



31 Homer Road  
Solihull  
West Midlands  
B91 3QJ  
0121 623 2300  
[www.xoserve.com](http://www.xoserve.com)

James Grayburn  
Head of RIIO-GD1  
Ofgem  
9 Millbank  
London  
SW1P 3GE

18 November 2011

Dear James

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

Thank you for the opportunity to respond to the open letter consultation and accompanying report from Cambridge Economic Policy Associates (“CEPA”) concerning the review of Xoserve’s funding, governance and ownership arrangements. Our responses to the consultation questions are attached for your consideration.

### **Proportionate Change**

The prevailing funding, governance and ownership arrangements have to date proved fundamentally fit for purpose, but some change to the GT Agent funding arrangements may be desirable to accommodate uncertainty over the forthcoming RIIO-GD1 and RIIO-T1 Price Control period. Changes to funding arrangements would need to be accompanied by proportionate enhancement to current industry governance arrangements. Changes must be proportionate to and targeted at the scale and nature of concerns that are to be addressed. We see no case for change to Xoserve’s ownership.

We believe that the desired outcomes can be achieved through incremental change. In particular, we are concerned that Options B and C as set out in CEPA’s Report would be unnecessarily disruptive, would take considerable time to implement, and would carry a high implementation risk at a time of major industry change. Xoserve would therefore encourage Ofgem to set aside Options B and C, and to focus industry attention on the targeted development of some of the features of Option A.

### **Funding and Governance Arrangements**

Future funding arrangements should retain ex ante allowances for the bulk of GT Agent services, and development work should focus on the identification, development and implementation of

proportionate measures to provide flexibility of funding to accommodate more uncertain output changes and consequential operating costs.

Any flexible funding mechanism must have clear rules around its application, with sufficient input to and transparency of decision making, prioritisation and cost allocation processes for all stakeholders. Any new arrangements should align costs with beneficiaries, balanced with alignment of risk with control and transparency.

A “negotiated settlement” approach (which is a feature of all Options A – C) will require the retention of an independent arbiter to resolve disputes between stakeholders, and to protect the interests of parties such as end consumers who are not directly involved in negotiations.

### **Implementation Approach**

We would encourage Ofgem to consider the establishment of a Working Group, formally constituted under RIIO governance, to develop prioritised proposals for the introduction of selected Option A features. Sufficient lead time should be allowed to develop industry rules in a considered manner, allowing adequate opportunity for stakeholder engagement and consultation.

It may be possible to build upon some of the principles of the prevailing “User Pays” arrangements. However, it will be important to ensure that full account is taken of lessons learnt from the implementation and operation of the prevailing arrangements. In particular, it will be important to ensure that there is a clear application of the principles of a future funding and governance framework to all aspects of investment expenditure and consequent operating costs.

### **.Funding Mechanism – Initial Thoughts**

We set out below some initial thoughts on the potential features of a funding mechanism for the provision of GT Agent services during the RIIO-GD1 and RIIO-T1 period. As Xoserve is providing GT Agent services for and on behalf of both National Grid Gas Transmission and the Gas Distribution Networks, it is important that the mechanism is fit for purpose under both the RIIO-GD1 and RIIO-T1 frameworks. We offer these as possible features, and would expect these to be subject to extensive consultation as part of the implementation approach outlined above:

- (a) GTs have an ex ante allowance for existing GT Agent Core Services and ‘minor changes’;
- (b) Capital investment expenditure is funded through the GT Price Control capex mechanism;
- (c) There is a flexibility mechanism for more material customer, regulatory or governmental driven / beneficiary change investment and consequent operating costs;
- (d) Flexibility is best achieved through enabling GT revenue allowances to accommodate uncertainty, recognising the need for assurance of necessity and efficiency of expenditure;
- (e) Minor investment could be funded through a term in the GTs’ allowances that enables them to factor additional opex into subsequent years’ transportation charges; and
- (f) In the main, decision making, prioritisation and efficiency tests in respect of the variable elements of funding should be the responsibility of a stakeholder committee with clear

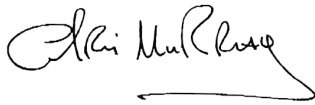
terms of reference, albeit decisions may be referred routinely / by exception to Ofgem who would have rights to test efficiency and would be the arbiter for escalated disputes.

It is our intention to continue to develop these ideas, and we would be happy to hold further discussions with Ofgem and the wider industry over the next few weeks.

We are happy for you to publish this letter and our responses to the consultation questions.

If you would like to discuss further any aspect of our response, please contact Nick Salter, Head of Strategy and Development on 0121 623 2305 or e-mail [nicholas.j.salter@xoserve.com](mailto:nicholas.j.salter@xoserve.com).

Yours sincerely

A handwritten signature in black ink, appearing to read 'Chris Murray', with a long horizontal flourish extending to the right.

Chris J Murray  
Chief Executive Officer

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## OPEN LETTER CONSULTATION: REVIEW OF XOSERVE

### XOSERVE RESPONSE

#### 1. Introduction

- 1.1 This document is Xoserve's response to Ofgem's open letter consultation ("Ofgem's consultation") and the accompanying report prepared by Cambridge Economic Policy Associates ("the Report") in respect of the funding, governance and ownership of Xoserve.
- 1.2 We have addressed in turn each of the Questions set out in Appendix 1 of Ofgem's consultation, with the exception of Questions 3 and 5, to which we have provided a single, consolidated response.
- 1.3 In addition to our responses to the Questions, we have set out in our covering letter our view of the key issues that should be addressed, together with a proposed set of principles and approach to achieve the outcomes that we understand will meet stakeholders' aspirations.

#### 2. Question 1: Xoserve's Performance

**Question 1:** 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.

- 2.1 We are pleased to note that CEPA have drawn positive conclusions from their stakeholder consultations about the value of the common agent model and Xoserve's consistently high performance in the discharging of obligations within the regulatory allowance and to the required industry standards. CEPA also highlight in their Report the consistent stakeholder feedback about reliable service delivery and the professionalism and high levels of competency of Xoserve staff.
- 2.2 The feedback that Xoserve has received from Shipper customers is consistent with CEPA's conclusion that there is substantial satisfaction with day to day service delivery. This is clearly evidenced by Xoserve's direct feedback from customers, both formally, as indicated in the record customer satisfaction scores that Xoserve is receiving from Shippers and the exceeding of Network customers' satisfaction targets, and informally through our programme of regular customer visits. Appendix 1 illustrates the continuous improvement in Shipper customer satisfaction scores that Xoserve has been achieving in recent months.
- 2.3 The strength of evidence for Xoserve's strong performance in the delivery of services contrasts sharply with the paucity of evidence in the Report for concerns about a lack of transparency and poor responsiveness associated with the management of change. Indeed, the Report acknowledges that concerns are "not always fully articulated by stakeholders"

and “seem to be based largely on perception”.<sup>1</sup> We note also that, to the extent that any evidence is offered, it relies almost exclusively on feedback from Shippers. We acknowledge, however, that even though feedback does not offer specific examples and tangible evidence of problems, some stakeholder concerns have been expressed with regard to Xoserve’s transparency and responsiveness. Xoserve has held a number of conversations with Ofgem, CEPA and Shippers to better understand the exact nature of these concerns, and has concluded that they relate to change funding and governance.

- 2.4 We have reviewed CEPA’s articulation of non-GT stakeholders’ concerns, and would acknowledge that some elements of the industry’s funding and governance framework for the provision of GT Agent services may not always afford these parties sufficient transparency of decisions. We also recognise that these parties may have concerns about the balance of control between different stakeholders. Addressing these concerns may be beneficial both for Xoserve and for its stakeholders, allowing the business to focus wholly on the provision of services and change, without the need to devote disproportionate time and resources to the management of some stakeholders’ concerns about governance and funding arrangements.
- 2.5 Timescales for achieving change are sometimes longer than those to which stakeholders would aspire. Industry discussions to establish requirements and funding arrangements are often lengthy and can contribute to a sense of frustration. Our rigorous and professional approach to change delivery adds further time, but ensures that the necessary effort is invested in understanding the full breadth and depth of the impacts of change on complex and highly integrated industry systems and processes. Consulting on future requirements through Project Nexus and planning strategic systems investments that offer easier access to future capabilities are key management tools to improving change responsiveness whilst maintaining service reliability and quality.
- 2.6 We also recognise that we may have historically not done enough to give visibility, communicate and explain to our stakeholders the scale and complexity of changes that we deliver. We have sought to address this more recently, presenting both in individual customer visits and at industry stakeholder events the full scope of our services together with a summary of recently delivered, ‘in flight’ and planned changes. We have received favourable feedback from this initiative, which has been welcomed by the industry. We will sustain this approach so as to give visibility to our change programme which will continue to progress through the remainder of this GT Price Control period and beyond.

### 3. Question 2: Current Arrangements

**Question 2:** 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.

<sup>1</sup> CEPA Report, Section 5.1.2, p.28

- 3.1 It is most important to make a clear distinction between industry arrangements that are concerned with the funding and governance of GT Agent services, and corporate arrangements that are concerned with the funding, governance and ownership of Xoserve Limited.
- 3.2 Xoserve's primary purpose is to act as the common agent of the GTs, appointed pursuant to Standard Special Condition A15 of the GTs' Licences. Xoserve as the GT Agent is required to discharge certain obligations of each GT as defined by their Licences and in the Uniform Network Code through the provision of central systems and services. Xoserve uses funds that are largely provided by each GT. In fulfilling its purpose, Xoserve must ensure that its services – and changes to those services - are delivered in accordance with agreed industry governance for the provision of GT Agent services.
- 3.3 Whilst Xoserve is actively engaged in, contributing to and influencing industry governance discussions about changes in service requirements, control and decision making rests with Code signatories. Industry rules dictate that the requirements of both Shippers and GTs must be subject to the same governance, and that GTs must test any proposed change to the UNC against their relevant Licence objectives.
- 3.4 There may be a perception amongst non-GT stakeholders that Xoserve's corporate ownership and governance arrangements may influence decision-making and prioritisation in favour of the GTs. Whilst Xoserve's Directors can clearly exercise control over the company's actions, they understand fully the necessity of operating in accordance with agreed industry governance, and that decisions regarding changes to services, regardless of whether these changes are driven by GTs or Shippers, are a matter for the relevant Code and Licence governance bodies.
- 3.5 Xoserve supports the implications of Section 5.2.2 of the Report with regard to the inappropriateness of not having any flexibility around ex ante allowed revenues for an eight year Price Control Review period. Within the context of its Business Plan submission to Ofgem, Xoserve is looking to bring forward the case for a more flexible funding mechanism that, within the framework of the GT Price Control Review, would recognise the uncertainty of the nature of and demand for certain services, and would provide greater agility to respond to emerging stakeholder requirements.

#### 4. Question 3: Options for Change and Question 5: Changing Current Arrangements

**Question 3:** What are your views on the costs and benefits of the three options for change (Ch.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?

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

- 4.1 We suggest below the key features that should inform the structure of a future GT Agent services funding and governance framework, namely:

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- (a) Alignment of the source of funding with the service beneficiary and parties that have most influence over the service usage;
  - (b) Alignment of service risk with control and transparency of the service provision and associated costs;
  - (c) Flexibility in funding arrangements that accommodates uncertainty in service requirements whilst retaining appropriate efficiency incentives;
  - (d) Efficient and unambiguous governance processes for prioritisation and funding of both tactical and strategic change, (including changes requiring capital investment);
  - (e) For all stakeholders, transparency of decisions and costs, and confidence in outcomes; and
  - (f) For Xoserve as the service and solution provider, early clarity of prioritised industry requirements and identification of sources of funds.
- 4.2 Any changes to prevailing arrangements must be proportionate to and targeted at the scale and nature of concerns that Ofgem and the industry is seeking to address, and should contribute to the promotion of the suggested key features.
- 4.3 Elements of the principles set out in Option A, especially those relating to “negotiated settlement” have merit and should be further reviewed and developed.
- 4.4 We are concerned that both Option B and Option C as set out in the Report would:
- (a) Be a disproportionate response to stakeholders’ concerns;
  - (b) Be unnecessarily disruptive and carry a high implementation risk, particularly at a time of major industry change; and
  - (c) Require the industry to reach its own conclusions about service priorities and funding arrangements without an “independent arbiter”, which may prove particularly difficult in situations in which there are diverse stakeholder interests.
- 4.5 The Report notes the work undertaken recently by UNC Review Group 334 “Post Implementation Review of Central Systems Funding and Governance Arrangements” (“RG334”), and acknowledges the incremental changes that RG334 considered could deliver benefits without the need for change to the prevailing funding, governance and ownership arrangements. Xoserve is working closely with both GTs and Shippers to give effect to a number of these changes and, where appropriate, progress is being monitored by and reported to the UNC Governance Workstream. Indeed, some changes have already been successfully implemented, and we are receiving positive stakeholder feedback in response to these. The strength of stakeholder support for prompt delivery of incremental changes reflects the desirability and sufficiency of a proportionate response.

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- 4.6 In order to explore the potential to achieve further targeted and proportionate change through incremental initiatives, Xoserve would propose to review other RG334 ideas. Our initial thoughts are that we would explore more fully, with input from stakeholders:
- (a) Shipper representation at Xoserve Board and change governance meetings, including the nature of the roles and responsibilities of Shipper representatives;
  - (b) The case for the establishment of a “Change Oversight Committee” (or a “User Requirement Planning Group” as envisaged in the Report), or possibly a refresh of the Terms of Reference of one or more of the existing UNC governance bodies that would achieve the same purpose; and
  - (c) The development and regular communication of an industry priority plan for the changes that Xoserve will be required to deliver.
- 4.7 Xoserve would therefore encourage Ofgem to set aside Option B and Option C, and to engage with the industry on the targeted development of some of the features of Option A, particularly the principle of a “negotiated settlement”. The wholesale adoption of features of Option A without further analysis and assessment might have unintended consequences and Xoserve would therefore encourage Ofgem to consider the establishment of a Working Group, formally constituted under RIIO governance, to develop prioritised proposals for the introduction of selected Option A features. The scope of the Working Group’s considerations could also include the progression of related ideas that have been discussed by RG334.
- 4.8 We have set out in our covering letter and reproduced here below some initial thoughts on the potential features of a funding mechanism for the provision of GT Agent services during the RIIO-GD1 and RIIO-T1 period. As Xoserve is providing GT Agent services for and on behalf of both National Grid Gas Transmission and the Gas Distribution Networks, it is important that the mechanism is fit for purpose under both the RIIO-GD1 and RIIO-T1 frameworks:
- (a) GTs have an ex ante allowance for existing GT Agent Core Services and ‘minor changes’;
  - (b) Capital investment expenditure is funded through the GT Price Control capex mechanism;
  - (c) There is a flexibility mechanism for more material customer, regulatory or governmental driven / beneficiary change investment and consequent operating costs;
  - (d) Flexibility is best achieved through enabling GT revenue allowances to accommodate uncertainty, recognising the need for assurance of necessity and efficiency of expenditure;
  - (e) Minor investment could be funded through a term in the GTs’ allowances that enables them to factor additional opex into subsequent years’ transportation charges; and
  - (f) In the main, decision making, prioritisation and efficiency tests in respect of the variable elements of funding should be the responsibility of a stakeholder committee with clear



terms of reference, albeit decisions may be referred routinely / by exception to Ofgem who would have rights to test efficiency and would be the arbiter for escalated disputes.

## 5. Question 4: Critical Issues

**Question 4:** 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?

- 5.1 From our understanding of the Report, we conclude that CEPA has identified four critical issues, namely:
- (a) The ability to separate Xoserve's activities and the systems that Xoserve manages from GT businesses;
  - (b) The extent to which Xoserve's activities are "co-operative" in nature;
  - (c) The appetite amongst non-GT stakeholders to assume a greater role, responsibility and therefore accountability for Xoserve and its activities, and to invest resource and potentially their own capital into the business as part of their collective industry responsibility for the services provided; and
  - (d) The criticality to the industry of the systems and services provided by Xoserve during a period of already significant change in the energy sector, and the acceptability of risk raised by fundamental change to Xoserve funding, governance and ownership.
- 5.2 Given Xoserve's purpose (see paragraph 3.2 above), it is unrealistic to seek to separate Xoserve's activities and the systems that Xoserve manages from GT businesses, as many of these are core to the delivery of GT services and obligations.
- 5.3 The feedback that we have received from Shippers both in bilateral discussions and at the "round table" event hosted by Ofgem on 24 October 2011 indicates little, if any, appetite amongst non-GT stakeholders to assume a greater role, responsibility and accountability for Xoserve Limited. This would suggest that stakeholders are broadly comfortable with Xoserve's corporate governance, control and ownership arrangements, and do not see Xoserve as a "co-operative" body.
- 5.4 We would reiterate the key observation that any changes to prevailing arrangements must be proportionate to and targeted at the scale and nature of concerns that Ofgem and the industry is seeking to address. We are particularly concerned that both Option B and Option C as set out in the Report would be unnecessarily disruptive and carry a high implementation risk at a time of major industry change.
- 5.5 In reaching its conclusions, we would encourage Ofgem to be mindful of the inclusion in total GT Agent funding requirements of the significant costs of providing services for and on behalf of National Grid Gas Transmission, including investment in and production support for the Gemini system.

Appendix 1 – Customer Satisfaction Results April 2010 – October 2011

