shippers *and* GTs.

Greater engagement between users and Xoserve (as an empowered service provider) should also help accommodate future industry changes. Funding would be agreed incrementally according to industry objectives and requirements. Furthermore, it would provide the agency with the vires to develop and deliver its own strategy and hence to provide the commercial services and innovative thinking required to deliver future industry changes.

Xoserve (as a GT subsidiary) would still be able to draw on its owners for the businesses working capital and financing requirements.

However, there are also clear risks associated with this option. Notably the capacity for a negotiated settlement not to work as envisaged and the risk (as identified previously) that rather than Ofgem having a "light-touch" consumer protection role, the regulator instead is asked to arbitrate on the detail of costs and services provided through the settlement participants consistently fail to agree on requirements and funding priorities.

The challenges associated with cost allocation should also not be underestimated. Indeed, cost allocation is an issue that applies fairly consistently across all the options where Xoserve has a more direct interface with shippers. As well as charges needing to be cost reflective, the methodology of allocating costs would need to be structured according to the cost drivers of the business. Either there would need to be an agreed methodology, or cost allocation would need to be a key component of any negotiated settlement.

Establishing Xoserve as a fully empowered GT subsidiary may also be challenging and costly to implement. For example, implementation steps are likely to include:

- Creation of a new licence for central systems and services in addition to changes to the UNC and the GT licences.

- Industry working groups to develop the rules, practices and procedures associated with a negotiated funding settlement.
- Standard issues around ensuring appropriate ring-fencing, creditworthiness and avoidance of cross-subsidy addressed through the design of the licence.
- As separate licensed activity there may also need to be changes to the way in which the GTs operate vis-à-vis Xoserve.

In terms of risks and costs a separate licence might arguably be overly complex for a relatively small entity and there is also the risk whether a negotiated settlement approach can work as envisaged through a corporatised and empowered GT subsidiary.

8.2.2. Cooperative body (Option C)

A cooperative body is in principle accommodative to many of the criteria set out for our review. For example, different industry groups would be able to drive the outputs and outcomes which they require from the central data and IT services that are provided to the gas industry. A cooperative by definition promotes transparency and engagement.

The objectives are also clear. Cooperative ownership and governance would aim to align industry incentives and interests, were changes to regulatory funding, obligations and governance considered too complex and or overly challenging to implement. There is precedent in other parts of the energy industry of the “cooperative” model having relative success, and so might be considered a “tested” model for delivering similar services. The overall result would be a less “thick” regulatory model allowing Ofgem to play a less interventional role in industry governance and delivery of gas central systems and services going forward.

However, while a number of industry stakeholders proposed a type of “cooperative” model in responses to our questionnaire (mainly larger suppliers) – highlighting their shared interests in many of the activities performed by Xoserve – there were also respondents who noted limitations with cooperative bodies. For example, it was felt that larger stakeholder groups can have too great an influence over activities and funding. Certain stakeholder groups valued highly the independence of an agent independent from the market under the current ownership model.

We note administration of the main industry code in the gas industry (the UNC) is also separate from the operational role performed by Xoserve. The rationale for shared ownership in other contexts has been driven by the need to balance interest group influence over code administration and change as well as shared interest in the delivery of certain activities (for example, settlements). As code administration is under separate governance from Xoserve, in our view, this slightly weakens the case for a shared ownership / interest model.

There are also risks with transitioning to a cooperative body. At a time of major change in the energy industry there is a risk that forcing through significant changes to funding, governance and ownership of critical systems and services could act to undermine the industry’s capacity to respond

quickly to required changes in systems and services. Equally, the risks of fundamental change apply to other options (such as a licensed, fully empowered subsidiary model).

There may also be implementation challenges.

Some of the activities that are currently performed by Xoserve are more closely linked to gas markets, while others are more closely linked to transportation businesses. A fully cooperative model might - at least in the short term - create challenges in defining who should have corporate governance and control of different central services and where accountability should ultimately lie for different activities across stakeholder groups.

One way to address this might be to develop a hybrid model between a separate licence, customer facing GT subsidiary and a cooperative body which separates/unbundles funding and governance of Xoserve's "market" and "network" services.

This would include more "cooperative elements" of a licensed central service provider that is funded and in part governed more directly by the beneficiaries of the different services which are provided by Xoserve. This could operate as follows:

- Xoserve Ltd (the parent company) could continue to be nominally owned by the GTs and would also own the information systems which support its business activities.
- Xoserve Ltd could also hold the licence that allowed the company to provide central services and systems to the gas industry.
- Separate subsidiaries would be established to govern the different central functions and licensed activities.

One such subsidiary would focus on the provision of GT services. Another would focus on the provision of services with wider industry participant interest. Each company would have its own board structure appropriate to the different functions / obligations carried out by the central agency company. As illustrated in Figure 8.1, one subsidiary could be tasked with servicing GTs with a board structure comprising GT membership ("Xoserve Networks"). The other subsidiary could be tasked with central services with wider stakeholder interest and so broader industry participant representation on the board ("Xoserve Markets").

Figure 8.1: Separate service company

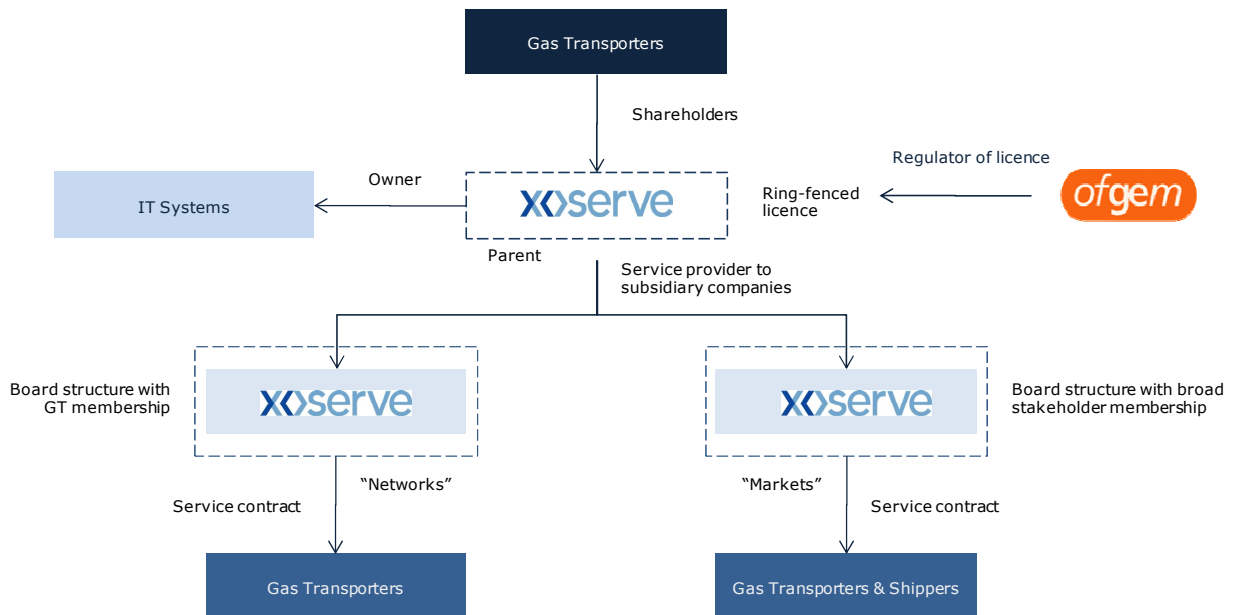


Figure 8.1 illustrates an arrangement where a licence is held by Xoserve Ltd which also owns the IT systems. In an alternative variant model, separate subsidiary companies could be granted the licence to perform certain activities (rather than the parent company) and the IT systems operated and managed by Xoserve separated into the different subsidiaries.

This highlights a key issue with any cooperative model, notably the feasibility of separating critical information systems and services from the gas transporter businesses. While systems could potentially be leased to Xoserve as a separate cooperative service provider to the gas industry our understanding of how existing services are used (see Section 3) suggests complete functional separation may in some cases be challenging.²⁶

The text box (overleaf) describes the governance model operated for the banking sector payment system operator (Bacs). Closer in ownership and governance to a fully “cooperative” business model, it is interesting to note that while Bacs now operates as an industry “cooperative” not-for-profit activity, in 2003 the infrastructure to run the Bacs scheme was separated into a separate company (VocaLink).

Under any cooperative model, there would be issues around cost and resource allocation and who should pay for incremental capacity driven by changes from the industry as a whole or within particular participant groups. By separating different functions and obligations from the GTs, Xoserve would also need to raise its own finance and working capital (rather than relying on National Grid Treasury) from across industry participant groups.

²⁶ A model such as illustrated in Figure 8.1 might help solve how systems could be leveraged to provide services to different industry participant groups, but then there are other complications including where obligations should sit (for example, at the parent or subsidiary level?).

Text Box 8.1: Banking sector payment system operator (Bacs)

- Bacs Payment Schemes Limited (BPSL) is the organisation responsible for the clearing and settlement of automated payments in the UK including Direct Debit and Bacs Direct Credit.
- BPSL is a not-for profit, self-financing organisation limited by guarantee. Its costs are met by payments from its members.
- Members perform a number of functions including funding Bacs, underwriting Bacs’ risks, and determining its business plans.
- The BPSL Board comprises directors appointed by members of the organisation, and the BPSL Managing Director.
- Due to its “critical importance” to the UK financial system, it was recognised in 2010 by HM Treasury for statutory oversight by the Bank of England under the Banking Act 2009.
- Bacs was founded in 1968 and is currently owned by 15 banks and building societies. Following recommendations by the OFT in 2003, BPSL was separated from Bacs Limited.
- BPSL became the not-for-profit body governing the rules of the Bacs scheme and promoting automatic payment schemes.
- Bacs Limited retained the infrastructure to run the Bacs scheme. One year later, Bacs Limited changed its name to Voca Limited and merged with the LINK Interchange Network
- In 2007 it became VocaLink. VocaLink continue to run, service and maintain the infrastructure network on behalf of BPSL.

8.2.3. Conclusion

Table 8.2 summarises our evaluation of Options B and C against the review evaluation criteria. As before, we score the options on a tick scale system of 1-5, where 5 is best. We also show our assessment of the materiality of the implementation issues / next steps.







Also as above, the capacity for the different models to help facilitate and accommodate iGTs in a single service provider is explored in Annex D.

Clearly a separate licence structure would help to facilitate provision of services to the iGTs like any other industry stakeholder in central systems and services. The transition to the new licence structure might also provide an opportunity to address funding issues around the transition to iGTs use of the central service provider.

Under a more cooperative model, a role for iGTs would need be created in the governance of central service provider activities.

Table 8.2: Evaluation of more fundamental changes to industry governance and ownership

Criteria	Option B	Option C
	Separate licence, customer facing GT subsidiary	Full cooperative body
Efficient provision of services	Clearer accountability to stakeholder groups and clearer customer / service provider relationship. Flow of funding to support services and systems would be more direct to the service provider.	Funding determined by stakeholders that value / use the services. Maintains incentives on users to consider costs they impose on Xoserve through the recharging arrangements for the company.
	✓✓✓✓	✓✓✓✓
Provision of good quality of service	Clearer negotiated settlement for information systems and business services. However, model is largely untested in regulated GB energy sector and relies on step change in industry working practices.	Clearer accountability to wider industry participants groups. Different industry groups able to drive outputs and outcomes. Xoserve services separation from UNC maybe weakens case for cooperative ownership.
	✓✓✓	✓✓✓✓
Responsiveness to customers' needs	A more empowered central service provider rather than constrained through a contractual arrangement. However, to realise benefits considerable behavioural change from Xoserve, GTs and Shippers required.	Clearer accountability to wider participant groups. All stakeholders have a stake in ownership and direction of the service provider. Potentially issues around cost and resource allocation.
	✓✓	✓✓✓✓
Transparency and engagement	Greater transparency with a separate licence while retained delivery in a central function.	Clearer accountability and transparency. All stakeholders have a stake in ownership of the agent although there are risks that certain stakeholder groups might dominate governance and processes.
	✓✓✓✓✓	✓✓✓
Accommodate future industry changes	Provides Xoserve with vires to develop and deliver its own strategy to deliver future industry changes. Transitioning risks during period of industry change with considerable behavioural change required.	Industry participants can drive the funding and requirements from the central service provider. Risks during period of significant industry change given implementation challenges.
	✓✓✓	✓✓✓

Criteria		Option B	Option C
		Separate licence, customer facing GT subsidiary	Full cooperative body
Ease of implementation / transition issues	Separation of services	Services would continue to be provided through a single agency model although separate (in regulatory terms) from the GT's businesses. There may be some transitional changes.	Feasibility of separating critical information systems and services from the gas transporter businesses would need to be explored further.
			
	Changes to regulatory framework	Major changes to the regulatory framework to develop licence. Standard issues around ensuring appropriate ring-fencing, creditworthiness and avoidance of cross-subsidy addressed through the design of the licence.	While there would be major regulatory change in the short to medium term in the future a less “thick” regulatory framework would be in place along with a reduced role for Ofgem.
			
	Resources	There will need to be industry working groups during establishment and potentially much greater enduring industry resource through participation in the service provider negotiated settlement process.	There will need to be industry working groups during establishment and potentially much greater enduring industry resource through participation in the cooperative body.
			

9. CONCLUSIONS AND RECOMMENDATIONS

9.1. Industry requirements and the role of funding, governance and ownership

From a contractual stand-point, as pointed out to us by Xoserve's management, Xoserve has fulfilled its obligations under the ASA, both within the regulatory allowance and to the required standards, as for evidenced, for instance, by Xoserve's own key performance indicators for 2010/11. This overall message is generally supported by the feedback that we received from stakeholders during the process of completing our review. Throughout our consultations we have consistently been told that on a day-to-day basis Xoserve is delivering its services and that its staff are professional and well qualified. Xoserve's management also set out the steps that have been recently taken to engage with Suppliers and Shippers in order to help identify and address any concerns that they might have.

Whilst in general there has been a degree of satisfaction with the services provided by Xoserve, our stakeholder consultations also identified concerns not just with User Pays services but also with Core services. Whilst not always fully articulated by stakeholders, their concerns seem to be based largely on a perception of, first, *poor responsiveness* to requests made by Shipper – particularly for services driven by change within the sector and which perhaps are more challenging or requiring a greater degree of resource or more innovative approach. Second, there was a degree of unease and even suspicion, regarding a general *lack of transparency* in the general arrangements, particularly as regards how charges for services are derived and their consequent value for money and how strategic decisions affecting the industry are taken. These views would appear to be consistent with views provided to Ofgem prior to it commissioning this review.

We believe that the arrangements put in place for Xoserve's funding and governance, in particular, help explain these observations. Or put another way, what is observed is to a large extent a natural consequence of what has been put in place.

Although suppliers of business process outsourcing are typically not owned by their clients, for the most part Xoserve does act as the provider of outsourced IT services to the GTs who, in the main, are its arm's length, contractual customers to whom it is answerable. Whilst this relationship dictates much of Xoserve's business, in addition it has sought to develop direct relationships with Shippers and establish itself as the client interface (even for ASA provided service), rather than the GTs.

We consider that the restrictions created by the ASA arrangements, the ambiguity that exists as regards customer relationships and the indirectness of payment flows, all contribute to the observed lack of transparency and service responsiveness. Indeed, irrespective of the efforts made by Xoserve's management in improving customer management, these arrangements and structures are likely to increasingly militate against success as Shipper and Supplier demands continue to increase as a result of changes within the sector.

Such problems are compounded by Xoserve's regulatory funding arrangements which are more suitable to a large capital network operator, rather than an IT services provider. A more flexible means of funding would be more consistent with the investment requirements of such systems.

Perhaps to a lesser degree, Xoserve's ownership and corporate governance regime have not been appropriately focused to address these problems and have thus also contributed to the observed problems. Whilst there is a logic to current ownership arrangements and Xoserve's board fulfil their fiduciary obligations, there is little evidence of a corporate ambition beyond meeting the requirements of the ASA. The absence of ownership or control adds to the perceived lack of transparency on the part of other stakeholders.

9.2. Options

Although the industry has proposed a number of changes (focused predominantly on change management and industry governance) to help address the issues identified, we believe that these are unlikely to be sufficient to address the problems identified and therefore more radical options should also be included in a detailed consultation exercise.

Having considered carefully the analysis in this report, there seem to us to be three credible options that could be considered further.

The first (Option A) would involve optimising the current arrangements through reforming industry governance (change management) *alongside* the funding framework. We would suggest that funding issues are best addressed through a more negotiated, rolling form of settlement rather than the regulatory arrangements that exist at present.²⁷ This will allow a greater degree of flexibility to meet industry requirements, as well as improving visibility as to how the funding requirement is established. Ofgem will still need to be prepared to step in – if required – to protect final consumer interests or to drive strategic industry change.

Where the existing regulatory and contractual framework for GT Agent services remains in place (as envisaged for Option A), it would be the GTs rather than Xoserve who would need to lead the negotiated settlement with industry participants.

The second approach (Option B) would be to remove the contractual arrangement (i.e. ASAs) between Xoserve and the GTs, making Xoserve a fully “empowered”, direct customer-facing subsidiary, with a separate licence. In this case an empowered Xoserve would lead a negotiated settlement with industry participants.

A third, more radical change (Option C), involves a cooperative approach where there is joint industry ownership and control of Xoserve. This would involve a step change in the way the gas industry delivers and governs central systems and services, with funding provided by Xoserve's shareholders/stakeholders according to recharge arrangements.

²⁷ This might be achieved either through extending User Pays or a formal negotiated process with a rolling budget funded through an identified /specific revenue term in the GTs principal revenue formula.

As regards Option A, we do not believe that the ASA arrangements remain fit for purpose if a more responsive Xoserve is desired. This leaves the two alternatives. A minimum means of achieving a more responsive Xoserve would be to move relevant licence obligations from the GTs to Xoserve, which will help empower it as a more customer facing subsidiary (i.e. Option B). The alternative is a more cooperative body (Option C) which would require collective engagement and accountability for Xoserve across industry stakeholder groups.

The benefits of Option B, as compared with the current arrangements, is Xoserve's role in the gas sector and its accountability to different industry participant groups would be made clearer and more flexible by removing the ASAs. There are risks with this model; considerable behavioural change would be required from GTs, Xoserve and other industry participants. While the principles of negotiated settlement in the context of Xoserve's business are in our view sound, the model is also largely untested in the regulated GB energy sector.

In contrast, cooperative ownership and governance would align industry incentives and interests, and potentially avoid the complexity of regulatory funding, obligations and governance under Option B. There is also precedent in other parts of the energy industry of a "cooperative" model having been a relative success. However, of all the available options a cooperative model may require greatest upheaval of the current arrangements.

There are costs and risks either way. With both Options (B and C) there is a risk that with the industry undergoing a period of change on many other fronts, radical changes to Xoserve funding, governance and ownership act to undermine the capacity for Xoserve to respond quickly to required changes rather than promoting responsiveness as intended. There are implementation challenges with either approach.

Ultimately, the optimal arrangements would, in our view, seem to rely on answers to a number of high-level, but fundamental questions, which can only be addressed through further consultation with different industry stakeholder groups:

- First, are the activities and systems managed by Xoserve separable from gas transportation businesses? If complete functional separation were considered challenging, or indeed impossible, then a fully licensed, empowered GT Agent subsidiary model might on balance provide the optimal arrangements for the future (on the basis of being the most practicable option for addressing identified issues).
- Second, following from the first question, are the activities performed by Xoserve "cooperative" in nature. With UNC administration under separate governance from Xoserve, is a shared ownership / interest model in this context appropriate? If the answer is yes, and Xoserve's systems and services are separable from the GTs business, then a cooperative model could provide the optimal arrangements.
- The next question is what appetite is there amongst industry participants outside the GTs to assume a greater role, responsibility and therefore *accountability* for Xoserve and its

activities?²⁸ Xoserve provides critical industry services, and will have a role to play in facilitating smart metering. A cooperative body would require Shippers, for example, to invest resource and potentially their own capital into the business as part of their collective industry responsibility for the services provided.

- Finally, are the systems and services provided by Xoserve of such criticality to the industry during a period of already significant change in the energy sector, that fundamental change to Xoserve funding, governance and ownership raises too great a risk? If the answer in this case is yes, then Option A would need further consideration, recognising there will be limits of what can and might be achieved.

9.3. Recommendation

We believe that the precise arrangements need to be determined by an industry Consultation which further explores the respective costs and benefits of each option and industry participants views on the consultation questions outlined above.

²⁸ Indeed, is the desire and envisaged role in Xoserve corporate governance and ownership the same across different industry participant groups?

ANNEX A: TERMS OF REFERENCE

8. **Appendix A: Terms of Reference for RIIO-GD1 price control review**

Introduction

8.1. Ofgem is currently undertaking a price control review (RIIO-GD1) of the gas distribution network (GDN) companies, which will set allowed revenues for the period 1 April 2013 to 31 March 2021. As part of the price control review, we propose to consider the funding, governance and ownership arrangements for xoserve, which provides transport transactional services on behalf of the major gas networks. We are seeking to procure consultancy services to undertake the study of the potential future arrangements for xoserve. The consultant's study will feed into our proposed consultation on xoserve which we expect to publish in the summer of 2011.

Background

8.2. The industry relies upon the GDNs and National Grid Gas (NGG) National Transmission System (NTS) (collectively known as Gas Transporters (GTs)) to provide wider data services such as billing shippers for use of the transportation network, managing the booking of capacity on the gas distribution network, running the industry settlement systems and managing the change of supplier process. Following the sale of the four distribution networks by National Grid in 2005, an agency was needed to provide a common system and service interface between multiple network transporters and the industry, mainly shippers and suppliers.

8.3. xoserve fulfils the role of the agency on behalf of the GTs in accordance with the terms of the Agency Services Agreement (ASA)¹⁽¹⁾. The ASA details the services to be provided by xoserve and the service standards 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.

8.4. We have concerns with the value-for-money and the quality of service users receive from xoserve. We also need to ensure that xoserve does not hold-up (and facilitates) the future changes facing the industry in relation to the roll-out of smart meters and the establishment of the Data Communications Company (DCC). The future arrangements for xoserve also need to be flexible to accommodate any change to its future role and potential funding arrangements provided to xoserve through the price control, and will need to take into account the potential changes over the 2013 -2021 period.

8.5. We propose to procure consultancy services to consider the future funding, governance and ownership arrangements for xoserve. In this section, we describe in more detail the key issues that the study will need to address.

8.6. Current Funding Arrangements – Users Pays

8.7. At the last price control we introduced a new funding mechanism called 'User Pays'. This was introduced to improve incentives for GTs to be proactive with users in the services they offer via xoserve and to encourage users to consider more carefully the costs they impose when they request additional services from xoserve.

¹⁽¹⁾ Which can be found on the Joint Office of Gas Transporters website at: <http://www.gasgovernance.co.uk/Misc>

8.8. Under this approach, regulated services provided by xoserve are classified as either Core services or User Pays services where:

- Core services - regulated services that are funded through price control revenues. The costs associated with these are recovered from all customers through gas transportation charges.
- User Pays services – regulated services that are funded using charges levied directly upon the user(s) requesting the service. These are classed as excluded services under the price control.

8.9. We considered that this funding model would have the following benefits:

- GDNs and NGG NTS (xoserve) would have an incentive to enter into dialogue with users to provide additional services and respond to their needs given the opportunity to earn additional revenues.
- The model provides users with an incentive to manage the costs they impose on xoserve because they would pay for the additional services they request / use.
- xoserve's cost forecasts include a significant amount of expenditure on an upgrade of UK-Link. User pays would help to make sure that the incremental capacity of these new systems is given to those who value it most.

8.10. There is some evidence that the arrangements have encouraged users to consider the costs they impose on xoserve when bringing forward code modifications. However, users do not seem satisfied that the arrangements have succeeded in encouraging the GTs to be more responsive to their needs. A number of shippers/suppliers have told us that the User Pays model has not had the desired effect of removing the incentives on network owners to block changes to control costs. In addition, they consider the ability of the supplier to pay for changes has provided sufficient incentives for xoserve to develop new services.

8.11. Roll-out of smart meters and Project Nexus

8.12. Project Nexus was established by xoserve following the provision of funding in the last price control to replace many of xoserve's core systems. The processes related to settlements and switching will need to be substantially revised to meet the demands of the smart meter programme and widespread use of Automatic Meter Reading (AMR) in the non-domestic market. Project Nexus is currently establishing users' requirements.

8.13. In respect of the settlements functions, there appears to be a consensus emerging amongst shippers as to how they would expect future systems to operate to maximise the benefits of the investment in new metering technology. There is an expectation that new arrangements will overcome the limitations of the existing UK Link systems.

8.14. The Smart Metering Implementation Programme has signalled that xoserve's systems are likely to be on the critical path for the development of the Data and Communications Company (DCC) that will be essential for the timely deployment of smart meters. Although the scope of the DCC⁽²⁾ is still being considered, it is anticipated that system interfaces will need to be built between the DCC and xoserve to enable the DCC to manage access control for smart meters and legacy IT infrastructure has been raised as an issue.

8.15. These are major change programmes that will impact the whole industry. There needs to be a high level of confidence in xoserve to deliver the necessary systems and

⁽²⁾ More detail on the scope of the DCC services and regulatory framework can be found in the Smart Metering Implementation Prospectus on our website at the following [link](#).

processes on time and to specification. This may mean that xoserve will have to respond quickly to the requirements of the DCC and to enable UNC Code changes derived from the Project Nexus work.

8.16. Support for Independent Gas Transporters

8.17. One of the considerations in the establishment of the agency services at the time of the network sales was whether the new arrangements might facilitate a single service provider for all gas transporters, including IGTs.

8.18. Shippers have identified the additional cost and complexity they face in having to deal with individual IGT systems and processes. There have been discussions between industry parties as to the viability of IGTs service being delivered by xoserve using common UNC standards. To date there has been little progress.

8.19. The establishment of a single service provider will now need to be considered in the context of the role of the DCC.

8.20. Industry reviews of xoserve services

8.21. The industry has initiated a review of xoserve under the UNC³⁽³⁾. The aim of the review is to assess the current User Pays model, identify areas of best practice and areas for improvement. The review will also consider whether lessons can be learned from other sectors. The review will also consider more fundamental reforms such as the scope for competition for some services. The first meeting of the UNC review group was held on the 22nd November 2010 and is set to run for a period of six months.

8.22. Xoserve has also initiated a stakeholder engagement process⁴⁽⁴⁾ as part of RIIO-GD1. The purpose of the engagement is to understand network users' views on the current services provided by xoserve, and their requirements for RIIO-GD1.

We expect the findings of both of these reviews to inform our review by providing useful evidence of stakeholder's views on xoserve services as well as providing information on the performance of the User Pays model. We consider it timely to proceed with our review now as we will be determining GT revenues as part of the price review which currently fund xoserve services.

9. The Requirement

9.1. The overall objective of the study is to set out recommendations with regard to the future funding, governance and ownership arrangements for xoserve that will promote the efficient provision of xoserve's services, a high quality of service, and arrangements that are responsive to customers' needs and future industry changes.

9.2. The review will identify alternative funding, ownership and governance arrangements, drawing on lessons from arrangements in other sectors (e.g. gas and electricity sectors in GB and elsewhere) where appropriate. Drawing on evaluation of alternative models, with explicit reference to the changing industry context, the study will set out recommended arrangements for xoserve.

9.3. Following the consultant's report, we will then consult on potential options for xoserve in the summer of 2011 before drawing final conclusions for xoserve for the RIIO-GD1 period (2013 to 2021) in the autumn 2011.

³⁽³⁾ UNC review group 0334: Post Implementation review of Central Systems Funding and Governance Arrangements <http://www.gasgovernance.co.uk/0334>

⁴⁽⁴⁾ Details of the scope of this review can be found in Appendix 3

9.4. We do not require the consultant to consider in detail the broader landscape of data services in the industry post- smart metering (e.g. the respective roles of xoserve, elxon and DCC). However, the consultant will need to describe the possible changes facing xoserve, and what arrangements are required to accommodate future changes to xoserve's role and funding requirements in setting allowed revenues for RIIO-GD1.

9.5. We do not require the consultant to estimate the future efficient costs of xoserve (i.e. if these continue to be funded through the price control). We will undertake this element following receipt of the consultant's report and our consultation on future arrangements for xoserve.

9.6. Specific tasks

9.7. In order to achieve the study's objective, we expect the consultant to identify a number of discrete tasks. We set out a set of indicative tasks below. We would also welcome proposed modifications or additions to this indicative list, where the consultant believes that such changes will help better realise the objective of the study.

9.8. *An appraisal of the current arrangements for xoserve.* The consultant will consider how the current funding, governance and ownership arrangements have met the objectives in ensuring least cost provision of transport transactional services, the quality of services, including the responsiveness of xoserve to shippers/suppliers requests for service modifications. In addition, the consultant will identify any other issues that they consider are relevant to xoserve's ability to meet industry challenge.

The consultant should also consider how the current User Pays model could be improved (as one potential future option). For example, the consultant should consider the services that constitute core services (and funded through the price control), and non-core services. Consideration should also be given to how extending xoserve services to include IGTs may be affected by the introduction of the DCC.

9.9. *Identification of alternative arrangements for xoserve.* The consultant will identify alternative funding, ownership and governance arrangements for xoserve. For example, potential options might include the widening of the ownership/governance of xoserve to include shippers/suppliers; the competitive tendering of all or some of xoserve's services etc. In determining different arrangements, we expect the consultant to draw on arrangements in other relevant (e.g. gas and electricity) markets in UK and elsewhere, including the proposed arrangements for the DCC.

9.10. *A review of how future industry changes, notably the roll-out of smart meters, and the development of the DCC, will affect xoserve's future role.* We expect the consultant to describe the future expected role of xoserve and uncertainties around this drawing on the on-going work undertaken as part of the Smart Meter Implementation Plan.

9.11. *Identification of models or regulatory tools that would be required to accommodate the future uncertainty with regard to xoserve's role, and xoserve's future funding requirements during RIIO-GD1.* The consultant will set out the regulatory arrangements required to address the uncertainty with regard to xoserve's role and required funding during RIIO-GD1 (e.g. with regard to re-opening the regulatory settlement for xoserve to accommodate any future required changes to funding levels).

9.12. *Evaluation of options:* The consultant will identify a number of potential alternatives to the current funding, governance and ownership arrangements for xoserve (including the current model) and to evaluate the different options. We would expect the consultant to identify the evaluation criteria during the study but we would expect the criteria to include:

- The efficient provision of services provided by xoserve
- The provision of a good quality of service
- The responsiveness to customers' needs
- The ability to accommodate future industry changes (e.g. with regard to the development of DCC)
- The ease of implementation

9.13. *Recommended option(s)*. We expect the consultant to set out a recommended option (or options), setting out clearly how the option will promote the efficient provision of xoserve's services, a high quality of service, and arrangements that are responsive to customers' needs and future industry changes. The consultant should also describe the proposed regulatory mechanisms to address future uncertainty with regard to xoserve's role and required funding for the RIIO-GD1 period.

9.14. Stakeholder engagement

9.15. In completing these tasks, we will expect the consultant to conduct interviews with the industry including xoserve, shippers, suppliers and other relevant stakeholders. Prior agreement with Ofgem will be needed on whether a member of Ofgem staff will also need to attend.

9.16. We also expect the consultant to review any outputs with regard to xoserve's stakeholder engagement, as well as take into account any findings from the UNC review of xoserve (as described above).

Deliverables

9.17. The consultant should provide a draft report and a final report. The draft report should contain a near complete draft of the required analysis to achieve the objective of the study, and draft recommendations for the future arrangements for xoserve.

9.18. The consultant should then provide a final report taking into account comments received on the draft report. The final report should be fit for publication.

ANNEX B: QUESTIONNAIRE FEEDBACK

This annex provides a summary of the responses that we have received to the Questionnaire and Issues paper. The annex summarises the key issues raised in the responses provided by the stakeholders under the different section headings presented in the Questionnaire.

B.1: Central bodies and the role of incentives

The responses that we received suggested that the provision of uniform services by a common central agent have remained consistent and not fragmented was valued by industry stakeholders. One response also voiced support for the current funding arrangements for User Pays services.

There were a range of different views provided on the extent to which current funding, governance and ownership arrangements have delivered least cost provision of services, good quality and incentives to manage change. While stakeholders were generally agreed that Xoserve does fulfil its obligations, some concerns were raised about the ability to judge value for money given the perceived lack of transparency in funding arrangements. However, there was a consistent view that current arrangements are not appropriate to enable Xoserve to manage change effectively. The main issue raised by a number of stakeholders was the incentives created by current funding arrangements to focus Xoserve's activities on least cost service provision. In addition the limited role for customers to engage within current governance arrangements was highlighted as a concern by some stakeholders.

The views on the appropriate reforms to address the issues with the current arrangements focused primarily on reforming the current funding arrangements, most responses suggested that Xoserve's current funding arrangements were sub-optimal and create an excessive focus on cost minimisation that is not conducive to facilitating industry change. Some suggestions were given on potential changes to the current funding arrangements:

- Providing Xoserve with a separate funding mechanism, to provide transparency on Xoserve's budget and to allow some of Xoserve's outputs to be incentivised.
- The inclusion of a pass-through mechanism in allowed revenue for User Pays arrangements would be more appropriate than the existing approach.

Some stakeholders also suggested that governance reforms were necessary to give all industry stakeholders more oversight of Xoserve's activities, particular reforms suggested include:

- The introduction of governance arrangements to allow stakeholders to have a more direct role in negotiating the development of Xoserve's business plan, to improve both transparency and stakeholder's ability to engage with decision making.
- The implementation of alternative governance models such as those currently in place for BSSCo and MRASCo.
- The implementation of the governance reforms suggested in the UNC 334 Review Group.

- One response suggested that modification to the UNC governance arrangements was required to improve industry change governance. This would give the industry a better focus on the medium to longer term strategic change planning, prioritisation and scheduling of changes, which would enable the central agency to plan ahead with greater certainty.

A few responses indicated the need for reforms to current ownership arrangements. The following was suggested:

- Joint ownership and responsibility for the provision of Xoserve’s market facilitation services between the GTs and customers.
- Separating out Xoserve’s market facilitation services, removing them from the price control funding and facilitating the introduction of competition in the provision of these services. Under these arrangements services would still be provided by a common agent but the shippers and the transmission system operator would have the choice on who that provider would be.

B.2: Role and performance of Xoserve under User Pays

There was a consistent view stated that the introduction of the User Pays arrangements, while in principle a good idea, has in practice created difficulties. Most stakeholders agreed that the arrangements have created inefficient overheads for both shippers and the central agent and have led to significant amounts of time being spent trying to apportion relatively small amounts of costs across the industry. Though there was some acknowledgement that the new arrangements had introduced some flexibility into the funding arrangements.

Some responses stated that the arrangements have created perverse incentives for the owners of the central agent to minimize costs under core services (a few responses suggested that there may have been some cost pass through to User Pays); whereas other responses suggested that the problem was the difficulty in securing industry agreement given the diverse interests and priorities of different stakeholders. None of the responses attributed the problems with User Pays to the individuals working within Xoserve.

In terms of suggested solutions to the problems with User Pays, a number of responses requested new arrangements to bring increased transparency and simplicity. One stakeholder suggested that all services should be classed as User Pays and then charged on a transactional basis, while another response suggested that the central agent should have to demonstrate improved performance against service standards for User Pays services to improve responsiveness.

B.3: Cost allocation and transparency

One response suggested that the existing regulatory consultation arrangements provide a proportionate opportunity for all stakeholders to engage in the process of determining Xoserve’s business plan. However, the majority of responses indicated that current funding arrangements have

created a lack of transparency and some suggested that the proposals developed at Review Group 334 should be implemented to address the concerns with transparency.

B.4: Xoserve, Nexus and the roll out of smart meters

Responses stated consistently that the current User Pays arrangements make it difficult to fund the delivery of large scale infrastructure investment. Most stakeholders were of the view that the necessary capital investment should be funded via the GT's allowed revenue, which would ensure sufficient clarity and that both current and future beneficiaries pay for the investment – the funding of Project Nexus was highlighted as an example of a good process.

However, one stakeholder suggested funding the investment on a transactional basis in line with standard cost recovery periods for IT systems, while another response emphasised the need for flexibility in funding arrangements if the costs of providing the new infrastructure exceeds the initial estimates.

With regards to the future changes to the industry, most of the responses noted that there was still significant uncertainty with regards to the potential impact of the roll-out of smart meters and the precise role of the DCC – though it was noted that meter / registration activities would be transferred to DCC from 2016/17.

Some of the specific issues raised in the responses were as follows:

- There was universal support for the need for a single centralised service provider for energy allocation, invoicing and demand forecasting.
- Given the uncertainty over the exact role of the DCC there is a need to build in uncertainty mechanisms into funding arrangements, as requirements from the central agent might vary over time.

B.5: Support for Independent Gas Transporters

The responses provided consistent support for the provision of GT and iGT services by a common central service provider. It was also generally felt that there were no / limited impacts from a potential migration of services to the a common provider in terms of a loss of comparators or less innovation; however some issues were raised that would need to be considered before this could be achieved:

- It was pointed out in some responses that the iGTs have limited incentive and indeed at present no regulatory obligation to take services from the common provider. There would therefore need to be regulatory involvement to achieve a common service provider for GTs and iGTs.
- There are a number of funding issues that would have to be overcome, such as the iGTs' contribution to Project Nexus; how much Xoserve would have to charge to provide agency services to them; and the size of allowances given for the iGTs' stranded assets.

- Any migration would have to take account of the current systems used by the IGTs to ensure that there are limited stranded system costs.

The IGTs were unable to submit a written response to the Questionnaire; however we were able to meet with them to discuss their view of the issues. Below we state their views on the potential issues surrounding the creation of a common agent:

- The IGTs were keen to stress that they are not averse to the idea of a common service provider; indeed they stated that they had indicated their support to both Ofgem and the industry at the time of network sale in 2005 and at other junctures.
- However, at the time they were told that including them within central agent functions might create various technical / regulatory implementation issues and therefore they were not included.
- The main issue for the IGTs is that the creation of a common agent would create costs for them: the costs of their stranded capital assets; and the costs of integrating into the central agent's systems.
- In their view the benefits would likely accrue to shippers and therefore there is no commercial incentive for them to seek to facilitate a common agent. They would be happy to enter into more dialogue on the creation of a common agent once further progress can be made about apportioning the costs.
- In addition to concerns around funding the development of a common agent, there would also be difficulties with both governance and ownership arrangements. In particular the iGTs may need to become a more integrated part of the UNC,
- The governance arrangements for the common industry service provider would have to ensure that the interests and needs of the iGTs could be catered for effectively, similar to other users of central systems and services.

B.6: Regulatory tools to accommodate future uncertainty

The introduction of smart meters and the DCC and the need to make sure that Xoserve's business plan for the next eight years is sufficiently flexible to respond to the industry uncertainty were the key issues highlighted in response to these questions.

B.7: UNC 334 Review Group

The general tone of responses that we received on this set of questions was that CEPA should take into account the findings and recommendations of the UNC 334 Review Group, while noting that the Review Group had yet to produce its final findings and that the Group did not necessarily represent the industry consensus on the necessary scope of reforms for Xoserve.

Furthermore, it was noted that the Group was not mandated to consider the more strategic issues that the CEPA review is required to address.

In terms of the options proposed by the Review Group, there general support for the incremental change options that had been proposed. Some stakeholders suggested that the findings of the Review Group imply that there is limited desire for significant industry change, while others were of the view that the incremental changes represent a necessary first step before the implementation of more wide-ranging reforms.

B.8: Other industry issues and challenges

A range of additional challenges for Xoserve were identified:

- Some responses identified the scope to combine electricity and gas service provision so that they are provided by a single service provider in the future.
- The need for approaches for funding Xoserve to consider the long-term forecasts for the decline in demand for gas.
- The uncertainty caused by the roll-out of smart meters was highlighted as an issue.
- The centralisation of iGT data management.

The only additional issue that was indicated for consideration in CEPA's review was the need to look at alternative contracting methods for the provision of central agency services.

B.9: Identification of options

The responses that we received on the preferred model for the provision of Xoserve's services provided a diversity of views:

- Some of the responses stated that Shippers should have a greater influence in the future model of service provision. The Elexon/BSCCo was indicated as a good model by some stakeholders.
- Further it was emphasised by some responses that the provision of services should be controlled by the stakeholders who are most affected by them. The need to introduce competition in the provision of Xoserve's market facilitation services was also emphasised in one response.
- One response put forward an alternative model in which Xoserve would be funded with a separate price control to improve transparency, combined with governance reform to improve Shipper representation and a review of the ownership arrangements.
- One response suggested that the existing model should remain largely unchanged, unless there was a clear demonstration of the benefits. The suggested reform would be an improvement in the transparency of funding arrangements by introducing a pass through term in the allowable revenue formula.

- One response provided support for the implementation of the incremental change options identified by the UNC 334 Review Group, however it was noted that this would have to be accompanied with an evaluation to ensure that the incremental reforms had the desired effect.
- One response suggested that any future changes should ensure that the alignment between funding, control over the provision of services and the duty to fulfil regulatory obligations is maintained.

B.10: Evaluation criteria

In most responses the stakeholders stated that the evaluation criteria set out in the Questionnaire would suffice, however a few suggestions for additional criteria were made. The impact on the ability to:

- deliver innovation and continuous improvement;
- engage with stakeholders; and
- resolve issues that had been escalated by stakeholders.

B.11: List of respondents and stakeholder meetings

Respondents to questionnaire	Stakeholder meetings
Xoserve	Ofgem
National Grid Gas Distribution	DECC (SMIP)
National Grid Gas Transmission	Xoserve
Scotia Gas Networks	National Grid Gas Distribution
NPower	National Grid Gas Transmission
EON	Scotia Gas Networks
British Gas	Northern Gas Networks
ICoSS	Wales and West Utilities
SSE	NPower
EDF	EON
	British Gas
	ICoSS
	EDF
	First Utility
	AIGT

ANNEX C: XOSERVE SERVICES

This annex outlines a summary of Xoserve's services to the gas sector under the ASA and various contractual arrangements with industry participants.

The services are grouped as follows:

- centralised data activities;
- trading;
- invoicing;
- supply point administration;
- information provision;
- annual quantity and data review activities;
- information exchange and query management.

The key themes and functions that emerge from the services Xoserve provides to the GB gas industry include:

- provision of IT services;
- management and operation of critical IT systems;
- data storage and systems;
- industry change and knowledge management;
- commercial analysis and information provision;
- customer services;
- data reporting, validation, publishing and transmission; and
- training; and
- process management.

The summary of services are provided as background material to help inform the main report. They are not necessarily inclusive of all services and activities performed by Xoserve.

Table C1: Gas central agent services

Services	Description	Nature of function / provision
Centralised data activities	Demand estimation	Xoserve demand estimation services are used to estimate the amount of gas used on a daily basis in each LDZ. Algorithms and parameters are used to estimate demand. Xoserve performs analysis and collects, monitors and analyses data provided by shippers (and their representatives). Data and information management services provided.
	Entry/exit capacity regime	Xoserve operates systems which facilitate entry auctions and allow shippers to book exit capacity on GB gas transportation systems. The function supports the commercial operation of the gas transportation system. System operation and data management services provided.
	Energy balancing and settlements	Xoserve operates systems which support settlements and credit risk management. Includes maintaining a record of shippers secured credit limit and calculating balancing indebtedness/charges. This function supports the process of NTS system operator and shippers interfacing directly with the arrangements for imbalance settlement. Data and information management services provided.
	Volume allocation	Recording and calculating transportation gas volumes which support profiling, charging, aggregation and imbalance settlement processes. Data and information management services provided. Process management services provided.
	Daily meter read processing	In relation to daily metered supply meters Xoserve is responsible for validation of meter readings and calculation of the metered volumes. Data and information management services provided. Process management services provided.
	UNC Signatory Registration	Xoserve maintains and manages the registration of signatories to the UNC (signed by gas transporters and gas shippers). Function supports operation of the UNC. Data and information management services provided. Process management services provided.

Services		Description	Nature of function / provision
Trading	Gas trading / nominations / information provision	Xoserve operates the Gemini system which supports gas nominations. It is a real time system with users able to bid on-line and through file transfers.	Operational responsibility for provision and maintenance of the Gemini system.
Invoicing	Funds collection and credit management	Xoserve calculates and submits invoices for credit interest on invoices adjustments and compensation. Xoserve notifies the gas transporters of submission of invoice documents.	Xoserve manages transportation and balancing invoicing on behalf of gas transporters. It is responsible for inputting transportation charging rate changes into the relevant IT systems. It is also responsible for notifying and engaging with network operators and shippers during the invoice process and providing supporting data.
	NTS transportation charging	Xoserve calculates and submits invoices and supporting data on behalf of National Grid NTS for transmission charges for each billing period. Xoserve notifies the gas transporters of submission of invoice documents.	
	DN transportation charging	Xoserve calculates and submits invoices and supporting data on behalf of the GDNs for distribution charges for each billing period. Xoserve notifies the gas transporters of submission of invoice documents.	

Services	Description	Nature of function / provision	
Supply point administration	Provide and maintain a supply point register and information service	Xoserve is responsible for maintaining a supply point register for gas transporters containing information in relation to supply points, supply meter points and supply point premises.	Operates and provides the UK Link IS application. The supply point registration process is central to the retail process. Gas transporters and shippers utilise the supply point information services. Xoserve provides the data and information management services that support these industry activities.
	Supply point switching	Xoserve is also responsible for updating the information in supply point register. It is responsible for receiving supply point nominations, submitting supply point offers, accepting supply point confirmations and facilitation of transfer of supply points between users.	
	UK-Link management and support services	Supply point administration information is stored on UK-Link. Xoserve is required to maintain and make available a UK Link manual to any UK Link system user and provide support service and equipment for the UK Link IS support services.	These services support Xoserve provision of UK Link and the user interface of this application.
	M-number helpline	Xoserve provides the M Number enquiry line service for end gas consumers. This enables consumers to call a dedicated phone number to establish what the M Number (the unique identifier) is for their gas supply point and also the identity of the current registered gas supplier at their premises.	Services include provision of a customer service centre for the gas industry
Information provision	Compliant information	Xoserve provides information and data required by a GB gas transporter in relation to a complaint by a user or consumer.	Xoserve's role is to provide data and information on behalf of the gas transporters to support their network businesses.

Services	Description	Nature of function / provision	
	<p>Reports</p>	<p>Xoserve provides various verification, information and reconciliation reports to gas transporters and the users of the transportation system. There are regular information reports to the gas transporters across the gas year.</p> <p>Xoserve provides capacity, consumption, interruption and trading data to NTS on each business day.</p> <p>These data flows support the gas market operation and NTS residual balancing services.</p>	<p>Services in relation to obligations under gas transporter licences. Xoserve's role is to provide information and data related to the transportation system to the gas transporters and on behalf of the gas transporters following shipper /user requests.</p>
	<p>Support services</p>	<p>Provision of gas transporter support services. Including attendance of industry meetings and user relationship management services.</p>	<p>Services in relation to obligations under gas transporter licences. Services include knowledge sharing, industry change management and process management. Xoserve also provides training services.</p>
	<p>Internet access to data</p>	<p>Xoserve provides internet access to certain data services provided through the agency service agreement.</p>	<p>Data transmission and publishing services.</p>
Annual Quantity and data review activities	<p>Determination of annual quantities</p>	<p>Xoserve is responsible for determining the provisional annual quantity for each supply meter point for the relevant gas year. Xoserve provides this data to NTS at the start of the gas year.</p>	<p>Annual Quantity values are used for the purpose of calculating transportation charges to supply points on gas transporters networks.</p>
	<p>Determination of supply point capacities</p>	<p>Xoserve is responsible for responding to capacity revision applications from shippers and responding to applications for a new or revised supply point capacity.</p>	<p>Supply point capacity values are used for the purpose of calculating transportation charges to supply points on gas transporters networks.</p>

Services		Description	Nature of function / provision
	Responding to user queries and appeals	Xoserve notifies users of provisional AQs and then responds to shipper queries and appeals regarding the Annual Quantity.	A customer/user service activity to support the Annual Quantity review process.
Information exchange and query management	Query management	Xoserve is responsible for the management and delivery of the information system ConQuest – an e-based query management system used by shippers, gas transporters and Xoserve.	The query management system is primarily in place to handle shipper queries regarding standards of services and data. Data management activities and a customer service role.
	Information exchange	Xoserve operates the Information Exchange Data Transfer Network (IXN).	A private data network to manage the flow of information between all the relevant parties involved in the processes of settlement and calculating demand. Data transmission and management services.

ANNEX D: INDEPENDENT GAS TRANSPORTERS

D.1: Introduction

Our terms of reference require us to consider the role of Xoserve in providing support services to iGTs. Specifically we are asked to consider how extending Xoserve services to include iGTs may be affected by the introduction of DCC and how alternative arrangements for Xoserve funding, governance and ownership might help facilitate incorporation of iGTs within a single-service provider. The issues associated with iGTs are slightly separate to other aspects of our review and so we address them separately within this Annex

D.2: Support services for Independent Gas Transporters

One of the considerations in the establishment of the GT Agent at the time of the GDN network sales was whether the new arrangements might facilitate a single service provider for all gas transporters, including iGTs.

Under current industry arrangements, the iGTs operate their own billing and registration processes (outside of the UNC and the GT Common Agent ASA). Our terms of reference note that Shippers have identified the additional cost and complexity they face in having to deal with individual iGT systems and processes. This can increase the costs of serving iGT network customers. The iGTs are also growing in market share, and therefore providing their own systems may not be sustainable when smart meters are introduced (see Section D4 below).

There have therefore been discussions between industry parties as to the viability of iGTs services being delivered by Xoserve using common UNC standards.

D.3: Feedback from our questionnaire

The feedback we received from the stakeholder questionnaire generally supported the conclusion that shippers face additional cost and complexity from having to deal with individual iGT systems and processes. Responses provided consistent support for the provision of GT and iGT services by a common central service provider.

It was also generally felt that there were no / limited impacts from a potential migration of services to the a common provider in terms of a loss of comparators or less innovation. However, there were a number of issues raised by stakeholders which they suggested would need to be resolved for iGT services being delivered by Xoserve. For example:

- Any migration would have to take account of the current systems used by the iGTs to ensure that there are limited stranded system costs.
- How much Xoserve would have to charge to provide agency services to them; and the size of allowances given for the iGTs' stranded assets.

The iGTs were unable to submit a written response to the Questionnaire; however we were able to meet with them to discuss their view of the issues. Their views on the issues are summarised in the iGT sub-heading in Annex B.

D.4: Impact of the DCC

The Government's response to Prospectus²⁹ noted the inconsistencies between the registration systems used by iGTs and Xoserve. The Government also noted that arrangements for smart metering must be designed to enable consumers on iGT networks to access the same benefits from smart metering. Accordingly, the Government suggested that consideration should be given as to any necessary changes that would enable DCC's access control arrangements to operate equally, regardless of the network on which the consumer is located. One option for facilitating this change might be iGT use of Xoserve systems and services.

D.4: Options for changing Xoserve funding, governance and ownership

Incremental change options (changes to funding within the current ownership and control arrangements) and models involving more fundamental changes to *governance* and *ownership* (as presented in the main body of our report) all in theory offer the opportunity to accommodate and incorporate iGTs within a single service provider:

- Negotiated settlement might provide the forum for industry participants to enter into dialogue on Xoserve providing services to the central services to iGTs as well as GTs.
- Under the envisaged model a negotiated settlement might be a forum for stakeholders to address cost appointment issues associated with iGT transition to Xoserve services.
- Under a separate licence structure, Xoserve would provide services to the iGTs like any other industry stakeholder in central systems and services.
- Under the more cooperative models, a role for iGTs would need be created in the governance of central service provider activities.

As noted in Section 5, an implementation issue under all options may be that iGT use of Xoserve services also requires iGTs to become a more integrated part of the UNC.

As regards different governance models, a separate licence structure where the services provided to iGTs can be most clearly defined, might provide the clearest framework for accommodating iGTs in Xoserve systems and services. The existing contractual framework for GT Agent services does not necessarily prevent Xoserve from providing services outside of the ASA and so might be the simplest mechanism of accommodating iGTs.

There would be issues around clarity of the customer relationship with use of the ASA mechanism.

²⁹ http://www.decc.gov.uk/en/content/cms/consultations/smart_mtr_imp/smart_mtr_imp.aspx

D.5: Conclusion

Based on the feedback we have received from stakeholders there may clearly be industry and consumer benefits from Xoserve providing central services for iGTs.

A model where regulatory licence obligations are moved from the GTs to Xoserve may provide the clearest (although not necessarily simplest) mechanism of incorporating the iGTs within a single central service provider to the gas industry

As highlighted by iGT comments (summarised in Annex B) governance arrangements for the common industry service provider (Xoserve) would have to ensure that the interests and needs of the iGTs could be catered for effectively.

The issue of stranded iGT assets and the apportionment of service provider costs to industry participants would also need to be resolved amongst stakeholders.