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Dear James,

Open letter consultation: Review of Xoserve

Thank you for the opportunity to respond to Ofgem's consultation regarding the funding, governance and ownership ("FGO") of Xoserve. National Grid Gas (Distribution) ("NGGD") relies on Xoserve as our agent to deliver most of our contractual and regulatory obligations that relate to the management of data that supports the transportation regime set out in the Uniform Network Code ("UNC"). The services that Xoserve provides under contract, through the Agency Services Agreement ("ASA"), are vital, to the smooth operation of gas supply competition in the UK, the accurate allocation of costs in the balancing and settlement process and the issue of transportation invoices.

Since the inception of Xoserve, NGGD has provided funding, along with the other gas transporters, for approximately 90% of its activities. Xoserve's funding requirement was determined as part GDPCR1 and is collected, in the main, through general transportation revenue. In recent years, a number of modifications have been implemented into the UNC and the cost of delivering the system changes and new service lines has been recharged to shippers under the governance of the Agency Charging Statement ("ACS") and User Pays mechanism. Such charges represent additional income over and above the ex-ante price control allowance.

Summary

We believe the FGO arrangements for Xoserve are broadly fit for purpose and deliver an efficient service to shippers in accordance with obligations enshrined within the Gas Transporters Licence. In general, our view is that Xoserve deliver the ASA services in a diligent, reliable manner, with high levels of service delivery and system availability. Their contract performance indicators are positive and customer satisfaction survey suggests that the level of service is good. Overall, we have no significant concerns regarding the day to day performance and delivery of services. However, the incentives on GDNs to provide an efficient low cost service do not sit comfortably with the need to meet shipper requirements for more flexible service offerings and this demand is likely to increase with the development of new industry arrangements to accommodate smart metering in future. In this context and that of the RIIO principles around taking due regard of stakeholder feedback and providing more customer led services, we firmly believe that the views of shippers should prevail in terms of the FGO arrangements.

The most significant challenge for Xoserve funding in our view is how to address the investment requirements arising largely from smart metering and related services, for which ex-ante allowances are inappropriate due to the degree of uncertainty involved. The advent of smart metering and its potential impact on shippers and Xoserve coinciding with RIIO GD1 provides an opportunity to create a funding model that is fit for purpose and flexible enough to address the needs of all market participants.

We believe that a model which clearly differentiates between the predictable basic services that Xoserve currently provides for which an ex-ante allowance is appropriate and a more flexible commercial service to support new service offerings revealed by market developments in smart metering and elsewhere is the most appropriate way forward. As long as GDNs are funded such that they can meet their licence obligations and these reflect any new FGO arrangements, it should be possible to provide a more flexible funding model to allow Xoserve to offer better, more responsive services to shippers where the costs of incremental commercial services are managed and defrayed by those benefiting from the service.

Please find attached our answers to specific questions raised in your consultation:

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.

It is our views that the industry is broadly satisfied with Xoserve's delivery of day to day services although we understand some concerns exist regarding Xoserve's involvement in the change process; both in terms of functionality changes linked to infrastructure replacement and engagement with the industry regarding changes to central systems as a consequence of UNC modifications. Concerns with the change process were largely the driver for establishing UNC Review Group 334 (Post Implementation Review of Central Systems Funding and Governance Arrangements), which resulted in identifying a number of easily implementable stages in the modification process to improve the Xoserve - shipper engagement process. Improvements have included several measures such as; introduction of the Rough Order of Magnitude ("ROM") process, High Level Analysis reports, more detailed cost breakdowns and the provision of a shipper liaison role. The liaison role allows a shipper to canvas the views of Xoserve, initially without involvement of transporters so that they can understand system issues before raising modification proposals.

In terms of developing the longer term transportation arrangements, Xoserve has been proactive in developing a suite of settlement and reconciliation variants to the current model through Project Nexus. It has achieved this through an extensive requirements gathering process to coincide with the implementation of the next generation of UK-Link.

In terms of the pace of change and level of costs, (both seen in the report as negative aspects), we would say that the modification process is generally slow and can be quite cumbersome, consequently it would be inappropriate to lay the blame for the slow pace at Xoserve's door. The definition of requirements can take time and only once they are finalised can costs be established with any certainty. The systems into which changes are being implemented sit on old infrastructure and are heavily integrated making change a complex business which needs to be completed carefully. Given the dependence the industry has on these systems, it is essential that Xoserve operate them with diligence and to minimise the risk of failure, as system unavailability would have a direct impact on the functioning of the gas market.

To summarise, we believe that there have been significant positive developments regarding the shipper engagement over period of this price control although there remains scope to improve the consultation process and improve understanding of the basis of change time-scales and costs.

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.

We believe that the CEPA report accurately captures the FGO arrangements and correctly points out some of the features of the regime that could be improved.

We agree that, as a service provider, Xoserve operates to the contract and at a relatively modest cost to the shipping community, but it is fair to say the current funding arrangements have some limitations, particularly in the areas of change and innovation. Certainly, it is around the change process, and the funding and governance of the Xoserve's project work that we believe there is scope for some revision.

The areas of funding that give us some reason to question the appropriateness of the current arrangements are: User Pays, smart metering developments and regime change of the type being developed through the Nexus work.

First User Pays; the initial concept of User Pays was to take existing services defined and delivered in the UNC, to identify individual service lines, isolate their cost base and sell them at a small margin as individually charged services. This process in itself was not easy, with certain services being retained in the UNC and others being sold directly by Xoserve's "Contract for the Provision of Non-Code User Pays Services". This process is now established and working well. Where User Pays becomes more difficult is when it is used to charge for incremental change. The process does not operate efficiently, particularly for the recharging for development work. The reasons for this are there is a lack of clarity regarding what has already been paid for through ex-ante allowances and what can be justifiably recharged as new incremental costs. The recharging is also cumbersome, since, as Xoserve cannot bill shippers in its own right, the cost is transferred to each of the transporters and recharged out to each shipper.

For User Pays to work more efficiently there needs to be improved clarity in terms of what has been paid for through ex-ante allowances and what can be justified as a recharge. Additionally, the money collection mechanism needs to be simplified. Some of the collected amounts can be quite small and having to raise an ad-hoc invoice per portfolio shipper per network operator is not very efficient. The cost recovery process could be improved by the introduction of transport revenue adjustment mechanism (e.g. a year on year logging-up term) or arrangement could be developed where Xoserve collects the money in its own name.

Secondly, we also agree with CEPA that the current funding model does not encourage expansion, as funding is inflexible. While this arrangement is appropriate for driving efficiency into a stable business, it does little to encourage innovation and risk taking.

To summarise, we believe that there are issues associated with the ex-ante plus User Pays supplementary funding model as it currently operates, although fundamentally it delivers a good service. Moving to a fully funded not-for-profit company with a major redesign of the FGO arrangements for Xoserve is probably not warranted at this juncture. However, a not-for-profit element of incremental funding, delivering market-facing services directly to shippers, responding to changing customer & supply market requirements while still within the existing UNC / ASA framework arrangement has attractions, as it would result in an incremental funding being made available by those advocating the change.

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?

Option A: "Enhanced as is": We agree that "negotiated settlements" are in effect what we have now but, we believe, that the current governance arrangements result in sub-optimal operation. The concept of base ex-ante funding, with a modest level of change built into the forecast with specific spending being built into separate funding model is attractive, given the difficulty of accurately predicting requirements over an 8 year period, particularly with the introduction of smart metering along with the Smart Energy Code governance model. Given appropriate definition & transparency, Option A should allow the efficient delivery of small changes, while providing defined routes for obtaining incremental funds for larger changes.

Option B: "Licensed entity": Of all the options this is our least preferred solution as it would require a new class of licence and require regulatory involvement to a greater degree than both other options. Xoserve is essentially a service provider with a value and turn-over not significant enough to warrant a stand-alone licence. However, if certain agency services could be removed for the UNC and transferred to a new licensed entity, in principal, we have no fundamental objection to such an option. Again, we believe that advocates of this model should be mindful of the degree of upheaval such a change would bring to the industry.

Option C: "Co-operative (Elexon) model": The gas industry already has a governance holding company, (SPAA Ltd) that could take on the UNCCo role. All the functionality required to support the market could be moved to a co-operatively governed vehicle, such as SPAA, and the remaining functions would remain the responsibilities of the transporters. Investment in changes to these market functions would fall on the parties desiring the change through the collective SPAA arrangement and would be funded by a shipper controlled budget.

However, to move to this arrangement would bring considerable upheaval to the industry as the data management side of the UNC would need to be divided into two. The move to a not-for-profit co-operative arrangement would require considerable investment, which may outweigh the benefits. From a systems perspective, the Nexus programme could be re-targeted to provide the system development that would facilitate the splitting of the market functions from the pure transporter requirements. Although, even under this model, we doubt that the UNC modification process would deliver central system changes any more efficiently than they do now, given the multi-party contractual arrangement that would still exist.

On balance, we believe that a compromise model is the way forward. We can see merit in all the options detailed, but we believe that a version of Option A / as-is model, with features drawn from Option C could deliver the desired benefits without the upheaval of the more radical solutions proposed in options B & C.

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? The Critical Issues are:

Can the activities and systems be split?

Yes, but there would be a significant amount of system re-engineering that would need to done to facilitate a split between transporter obligation and Market Operation Functions.

Does separate governance & share ownership give rise to any issue?

Not especially, there are many organisations that deliver obligations for customers who are neither the owner nor shareholder. Ownership and governance of Xoserve was vested with transporters through the distribution network sales as it was seen as the obvious place to locate it. The important feature of any FGO arrangement is the effective discharge of the contractual obligations, which could be done equally well by an agent employed by the transporters as one owned by them.

What is the appetite for shippers to be accountable for Xoserve?

This is a relevant question, but dealing with the funding mechanism, in particular, providing clarity on the basis of the ex-ante allowance and developing an improved flexible funding mechanism is more important.

Issues that need to be borne in mind as part of the decision:

- Cost of change versus value of ASA versus PCR value. The value of the points of contention, while significant to the functioning of the UNC is small in PCR terms.
- Complexity (shifting of obligations / setting up new licences) of options B & C: it would be no minor task to split the ASA along GT essentials versus market facing functionality

To summarise: the Xoserve, central agent model; was the best value solution at the time of network sales, and we believe still is. However, Xoserve's desire to lead industry reforms brings into question whether or not funding transporters via ex-ante allowances is the best mechanism for financing change that underpins the operation of the supply market. An Xoserve with its own supplementary fund raising arrangements could serve the market well, but a structural change to the extent prescribed in Options B & C would be costly and require considerable industry focus at a time of significant change in the gas industry. We believe that more flexible, incremental funding arrangements as advocated by the “not-for-profit” concept established in Option C, and overlaid on the current FGO arrangements, could realise the desired benefits with only a fraction of the upheaval.

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

We believe that an enhanced version existing model is the way forward. NGGD has no desire to constrain Xoserve in terms of the additional services it offers, providing the services meet with the relevant objectives and funding can be generated outside of price controlled ex-ante allowances. We have seen relatively expensive shipper driven projects being implemented, without any take-up of the service, and quite rightly we should look to insulate our shareholders from such speculative undertakings. We believe that funding and governance mechanisms can be put in place that provide innovation and the delivery of new services, but the risk and cost of delivering these services should rest with the beneficiaries. As Xoserve becomes more accountable to shippers directly, so perhaps should shipper involvement increase in terms of membership of project boards for the more significant pieces of work.

It is our view that the most important improvement that could be made to the current arrangements is to provide greater transparency as to what the ex-ante allowance comprises, thereby making it clear as to when the flexible funding arrangement would be employed:

What would comprise the ex-ante allowances?

In principle, the ex-ante allowance would be used to provide predictable base services, although it would include a small contingency for minor changes: Typically the components would include: Run the Business" (Staff, Overheads, and Buildings); IT System support and bought-in services; capital for a replacement cycle for Xoserve's' back office systems plus a hardware replacement cycle for of UK Link; and would include an element of funding to cover minor changes resulting from Legislative, Regulatory, European change and would also incorporate transporter initiated changes to UNC, Pricing, and internal operational systems.

Additionally, we are proposing a separate change budget that shippers could draw down from to fund minor changes where the shippers are the advocates for change. For example, this could about £1m, but it would be ring-fenced from other ex-ante funding and, if it remained unspent at the end of a year it could either be carried-over to the next year or refunded in proportion to shipper market shares. The budget would be under the control of the shipping community, and would be incorporated into the UNC governance process. By ring-fencing and giving control to shippers, conventional ex-ante funding pressure on transporters to minimise spend would be removed.

What would be the subject of flexible funding?

Typically these are significant changes to the industry where it is not possible to accurately predict the costs at the time Xoserve funding allowances are set. Examples that are currently being discussed are: Large European driven change relevant to supplier activities; Nexus-driven UNC regime change; Adoption of iGT Supply Point Admin and other iGT services, and smart metering implementation issues, such as obligations arising from the set up of the Data Communications Company and the forthcoming Smart Energy Code. However, it is not intended this is an exclusive list and the components included could change as the market develops over time.

In summary, we are aware of some of the issues that exist in the current mechanism. We have analysed the report and, while we believe the issues have been captured, we don't agree that radical reform is the best way forward. There are tensions in the process, but we believe they are largely as a result of a lack of clarity in the current funding arrangements. We believe these issues can be resolved under the current governance and ownership model by the adoption of a range of evolutionary measures rather than initiating a major revision to the current arrangements. We believe all the options could be made to work, but the degree of industry upheaval required to implement options B & C would exceed the value of the issues under examination. We believe that the solution lies in a mix of the existing arrangements, with some improved measures to deal with significant incremental demands being placed on the ex-ante allowances. Xoserve should be given the ability to propose incremental funding where change is significant and falls into a pre-defined set of service lines. A new shipper controlled change budget could be introduced and used to fund shipper-requested minor changes.

We believe that fundamentally the FGO arrangements covering Xoserve are sound, but there are some changes that could be introduced to streamline the way that incremental and unforeseen costs are recovered from market participants.

If you have any question regarding this response, please contact myself or Alan Raper (alan.raper@uk.ngrid.com / 07810 714756)

Yours sincerely,

Paul Rogers

By email