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Dear James

## Review of Xoserve

We welcome the opportunity to comment on this consultation. This is a good time to review Xoserve; it's illustrative of its arrangements that Ofgem is doing this as part of the distribution price control review. The implication is that if Xoserve reform does not take place now, then it will endure for the eight years of the review. This is reason enough to put in place changes given the present pace of change in the energy supply industry.

***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.***

In general, we agree with the CEPA analysis on the need for greater transparency of, and responsiveness by, Xoserve. However, it has several roles and any review should take account of those; we consider that its operational processes work well and we have a good relationship with the company. Given its critical role in the industry we would expect Xoserve to display more transparency about its activities and performance than we presently see. We believe that this is a function of the institutional arrangements controlling it and therefore see Ofgem's consultation as an opportunity to reform the company proportionately.

The present arrangements may have been suitable at the time the company was established; for understandable reasons Ofgem would have created a regulatory regime to discharge the licence obligations of the gas transporters expecting that they would also automatically meet the needs of customers.

## Need for reform

Since then the industry has matured and is more stable. Regulatory and commercial requirements on shippers mean that changes need to take place more frequently and quicker. Xoserve's management of change could be more responsive to the needs of customers in both transparency and speed. We acknowledge that Xoserve's systems reflect its various roles and that the interrelation between them results in complexity that takes time to analyse. Nonetheless, lengthy change cycles can contribute to higher costs and delays, which can complicate customers' processes and systems. Some changes, for example, DM elective, have resulted in no take up but parties have still incurred costs for no apparent benefit. A process that better balances the needs of customers with the relative benefits and costs would be a welcome development.

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An illustration of where different arrangements could have given a more responsive solution is the work to manage suppliers' obligations to meet the customer protection requirement of the EU's Third Energy Package for suppliers to switch customers within three calendar weeks. Earlier engagement by Xoserve with DECC and Ofgem alongside the suppliers could have resulted in the development of solutions sooner than now. Several months after the obligations came into force we still have no clear idea of the timescales and cost of changes shippers require.

Simple measures, such as putting in place regular releases of changes, would give parties more certainty and control over the change management process. This approach works well in the electricity industry, where there are three industry releases a year, enabling suppliers, their agents and network operators to plan their management of change in a coordinated manner.

### **Project Nexus, lessons learnt**

On the other hand there are notable exceptions to the perceived lack of responsiveness; in the recent past Xoserve has developed and managed Project Nexus in a way that has taken account of differing interests and a changing regulatory environment. It's worth looking at what made this successful; first, Xoserve was responsive to the demands of an uncertain regulatory environment, principally, the Smart Metering Implementation Programme. That led to de-scoping of several work items to form a more realistic and achievable project. Second, all parties, shippers, gas transporters and independent gas transporters were included and played an important role to develop a solution that better reflected the needs of all users. Finally, Xoserve used project management techniques to good effect, which provided clarity and managed expectations of parties.

However, the process also raised some items of concern that are illustrative of the issues set out by Ofgem. We do not know whether Xoserve would have altered the scope of Project Nexus were it not for the uncertainties caused by the Ofgem's and DECC's work on the Smart Metering Implementation Programme. By responding to the needs of the imposed constraints of the project Xoserve also met the needs of its customers and in doing so developed good working practices for managing change in uncertain circumstances.

Second, there still remains some uncertainty about the next stage of the process; how will Xoserve translate the requirements specification into changes? We have worked well to identify the requirements and this process should continue to develop as it will take into account the needs of users and customers. Nexus has produced some good results and we would like to see them continue into the implementation stage.

Finally, Nexus has taken a long time to get this far. That's partly because of the complexity of the gas trading arrangements and uncertainties due to other developments in the energy supply industry and the sometime conflicting requirements of parties in the industry. It may also be a reflection of slow pace of change in the industry.

### ***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.***

Xoserve's central role provides services to different groups in the industry, principally to shippers and to transporters. Yet, for understandable reasons, the arrangements



seem more focussed on the business interests of the transporters. The user pays arrangements are a useful development that provides some transparency of the management of change. However, again we agree in principle with CEPA's conclusions that there is a "limited transparency in service... costings and a lack of responsiveness to customer requirements". Although Xoserve's operational performance is good, further application of continuous improvement techniques could bring additional benefits to all parties and not necessarily increase costs.

### ***Funding***

The funding arrangement is the institutional driver of the lack of transparency and responsiveness; without its reform initiatives by Xoserve to be more responsive cannot be fully effective. We believe that the funding arrangement, whereby the bulk of Xoserve's funding comes from the regulated revenue of gas transporters is no longer appropriate for the operation of the company in the present market conditions.

We agree with CEPA's analysis that such arrangements are not flexible enough for organisations that develop and manage systems and processes and are better suited to regulating longer term capital investments. The User pays arrangements go some way to address these issues, but they too are less than effective without wider reform of the funding arrangements.

Ofgem's review process focuses on gas transporters' network assets, and much less so on Xoserve's planned investments. Customers of Xoserve have a disproportionately small influence in the funding arrangements, especially as shippers rely heavily on their systems to maintain their business process.

### ***Limitations of present ownership***

The ownership and governance arrangements mean that Xoserve's principal responsibility is to its owners, with a secondary responsibility to its customers. Yet, despite having a critical role that parties must rely on, some additional functions that Xoserve could undertake to improve industry performance have not been included in its arrangements. For example, Xoserve can only provide limited reports on the allocation of energy between shippers as part of the gas allocation arrangements. It has no role to review the validity or accuracy of data nor to suggest corrective action or remedies if it detects errors or identify the consequences of poor quality data.

This leads to errors in the allocation of energy between shippers; the lack of analytical and corrective techniques to remedy these errors means the present and future reconciliation and settlement arrangements are not optimal. We believe that this has a material impact on shippers and their performance.

### ***Transparency***

Giving Xoserve an obligation to develop and implement appropriate arrangements for addressing data and industry quality issues would improve customers' confidence in the arrangements and help to drive down costs to shippers and their customers. Moreover, they could easily be introduced with a licence modification. We recommend that Ofgem includes development of a performance assurance framework as part of its reforms as this is an appropriate role for Xoserve and would improve transparency of the market arrangements without major changes.



**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?**

Our principle objective from any reform is to preserve the integrity of the Xoserve arrangements insofar as they promote our regulatory and commercial obligations as a shipper and supplier. However, we believe there is scope for Xoserve to improve its performance and responsiveness. In contrast to our comments about the funding arrangements, the ownership of Xoserve is not a critical issue to npower. We believe there are techniques to improve Xoserve that fall short of changing its ownership. Indeed joint ownership by the gas transporters provides more confidence about its independence that other forms of ownership, perhaps by companies outside of the energy industry, may not.

At the moment the energy supply industry is subject to a high level of change; we have a Smart Metering Implementation Programme, major development programmes like Nexus and environmental programmes such as the Green Deal. Unless there is a compelling reason to change the ownership arrangements, which we believe there is not, there are better means of reform that would cause less disruption. For these reasons we do not support Option C, the cooperative model.

Option A, changes within the current ownership, is also not appropriate given our comments about the funding arrangements. Some of the measures suggested by Ofgem in this option, an Oversight Committee and a User requirement Planning Group are measures that could be employed in any of the models and are separate to the funding and ownership arrangements.

***Npower's preferred option***

Option B, which is a customer facing subsidiary of the gas transporters, is our preferred option, as it balances relatively simple changes that overcome the constraints of the funding model with the means of achieving our objectives of preserving the integrity of critical functions, increasing transparency, improving responsiveness and providing the potential to improve performance assurance techniques.

**Ownership** – The funding and governance models need to be appropriate to the requirements of interested parties and stakeholders so applying a model used elsewhere to a different set of circumstances may not be the best approach. The review is an opportunity to develop appropriate arrangements that best meet the needs of gas transporter and shippers by acknowledging their common interests and providing proportionate means to minimise their differing ones.

There is no compelling reason for the gas transporters to relinquish ownership of Xoserve as long as Ofgem reforms the funding arrangements. There is a possible anomaly with this as owners may not have any financial benefit in Xoserve, yet would have all the liabilities associated with ownership. There is precedence for this in the energy supply industry. National Grid owns Elexon, the BSC Company, but users fund its operation. Any surplus or loss it makes is passed onto users.

**Funding** – we would like to see Xoserve's funding separated from the gas transporters' allowed revenues and replaced with an enhanced users pays arrangement whereby users of Xoserve's services pay for them in a cost reflective manner. Ofgem would need to adjust the gas transporters' allowed revenues to compensate for the greater contribution by users, but overall under this proposed arrangement users should pay no more for Xoserve's services than at present.



This would apply to gas transporters and shippers alike, but as they take different services there would need to be a range of charges. A charging methodology and financial reporting would give users transparency of the arrangements. We believe that Xoserve would set out its investment plans in consultation with users and put in place consultative arrangements that would contribute to a strategic planning process. Such a process would allow all users to discuss the relative priorities of changes and developments in a more holistic manner than at present.

**Governance** – accountability under such proposed arrangements would arise from a range of measures. It may be appropriate to licence Xoserve’s activities separately; that would have the merit of specifying its responsibilities to parties and setting out the relative weight it would have to give to differing parties. We would like to see the board comprise representatives from its owners, users and have independent representation. It should consult with users on its business and strategic plan.

There should be a body like the proposed oversight committee that has the role of assisting Xoserve in managing industry and regulatory changes that balances the interests of parties using Xoserve’s services. This would be an extension of the successful aspects of the Project Nexus arrangements

**Other Services** – an additional duty that we would like Xoserve to adopt is one of further facilitating competition in the industry, particularly implementing a range of performance assurance techniques. For example, in the allocation process we think Xoserve should take a more active role in validating and correcting data. In some cases there is an argument to apply some form of reallocation of costs in the event that the actions of a party have an undue impact on others. Shippers and gas transporters know the sources of poor data quality the affects the industry and could develop, in conjunction with Xoserve and other interested parties, an appropriate and proportionate set of techniques to remedy such problems

***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?***

We believe that a charging methodology would provide adequate transparency to enable parties to understand the scope of an enhanced user pays regime.

There is an argument to align the code governance arrangements with the management of the UNC. We do not consider that ownership should have any impact on such a reform as the primary focus of such a reform would be on efficiency and accountability.

Whilst Xoserve’s systems are critical to the smooth operation of the industry, again we see governance, operational excellence and performance assurance techniques as success factors rather than ownership.

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

Yes, Option B, with the enhanced user pays arrangements set out above and governance that promote transparency and with a performance assurance framework. However, the outcome of the change is more important than its form.

Yours sincerely

John Stewart