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Dear James

### **Open letter consultation: Review of Xoserve**

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, combined heat and power plants, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including both residential and business users.

We welcome the opportunity to respond to this consultation. As a gas Shipper and Supplier we are keen for a regulatory and commercial framework to be put in place that will enable us to address some of the constraints that have been identified with the current industry arrangements. An appropriate framework is needed to realise the full potential that could be delivered from a GB wide roll out of smart meters. In gas Xoserve is the key service provider that will facilitate these opportunities, and so it is appropriate that their governance and funding arrangements can support this.

The key points from our response are as follows:

- The current governance and funding arrangements have been successful in delivering services reliably and at the lowest cost; however, it is not clear whether these will remain appropriate to support significant change in the face of industry requirements and general IT developments.
- Xoserve has improved its approach to stakeholders; however, control remains with the Gas Transporters (GTs) on the information that Xoserve provides and what resources are devoted to particular areas. This will continue to represent a concern for Shippers until an open and transparent governance arrangement is implemented that empowers Xoserve.
- The work undertaken as part of Project Nexus and development of the Data Communications Company (DCC) has demonstrated that Shippers and Suppliers are driving change, but they are not represented in Xoserve's current governance structure.
- Any changes to the Governance and funding of Xoserve are dependant on the resolution of the GT Licensing issue which currently places an obligation on the GTs to deliver the services provided by Xoserve. Any changes to these requirements should be progressed alongside the governance and funding review.

- We fully support Ofgem's preferred solution to restructure the board of directors so that it is fully independent from the GTs and to reform the funding arrangements so that Xoserve are in control of their own budget. This represents a significant improvement on the current arrangements.

### **Xoserve's structure has supported the delivery of existing services at lowest cost**

The current funding and governance arrangements for Xoserve have remained unchanged since the Distribution Networks (DNs) were sold in 2005. This required the creation of a single agency service; however it is unclear whether this created new roles and responsibilities, or merely formalised what was previously an internal Transco business unit. The Xoserve board is made up of GT representatives and supporting structures and boards also have full GT representation. It is the GTs who determines what system changes should be implemented by Xoserve, who release Xoserve resources to identify the costs associated with a change proposal, and who authorise what information is made publicly available to Shippers on these costs.

The governance of Xoserve was set up to meet GT Licence requirements, rather than to provide a service to Shippers. At the same time the treatment of Xoserve as an opex allowance incentivised the GTs to minimise Xoserve's costs. Xoserve has therefore been set up to discharge the GT Licence requirements at least cost to the GTs.

### **Xoserve's approach to stakeholders**

It should be recognised that Xoserve's approach to stakeholders has improved significantly in the last 12 months, with a clearer focus on customer satisfaction and requirements being displayed by Xoserve at both industry as well as bilateral meetings. This has been welcomed by some industry participants, including ourselves, but a concern remains regarding Xoserve's ability to support change. This in part is being driven by concerns over the costs for change quoted by Xoserve, along with the structure of Xoserve which remains designed to deliver GT Licence requirements and retains control with the GTs. It is this control that in the past has led to concern from Shippers with regards to Xoserve's approach to stakeholders.

### **Xoserve's structure should be reformed to support future change**

It is the Shippers who are predominantly driving change in Xoserve's services through UNC modification proposals. It is not clear that Xoserve's current structure can facilitate these changes or provide long term strategic vision as there is no exposure to these business interests within Xoserve's governance structure.

The gas industry is facing a period of significant fundamental change. The roll out of smart meters and the introduction of the DCC may fundamentally change how the gas industry operates. In addition to the benefits from increased data granularity, along with the potential for improved data quality, there may also be changes to the flow of data. As CEPA's report has identified this could have a fundamental impact on the role that Xoserve fills.

Replacement of Xoserve's central systems provides the opportunity to resolve the issues and constraints currently experienced within the industry, as well as setting the foundations to realise the opportunities that smart metering will deliver. It is therefore imperative that the funding and governance of Xoserve is reformed so that these opportunities are realised. This reform will be dependent on the resolution of the GTs' obligations within their Licences, and so it would appear appropriate that this is progressed alongside any funding and governance review.

### **Xoserve's structure could benefit from an independent board and funding**

We fully support Ofgem's preferred solution to reform Xoserve so that it follows a model based on Elexon or MRASCo as this represents an improvement on the current structure. Moving to a board of directors independent from the GTs will help to address perceptions that Xoserve's only role is to discharge the GT Licence requirements at lowest cost; and also ensure that the strategic direction of Xoserve can be set based on the views and insights from a wider range of participants than just GTs. Further resolving the governance arrangements within Xoserve so that they have stakeholder representation should support a more collaborative and transparent approach. There is also a value in providing Xoserve with its own revenue stream and budget, as this will help to provide transparency over the costs of change and address concerns that Xoserve is treated as an opex cost which needs to be minimised.

This is similar to the arrangements for Elexon and MRASCo, and for clarity although we support this model as an improvement on current arrangements for Xoserve we also acknowledge that Elexon governance arrangements might also be improved. It may be appropriate to formulate Xoserve as a licensed entity, with an independent board, to ensure that key services continue to be delivered. There may also be value in looking at the constitution of any independent board to ensure that it is not dominated by Executive Directors, or non-Executive directors that come from particular backgrounds or interests.

Our detailed responses are set out in the attachment to this letter.

Should you wish to discuss any of the issues raised in our response or have any queries please contact my colleague Stefan Leedham on 0203 126 2312, or myself.

I can confirm that this letter and its attachment may be published on Ofgem's website.

Yours sincerely,

A handwritten signature in black ink, appearing to read "D. Linford".

**Denis Linford**  
**Corporate Policy and Regulation Director**

## Attachment

### Open letter consultation: Review of Xoserve

#### EDF Energy response to your questions

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

As noted in our covering letter the current governance and funding of Xoserve has supported the delivery of existing services to a high standard and at a low cost. This is supported by the results of the customer satisfaction surveys that Xoserve issue to Shippers and Suppliers. This is also recognised in the CEPA report which identifies that it is Xoserve's ability to respond to industry change that raises concerns. This appears to focus on two key areas.

Firstly, there is continuing concern from industry with the costs of implementing change to Xoserve's systems, which in general appears to be on the high side for an IT change. Most recently this has been seen in the implementation costs associated with UNC modification proposals 0333 and 0276. Both modifications were perceived as requiring relatively minor system changes, with 0333 requiring a number change within a field to reflect new default prices; and 0276 having low demand volumes that could have been supported by a manual workaround solution. Both proposals were identified as having six figure implementation costs and as a result of which an alternative was raised to 0333 and 0276 has not been implemented into the UNC.

From a Shipper perspective the implementation costs of both proposals appeared on the high side, and there was limited information to support the costs identified. In the case of 0333 this would have benefited from a clearer explanation of why the costs were as high, along with an explanation as to what alternative solutions were considered and why these were not taken forwards. It is not clear whether this is included in the information that is provided to the GTs, but it appears that the GTs have to approve the release of any ROM information to the industry. It is not clear why this scrutiny is required, and merely adds to the perception that information is being filtered. For 0276 there was a perception from Shippers that there was no incentive to minimise costs as this was not a service that NG as NTS owner required. This fed the concern, among some Shippers, that a fully automated solution was progressed when a manual workaround would have been sufficient.

Secondly there is a concern from Shippers with regards to the time taken to implement change. In particular there is a concern that Xoserve appears to be able to implement a Transporter driven change with relatively short notice, such as 0268 which could have been implemented one day after an Ofgem direction; whilst Shipper led proposals can take a lot longer to implement, such as 0270 which was identified as requiring at least 12

months to implement. Although there should be recognition from Shippers that they also have systems that can take a while to implement changes to (as witnessed with 0345) the concern appears to focus on the fact that the lead time for Xoserve to implement a Shipper change is always long and in excess of 12 months.

Both of these issues were raised and discussed during review group 0334 which looked at reviewing the funding of central system change processes. This proposal identified some simple improvements that could be made to the change process that would address some of these concerns and provide additional transparency in the change process. However, it is not clear that many of these recommendations, that did not require a modification, have been put into practice. There therefore remains a concern that the funding, governance and structure of Xoserve has been established in such a way that control and responsibility for changes lies with the GTs, with a perception that the information that is provided to Shippers is filtered.

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

In previous price controls the funding of Xoserve has been treated as an opex allowance for the GTs within their price controls. However, the GTs are allowed to keep any under spend on their opex costs, compared to what was allowed in the price control formula. This therefore places an incentive on the GTs to minimise their opex costs, and so also minimise the costs incurred by Xoserve. Although it is recognised that the IT replacement costs will be treated as capex cost, with associated sharing factors, the concern remains that the overall approach to Xoserve by the GTs has been to minimise costs. This was appropriate in a stable commercial environment, but causes concerns when Shippers are looking to alter the services provided by Xoserve as service expansion or improvement does not always fit within a cost minimisation model. Further as the allowance for Xoserve is contained within the price control, and is a relatively small allowance, this creates ambiguity as to what revenue has been allocated to Xoserve by Ofgem compared to what the GTs have allocated in their budget. It is also unclear what funds were made available to cover system replacements. This causes concern as to whether Shippers are being required to fund services twice, once through the Transporter revenue and also through the User Pays services.

As noted in our response to the previous question, the current Governance creates concerns as the day to day control for requesting, authorising and delivering change sits with the GTs. This creates the perception that the governance and structure of Xoserve has been designed to support the delivery of the GT licence requirements, and not to respond to Shipper initiated change. Although the approach of Xoserve to Shipper initiated change has improved in the last 12 months, the control structure still sits with the GTs. Further as the board of directors has full GT representation, there is also the concern that the overall strategy and direction of Xoserve is being determined to deliver GT requirements. In the face of significant industry change, and opportunities it is not clear

how the interests or requirements of Shippers, or customers are being fed into the strategy and direction of Xoserve. There is also a perception that retaining this board structure will prevent the fundamental changes required throughout the business to support a move to a customer led change agenda.

As such therefore, our concerns are focused on the governance and funding of Xoserve and less so on the ownership structure. In particular it would appear that if these were resolved so that they were entirely independent from the GTs then the issue of ownership becomes a mute point. We therefore agree with CEPA's assessment that the current funding and governance of Xoserve does not sufficiently empower them to act as a service provider for their customers, which includes Shippers.

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

Overall it would appear that CEPA has identified the main options for changing the governance and funding of Xoserve, although there would also appear to be a fourth option that we discuss in more detail below. In terms of the options identified by CEPA our main comments are:

**Option A – Changes within the current ownership and governance framework:**

This model represents an improvement on the current arrangements as it enables representation at board level which should help to influence the strategic direction of Xoserve; and also introduce a planning group which would enable Shippers to identify future requirements from Xoserve. However, it is not clear whether this would deliver any significant changes in the structure of Xoserve and the GTs' controls. This therefore runs the risk that no material benefits or changes are delivered as Xoserve is maintained as a GT owned and controlled entity designed to deliver their Licence Conditions.

**Option B – Separate Licence, customer facing GT subsidiary:** This is a clear improvement on Option A as Xoserve would be responsible for delivering key services and so be empowered to deliver their customers' requirements within a budget which we would assume would be set by Ofgem. Under this option there may also be a value in requiring Xoserve to become a party to the UNC to provide a contractual basis for service delivery and to remove the reliance on GTs to raise modification proposals on their behalf. This model has the potential to address the concerns expressed by Shippers, although we note that this retains the risk that the internal controls and board of Xoserve remain dominated by the GTs. This could constrain Xoserve based on historic arrangements and so no real change is delivered.

**Option C – Co-operative body:** This is our preferred approach as it would place Xoserve as an independent, empowered service provider and remove the control mechanisms that the GTs currently possess. As with the previous model, there may also be a value in Xoserve acceding to the UNC as a code signatory. We note that this would move Xoserve

towards a model similar to Elexon and MRASCo, which would represent an improvement on current arrangements; however, it should be recognised that these models could also be improved upon. To implement this model, there would be a value in creating an implementation workgroup, comprised of selected stakeholders to look at issues such as board constitution, removal of current GT control mechanisms and ensuring continued service delivery. We would note that both this model and option B, would require a change in Xoserve's corporate behaviour and approach, which will not be delivered overnight. This model therefore requires appropriate governance and funding mechanism to be put in place and a period of time for this to permeate into different working practices.

As a fourth option we note that Xoserve is currently structured in a co-ordination/contract management role, with most of its IT services and support delivered by third party contractors. This would appear to be a similar role as that employed by Elexon. A fourth option could be to look as to whether this contract management could move to a third party, such as Elexon and so benefit from synergies and economies of scale. This would require transition periods and planning and may also provide significant cost savings to the industry and customers.

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

CEPA appears to have identified the questions that need to be answered in order to identify what change should be progressed, but there may also be value in identifying why change is required. In particular the question that could be posed is what has prevented Xoserve from delivering change in a manner required by Shippers? If the constraints have been caused by budgets, then changing the funding of Xoserve could resolve these issues. Equally if the constraints have come from the GTs at either a board or working level then it could be that Governance reform is sufficient. The options identified by CEPA address the situation where constraints have been caused by both governance and funding, however it is not possible to identify their appropriateness until it is clear what is causing the issues.

Of the issues identified by CEPA we would make the following observations:

- **Are the activities managed by Xoserve separable from GTs' businesses?**  
It would appear that the fact that Xoserve is managing these services on behalf of the GTs suggests that they are separable; and so the question is where should the requirements to provide these services sit? It could be argued that although some may be driven by safety requirements (such as the sites and meters database) this does not require them to be provided by any particular entity, only that they are provided. It may therefore be appropriate to place a licence requirement on Xoserve to ensure that the services are delivered to enable the GTs to discharge their safety requirements.
- **Are the activities performed by Xoserve co-operative in nature?**



The range of services that Xoserve provides to the gas industry are similar in nature to the services provided in the electricity regime, although in gas these are governed by a single code and have a single service provider. However, the fact that these services in general are provided on a co-operative basis in electricity, suggests that they could also be provided on a co-operative basis by Xoserve. Although this would require behavioural change from most industry participants there is a strong desire from Shippers to work with Xoserve to deliver the change that is required to meet industry requirements. There is therefore a strong argument that the activities are co-operative in nature.

- **What appetite is there to assume a greater role?**

The interests in services by Xoserve, and the appetite to be engaged in the process for delivering these changes has been increasing since the introduction of the User Pays mechanism as part of the 2008-13 GDPCR. Most recently the workgroup looking at the provision of central services found a strong appetite from Shippers to be actively engaged in the governance and funding of Xoserve. There is therefore a strong appetite from Shippers to assume a greater role in the governance and funding of Xoserve. However, consideration needs to be given as to how any greater control is formulated to ensure the interests of customers overall are considered, and governance is not dominated by Shippers as a result of collaboration in organisations whose membership is restricted.

- **Does fundamental change present too great a risk?**

As previously noted the benefits from any change to governance and funding will take time to be realised and implemented, and so it could be argued that the greatest benefits would have been realised if this structural reform had been considered when the previous price control was met. At the same time the benefits from smart metering will present opportunities over a period of time, and so it is important that these future benefits are captured as they crystallise, along with benefits that can be realised on roll out. There could be a risk that these opportunities are not realised if the industry and Xoserve continue to be constrained by the current governance and funding models. Further the services provided by Xoserve are key to Shipper and Supplier operations, and so it is imperative that an appropriate governance and funding mechanism is implemented to ensure their continued delivery. The current arrangements may threaten this.

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

There are clearly strong arguments expressed by industry and CEPA that the current arrangements should be reformed. We believe that Ofgem should adopt Option C – Co-operative body – as this will address the concerns that currently exist whilst also providing a governance and funding model for Xoserve that will allow it to respond and adopt to future change and opportunities.

**EDF Energy  
November 2011**