Future arrangements for the Gas Transporter Central Agent

Annex D: Corporate governance options

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Final report

CEPA

tpa

ESP Consulting

CONTENTS

IMPORTANT NOTICE

1. INTRODUCTION

1.1. Context

In January 2012 Ofgem issued a decision letter where it concluded that a "cooperative" model represents the optimal set of future funding and governance arrangements to support the range of centralised data services currently provided by the GTs appointed agent, Xoserve. A consortium of CEPA, TPA Solutions and ESP Consulting has been commissioned by Ofgem to develop options and recommendations for these future arrangements.

1.2. Purpose

The purpose of this annex is to provide a detailed analysis of different corporate governance arrangements, which can be seen as being cooperative in nature and consistent with Ofgem's decision letter. It begins by identifying the various elements that need to be incorporated into the different options, highlighting the alternative approaches that might be utilised. From this analysis a number of options have been developed which have subsequently been assessed against a range of criteria, including the implementation and potential transition issues that they give rise to.

1.3. Process

An initial draft of this paper was developed and then discussed with an industry Governance Working Group.[1] Based on feedback from the working group, we have subsequently updated the analysis and reflected this in this final report.

Where there were differing views amongst industry participants on particular issues, we have highlighted these differing views as part of the analysis. Whilst industry feed-back has been invaluable in testing and further developing the different options, responsibility for providing conclusions and recommendations rests fully with CEPA.

1.4. Approach

The starting point for the initial paper on corporate governance issues, was the analysis presented by the CEPA team at the first industry Steering Group meeting in November 2012, which set out a first set of "straw men" options. These were arrived at following an initial phase of work which explored, amongst other things, corporate governance options operating in analogous contexts.

A key output of this analysis was the need, in our view, to change the paradigm within which Xoserve operates. Whilst Xoserve was established primarily to deliver transporter licence and Code obligations following distribution network sales, we have suggested that any future arrangements should begin with an assessment of the services that it provides to various parties.

[1] The industry Governance Working Group comprised representatives from Shippers, Gas Distribution Network operators (GDNs), National Grid Gas Transmission, Ofgem and the CEPA led consortium.

This involves considering Xoserve primarily as a central services provider to the industry supplying critical data, information and IT services which can support system operation and the competitive wholesale and retail gas markets. This involves moving away from the primary purpose of the company being to act as the GTs' appointed agent, responsible for delivering certain of their regulatory obligations under licence and the UNC, to being in its own right an empowered central service provider to the industry as a whole.

In terms of developing and testing corporate governance options the objectives of the paper and its associated working group have been to:

- Identify and assess key corporate governance issues, in terms of constituencies, structure, principles of control, risk allocation and financing.
- Test whether or not the options as proposed deal with the key issues and whether other options should also be considered.
- To assess how different participants view the impact of the proposed options on themselves and to what extent the proposals can be modulated to accommodate any concerns.

1.5. Principles

A number of principles underlie our proposals on governance. These include:

- As set out above, seeing Xoserve's role as a data, information and IT facilitation company providing various services to gas industry participants, rather than a company delivering certain licence and Code obligations.
- A focus on the governance of Xoserve and not the governance of the gas industry generally or changes to documents such as the UNC.
- Considering how best to manage such a company in the interests of all participants, as implied by a cooperative model.
- Considering also how best to manage the risks inherent in such a company and aligning those that bear such risks with their ability to control the affairs of the company, whilst accepting that shared risks will also mean shared control.

Any workable corporate governance option needs to be consistent with these principles. In addition, Ofgem considered at the time of network sales a number of criteria against which to assess governance options. We use these criteria together with some additional ones as the starting point for our design of governance arrangements, by testing various proposals relating to elements of governance against them.

The Ofgem criteria were that the new arrangements should deliver:

- Transparency
- Inclusiveness
- Effectiveness
- Efficiency.

Additional criteria were that any common service arrangements should allow:

- Cost mitigation for customers
- Competition to be supported
- Services to be defined clearly
- Appropriate quality of services

Apart from the above, other principles regarding governance are:

- to utilise existing arrangements where appropriate (without compromise to desirable change); and
- to read across to arrangements in other bodies that offer parallels for Xoserve to adopt and to import such arrangements to the extent necessary.

In analysing the different corporate governance options we have been cognisant of the above, identifying where, in our view, any option is either consistent or at odds with the principles or criteria as outlined.

1.6. Document structure

The sections which follow consider:

- building blocks for corporate governance option development (Section 2);
- identification of options and their assessment against our proposed principles (Section 3);
- the implementation challenges and transitioning issues with different approaches (Section 4);
- other governance issues that also need to be considered as part of implementation (Section 5); and
- our overall conclusions (Section 6).

A series of appendices provide supporting analysis on:

- separation of ownership and control;
- performance risk allocation issues;
- transitioning issues; and
- impact on major projects.

2. BUILDING BLOCKS FOR OPTION DEVELOPMENT

In this section we set out and discuss a number of elements in relation to governance of a cooperative organisation, which are then used to construct full corporate governance options in Section 3.

It is important first to highlight the overall change in focus that we are proposing, namely that Xoserve is looked at as an organisation delivering various IT services largely on a monopoly basis to gas industry participants. If the overall arrangements for such a company move to a cooperative basis, then we suggest that all participants need to consider carefully both the appropriate governance arrangements for such a company and how matters such as performance risk are managed. We use the building blocks approach to assist in those considerations, with the relevant blocks being:

- the issue of *constituencies*, that is, whether say, GTs and Shippers should arrange their representation within separate groupings;
- *type of organisation*, principally whether the central service provider should be a company limited by shares or a company limited by guarantee;
- *structure*, whether the central service provider should both procure and provide services or be split into a smaller procurement agent and an arm's length delivery organisation;
- *ownership*, in particular should the current arrangements continue or should a wider form of ownership be introduced;
- *risk allocation* and where we discuss the risks that the central service provider faces and what parties should bear them;
- *financing*, where we consider how the central service provider should be financed;
- *corporate governance components*, in which we discuss how the central service provider should be governed in terms of the role of the Board and Shareholders/ Members; and
- *regulatory governance*, particularly what forms of oversight would be appropriate, for example, in terms of the funding of the common service provider.

It has been suggested that governance and the development of a cooperative model should focus on contract matters, within much the same overall arrangements as now. Whilst it is debatable whether such a model is consistent either with the Ofgem decision to progress Option C or our terms of reference, in the interests of balance we include it in this assessment. In relevant areas, therefore, we discuss some of the building blocks in terms of both a 'light' cooperative model, with as many as possible of the current arrangements continuing, and a 'full' cooperative model, the latter involving more active participation by those parties not currently represented on the Xoserve Board.

Both the 'light' and 'full' cooperative models have been discussed and developed with the industry participant working group meetings.

2.1. Constituencies

2.1.1. Role of constituencies

Whichever participants take part in corporate governance arrangements, they can do so on one of at least three bases:

- Acting individually.
- Acting within defined constituencies.
- Acting on behalf of the industry as a whole.

In practice, notwithstanding things such as the fiduciary duties of Directors, it is natural for participants to look first to the interests of their own companies. Nevertheless, broader forms of representation can also be considered.

The participants in Xoserve break down into two broad groups, Shippers and Transporters, within which further subdivisions can be considered. As we have discussed in the Services paper (see supporting Annex B), we do not consider that there is a strong case for splitting Xoserve into two organisations, one serving GTs and the other serving Shippers. We therefore begin with arrangements that are related to the status quo, but we do recognise that there are different interests as between GTs and Shippers, and indeed within these groups.

In the 'light' cooperative model, constituencies are not appropriate. In the 'full' cooperative model, however, we suggest that differences between industry participant groups be recognised by creating constituencies through which Board members can be elected, to ensure an appropriate range of representation and to avoid domination by one or other group; such an approach also aligns to the governance of the UNC panel.

2.1.2. Number of constituencies

How many constituency groups should be recognised in the central service provider's corporate governance arrangements was an issue discussed in considerable detail at the industry working groups. Some participants were in favour of just two constituencies, one for GTs and the other for Shippers, rather than creating smaller groups, so as to avoid issues such as:

- who should have what weight within and between those smaller groups; and
- how to deal with participants that met the criteria for membership of more than one smaller group.

Other participants proposed alternatives, and suggested that particular industry participants, for example National Grid Gas Transmission (NGGT), would need to be recognised as individual constituencies in their own right.

There was, however, reasonable consensus amongst the working groups that whilst there was a clear role for constituencies within the corporate governance framework, the arrangements needed to be fit for purpose for a data and IT services company.

We have considered carefully the pros and cons with different approaches. We consider that a proposal which limits constituency groups to just two, Shippers and Transporters, to be the most consistent with the proposed paradigm shift to establish governance arrangements for a central data and IT services provider acting in its own right, rather than an industry agent or vehicle for the development and governance of industry policy.

The only exception to this is NGGT, where although we expect the Gas Distribution Network operators (GDNs) to be aligned on the majority of issues, there may be cases where transmission has different interests as regards the central service provider. Given the unique role of NGGT within the industry, we also consider that a data and IT services provider to the gas sector would be likely to benefit from its participation.

While we would not recommend that NGGT is provided a preferential role over other constituencies, we do recommend, as discussed as part of our corporate arrangements proposals below, that one of the GTs' Board member seats is reserved for NGGT.

2.2. Type of organisation

Xoserve is a relatively small company, but as has been pointed out to us by several participants, the things that it does have economic and commercial importance far greater than its size.

This argues for some formal governance arrangements associated with particular forms of organisation; whilst other vehicles to express standards can be considered, for example detailed contracts, it is probably helpful to have some external standards as a benchmark, such as the need to publish accounts and appoint Directors or Board members. If so, the unincorporated body, the approach adopted by the Joint Office, would not seem appropriate. Also partnerships, both standard and with limited liability, would also not seem appropriate as much of their governance is set out in the Partnership Deed and there are fewer external standards to be followed than in some other types of organisation.

Three basic organisational models are therefore considered, a company limited by shares, usually called a limited company in the UK, a Company Limited by Guarantee (CLG) [2] and an Industrial and Provident Society.

An Industrial and Provident Society can probably be ruled out at this stage. Whilst such bodies are often used for trading by cooperatives and clubs, and have model rules and a Registrar, they do not seem to offer advantages over the alternatives of a company limited by guarantee; in particular, there is no ability for constituencies.

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[2] Examples of CLGs include the Central Market Agency (CMA) which administers the market for water and wastewater retail services in Scotland, Network Rail and Dwr Cymru Welsh Water. See our supporting comparator paper (Annex A) which reviews CLG structures.

Whilst limited companies typically have a number of different owners, normally they have a for profit purpose. This is not mandatory, however, and cooperative and other arrangements can be organised within a limited company framework. Nevertheless, when there is a common purpose which is other than for profit, or in which for profit is perhaps a subordinate aim, then a CLG is often used instead.

Table 2.1 below assesses the two options of a company limited by shares, termed the Limited Company and a CLG against the criteria described in Section 1.2.

Table 2.1: Type of organisation

Criterion	Limited Company	Company Limited by Guarantee
Transparency	Depends on detailed rules, although specific standards apply to published accounts	Depends on detailed rules
Inclusiveness	Inclusive if all participants are involved in ownership and governance	CLGs are able to create different constituencies and hence may be considered as inclusive at a more granular level
Efficiency	Depends on degree of oversight and commercial environment	
Effectiveness	More effective if clear profit target and penalties for non-performance	More effective if common service obligations spelled out in ways that ensure participant needs are met
Cost Mitigation	Greater focus if profit motive	Needs specific measures to ensure sufficient focus as CLGs are typically not for profit organisations
Support Competition	Little discernable difference	
Define Services Clearly	Little discernable difference	
Define Appropriate Quality	Depends on contract terms	Depends on remit within and between constituencies
Utilise Existing	Xoserve is already a limited company	Departure – would need careful transition
Read Across [1]	Elexon, MRASCo, SPAA	CMA

Source: CEPA, TPA and ESP

Note 1: See accompanying paper (Annex A) on comparator organisations

The analysis indicates that the criteria of Inclusiveness, Effectiveness, Cost Mitigation and Utilising Existing structures appear to be of most importance in determining the appropriate type of organisation.

The more that participants wish different constituencies to be recognised, the more that a CLG should be chosen. The more that ease of transition or cost control matters, the more that the Limited Company offers advantages if it has a profit focus.

Effectiveness flows to some extent from the Inclusiveness criterion; the more that it is possible to identify common interests and align the company to achieve them, the more that a CLG is preferred, whereas if the objective is to more towards meeting profit and perhaps cost targets, then a Limited Company may be of greater advantage.

It should be noted that other measures can be introduced to overcome some of the perceived disadvantages of either form. For example, more explicit definition of service standards, especially related to change, may allow a single company to meet quality expectations. Also, it would be possible to separate ownership from control and thus enable a limited company to act in governance terms as though it was a CLG. If a CLG is preferred, then it would need some explicit statement of cost expectations and a governance structure that supported those expectations.

Finally, we recognise that there could be TUPE and other problems were Xoserve transform into a CLG. We discuss these issues separately in the section on transition and implementation issues below (see sections 4 and 5) and for the purposes of developing options, we assume an unconstrained analysis of organisational options.

2.3. Structure

Structure refers to the environment within which the central service provider operates, and in particular whether Xoserve is the central service provider, or transforms into two parties, one a contracting entity and the other an arm's length service provider with which the former contracts for the provision of services. There are a number of aspects to be considered, in particular:

- If Xoserve is the central service provider then it is presumably undertaking that role in perpetuity and therefore governance needs to focus on the monopoly provision of common services and how to ensure that the interests of users are properly protected.
- If Xoserve contracts with an arm's length service provider, then a separation of duties and responsibilities has to be undertaken, with a central entity representing the interests of UNC participants and the arm's length service provider delivering a range of services to enable the central entity to discharge those interests.

At this point it is probably helpful to note that in broad terms Xoserve being the central service provider represents the status quo and that the separation of existing Xoserve functions between a central entity and an arm's length service provider is more akin to the approach adopted by MRASCo and the SPAA, albeit that these are both much smaller and narrower organisations than Xoserve. In this paper the first is called the 'One Company' model and the second the 'Two Company model', with the former specifying the services that the latter delivers under contract.

From observations put to us, it is apparent that some participants consider that the service providers to MRASCo and the SPAA, Gemserv and ElectraLink respectively, act in a more commercial and customer-focused manner than some other common service providers. These participants argue that a primary reason for the difference that they perceive is the commercial incentives on the two service providers, whose service contracts can be retendered, to act more directly in the interests of customers. They contrast this with arrangements which in their view perpetuate a monopoly service provision, so that whilst customer views are taken into account under such arrangements, they consider that they are not given sufficient weight as compared to other factors.

The opposite point of view is that one company can provide all that is required, as long as its governance arrangements are properly defined, the services that it provides are clearly articulated and its senior management acts in the interests of all stakeholder groups.

Table 2.2 below assesses the two options against the criteria described in Section 1.2.

Table 2.2: Company structure

Criterion	One Company	Two Company
Transparency	Depends on detailed rules	Depends on detailed rules, but probably marginal improvement on one company model, especially if the specification company sets out disclosure rules
Inclusiveness	Little discernable difference	
Efficiency	More efficient if internal structures encourage efficient delivery	More efficient if need to define contract terms encourages separation of duties and efficient delivery
Effectiveness	Effective if clear definition of roles and duties	Potentially more effective if contract terms define clearly what participants require
Cost Mitigation	Depends on governance arrangements	Depends on clarity of specification
Support Competition	Little discernable difference	
Define Services Clearly	Depends on detail in ASA and in any equivalent for Suppliers	As one company, but separate focus on specification may encourage greater clarity
Provide Appropriate Quality	Depends on both contract terms and governance, especially in relation to change	May encourage greater focus on quality as part of specification process
Utilise Existing	Xoserve operates the one company model	Departure – would need careful transition and detailed specification of who does what
Read Across [1]	Elexon	MRASCo, SPAA, CMA

Source: CEPA, TPA and ESP

Note 1: See accompanying paper (Annex A) on comparator organisations

In part the analysis of the two structural models is linked to that of type of organisation:

- If the Limited Company model is preferred, with an emphasis on cost effective delivery, then this might align better with the One Company model. It should be noted, however, that there is a risk that a focus on costs may lead to services not being provided necessarily to the standards that users might expect or that proposals for change might be discouraged on cost grounds. To guard against this, governance arrangements need to be introduced to ensure balance stakeholder representation and a focus on matters of concern to all participants and not primarily sub-groups of them.

- If the CLG model is preferred, with the emphasis on the delivery of specified services, then the Two Company model has advantages. It will be important to ensure in this model that the CLG, through its separate service provider, does delivery quality services to an acceptable cost level. This could become a key criterion for the specification company to consider when contracting out for services, especially if the commercial pressures on a company whose contract is not indefinite are taken into account. If the Two Company model is not adopted, however, then careful attention has to be paid to rules and processes that ensure that the CLG delivers value for money to participants.

2.4. Ownership and control

Whilst a number of participants initially indicated to us that they felt that ownership and control should be precisely aligned, it is apparent that the working groups on governance issues took a different stance and generally considered that the two can be separated.

There are various mechanisms that could be used to effect such a separation. This was an area that industry participants requested further information to what we had initially presented to the industry working group meetings.

In Appendix A we have provided a short discussion of the objectives of separating ownership from control, followed by the options for how this might be achieved in practice. While further legal advice is required to develop our proposed approach, which involves the rights of constituent groups that are not owners to be enshrined in the Articles of Association of the company, subject to shareholder agreement, we are confident that a separation of ownership and control could be effected should this be considered appropriate.

Separate to the actual mechanics of how the separation of ownership and control might be given effect, the subsections which follow go back to first principles by setting out the building blocks and options for ownership and control. These are then used to develop overall bases for cooperative governance arrangements as discussed in Section 3.

2.4.1. Ownership

Xoserve is currently owned by the GTs (in this case control is aligned with ownership), who bear most of the financial risks associated with the company and are allowed to recover most of its costs through regulatory rules.

In terms of ownership, we consider three options:

- Ownership remains as at present.
- Ownership is by all participants.
- Ownership is by one party.

Ownership could remain as it is at present, that is by the GTs collectively. Whilst different GTs have different shareholdings, if the risks of shareholding are removed through our funding and financing proposals, then these differences may not matter. This option is perhaps the simplest to implement as it would not require any changes to this element of the existing arrangements.

Ownership could be by all participants. The arrangements could for example require any UNC participant to take up a share (in the case of a limited company structure) or membership (in the case of a CLG) in Xoserve for a nominal amount.

Ownership could be by one party, say one of the current GTs prepared to take on that role.

The last two options would require changes to the existing arrangements. To minimise the costs of any such change, should it be agreed, we suggest that the current funding arrangements, whereby the GTs provide funding which goes into their RABs and is then recovered over a lengthy period of time, should remain in relation to existing assets. In this case there is no value loss to the GTs who relinquish ownership, thus limiting the costs of change overall. Any new assets would then be funded in ways discussed in our funding paper, leaving the Xoserve elements of the GTs' RABs to be depleted over time.

2.4.2. Control

The separation of ownership and control would appear to be relevant only to the full cooperative model; in the light cooperative option, because the current arrangements are retained, separation is not practical, because by doing so in effect the full cooperative model is adopted.

If the owners are divorced from control, then some other body or bodies have to exercise it. We discuss later the role of the Board and we suggest that this is the body that controls the central service provider. Furthermore, we suggest that two constituencies, Transporters and Shippers, each elect Board members so if there were concerns about the Board not exercising appropriate stewardship these could be addressed through fall back arrangements that gave the constituencies powers to remove Board members prior to the end of their normal term of office. In this model the constituencies therefore take on the normal role of the owners.

The arrangements by which ownership and control are separated would need to be carefully defined to ensure that relevant legal obligations regarding ownership were properly discharged without risk to the ultimate owner. As discussed in Section 2.8 (regulatory governance) there would also need to be *in extremis* arrangements for the owners to step in, perhaps only under instruction from Ofgem, if for whatever reason the then current governance was seen to be manifestly failing.

2.5. Risk allocation

Gas Transporters, who currently are at risk if Xoserve's costs exceed regulatory allowances, and Shippers, who may in future take on some of those risks were financing arrangements to change, may not consider that they are in business of running IT services for third parties (even if they themselves are such a third party). In other areas, these companies will either provide IT services in-house or will contract them out.

The amount of risk that they bear relating to IT is largely a matter of choice and relates to matters such as the degree and depth of in-house expertise, the scale of contracted-out activities and the terms of the relevant contracts. In relation to Xoserve; however, the parties have little or no choice both because the services that are provided require central systems that aggregate data from all parties and because use of most of the services is mandated under licence or Code.

The following principles are proposed in relation to the issues in this paper:

- Wherever possible, the new arrangements should be very clear as to where financial risks are allocated.
- The parties that bear risks should be in a position to exert control over Xoserve's affairs to the extent necessary to manage those risks.

In terms of financing and control, here as elsewhere it is assumed that Xoserve is primarily in existence to deliver services to gas industry participants, in large part so that those participants can fulfil various obligations as set out in Code and licence.

Table 2.3 describes the principal forms of financial risk, proposes to whom such risks might be allocated and discusses why such allocations are proposed.

Table 2.3: Risks and their allocation

Risk	Allocated to	Discussion
Core Services cost overrun	Parties that control Xoserve	Performance risk should not be allocated to customers (the fact that customers, or a sub-group of them, may control Xoserve is a different matter)
Bespoke Services cost overrun	Parties that control Xoserve	Performance risk should not be allocated to customers (the fact that customers, or a sub-group of them, may control Xoserve or ask for Bespoke services is a different matter)

Risk	Allocated to	Discussion
Bespoke Services underutilised, so cost recovery not complete	Users through contract terms	Assuming that negotiations over Bespoke Services identify both the price and the volume of services to which a particular User commits, then if the service is underutilised Xoserve should be able, within reason, to recover the shortfall. In future years, re-budgeting would be required that might include revised allocations of central costs based on a revised estimate of the volume of Bespoke services. Under current (User Pays) arrangements, most of the upfront cost is met by the parties concerned, and annual running costs are relatively small, so the exposure here, which is primarily opex based, should not be significant.
Financing costs increase	Parties that finance (control) Xoserve	This is a 'normal' commercial risk that the financing parties should bear
A User goes into administration and cannot pay monies due to Xoserve	1. Parties that control Xoserve	This is effectively an insurance risk. Parties could decide to leave the risk with the controllers of Xoserve, who would then rightly want a premium for the exposure
	2. All participants	Participants could decide effectively to self-insure, which may place more emphasis on credit checking
Systems failure leads to claims for damages	1. Parties that control Xoserve	For an IT service provider, this is a normal commercial risk. For the parties that have to meet the costs in relation to Xoserve, it may be seen as a significant additional risk to their normal operations
	2. All participants	As above, again the risk may be seen as a significant addition

Source: CEPA, TPA and ESP

Against the risks that are identified, allocation options appear to be restricted to those that control and fund Xoserve and all participants (apart from User Pays volume risk, which is considered to be minimal). If all participants are required to fund Xoserve, then these differences disappear. If only a subset of participants control Xoserve, then they are important.

A further option is for service delivery to be put at arm's length from the central entity through the contracted services / Two Company structure described in Section 2.3, in which case participants are indifferent to risks borne by those who control Xoserve, as opposed to those borne by participants themselves, providing that the central entity specifies requirements appropriately and manages their delivery through a service provider (or providers) effectively.

There is also an important link to be made between performance risk allocation and the proposed funding arrangements of the central service provider.

As set out in the supporting paper on funding and charging (see Annex B) we are proposing that, at least in the 'full' cooperative model, there should be full pass through arrangements for budgeted costs. While budgeted costs are a simple pass through arrangement, slightly more complex arrangements are proposed for budget over and under runs:

- We have proposed that if these exceeded an agreed threshold held on the balance sheet, the deficit would need to be funded by those who control the central service provider and would trigger a letter from Ofgem on future arrangements.
- In the event that a deficit needed to be funded in such a way this would however, still be treated as an allowed pass through. The letter from Ofgem creating a reputational incentive for this event to be avoided.

The implication is that because all costs are a pass through, rather than those who control the central service provider bearing performance risk for the company, it is largely consumers who would actually bear the costs from performance failure.[3] While this is a concern from the perspective of protecting consumers in general, it potentially also undermines the effectiveness of a cooperative model as it weakens the incentive for the industry to manage risk effectively.

We provide a discussion of the options which might be considered to better achieve the intended alignment of performance risk with those who would control the central service provider (industry participants) in Appendix B.

Our proposal, as developed within the supporting annex on regulatory and legal frameworks (see Annex E) is that a licence condition should be imposed on those who control the central service provider to participate in the company and manage it in an "efficient and economic manner".

The effectiveness of such a mechanism is a key issue for consultation. Whatever approach is adopted however, needs to be consistent with the design principle of the new arrangements, that obligations and performance risk be aligned with control.

2.6. Financing

If the current arrangements are broadly continued in the light cooperative model, it is reasonable to propose that the current financing arrangements are also continued, that is that the GTs finance Xoserve 100%. In this model, there are issues associated with the amount of risk that GTs should bear, particularly in relation to Shipper service lines. On the other hand, if Shippers are unable to

[3] The assumption being that those who control the central service provider still bear some reputational risk if the event, for example, of a major systems failure.

participate in the governance of Xoserve, it seems difficult to expect them to bear risks over which they have little or no control.

If the arrangements are changed to the full cooperative model, then we suggest that financing arrangements should also change. We consider two areas, run costs and the development budget, and major project costs.

Run costs and development budgets were outlined in the Funding paper (Annex C). In summary, run costs are the operating costs of Xoserve and the development budget is primarily to support the UNC Panel change processes. We anticipate both that these costs are readily easy to forecast and also that they should not impose significant working capital requirements on the company, especially if charges to customers are paid promptly. Whilst we would seek advice from Xoserve, we would not anticipate that on an annual budget of say £35m that the working capital element should be more than say two months invoicing at most, perhaps around £6m. This amount of working capital could probably be financed through loan arrangements guaranteed by participants, perhaps in proportion to their share of such costs met through charges (or even ultimately on a 'last man standing' basis). Alternatively some form of levy could be imposed on a one off basis when the new arrangements are introduced.

Xoserve also incurs significant costs in relation to major projects. It is for the industry to consider whether these should be financed in the same way as the working capital for run and development budget costs, or separately in relation to specific projects. Alternatives include a levy on those benefitting from a particular project, arrangements with the presumably external service provider delivering the project that capital costs are amortised within the charges for the service or a separate loan funding arrangement guaranteed only by the beneficiaries.

The run budget discussed above will include bespoke 'user pays' services (which would in this model probably be much more narrowly defined). Whilst there is a case that these should be funded 100% by the appropriate users, this may introduce a level of complexity for little gain, given the expected small volume of such costs. Whilst detailed financing arrangements will be a matter for the Board to propose to members, we suggest as a starting point that bespoke 'user pays' service financing is subsumed into the general financing for run costs.

2.7. Corporate governance components

The following principles are proposed in relation to governance arrangements:

- Control should be exercised by appropriate voting rights.
- Control should be exercised as effectively as possible, without disregarding the views of the full range of parties involved in control matters.
- Minority or particular interests should be safeguarded where appropriate.

The two principal organisational structures that have been proposed are companies limited by shares or limited by guarantee. In terms of control, whilst company law defines differences between them, there is likely to be a common hierarchy that together will encompass governance:

- One or more General Meetings of the company each year, where all members can attend and cast votes.
- A Board that is in day to day control of the company.
- One or more sub-committees or other bodies that offer the ability for more focused attention by non-executives on particular matters.

In this paper this hierarchy is discussed on the assumption that it could be applied equally to a company limited by shares and a CLG.

General Meetings

In the light cooperative model, we do not envisage any significant changes to the existing arrangements regarding General Meetings.

In the full cooperative model, consideration has to be given to the role of General Meetings, given that most participants will not be directly represented on the Board of the central service provider. In very few companies are General Meetings the focus of governance arrangements. In most companies it is commonplace to have a Board that conducts business with the General Meeting having relatively limited powers. It is suggested that this principle is generally applied, with the General Meeting having powers limited to:

- Appointing and removing Directors.
- Approving the remuneration of Directors (and potentially one or more senior officials of the company).
- Approving or rejecting the Annual Report and Accounts, where rejection would be taken effectively as a vote of no confidence in the Board.
- Other relevant matters such as the appointment of auditors.
- Approving or rejecting the Annual Budget, where again rejection would be taken effectively as a vote of no confidence in the Board.

The first four points above are standard items for AGMs in many organisations. The last is less typical, but is proposed as a way of ensuring more inclusion of those who help fund the costs of Xoserve but who do not participate in its Board or sub-committee arrangements.

If ownership is separate from control, however, then the AGM is technically limited to shareholders and other participants would have little or no voice in its proceedings. In that option, we therefore propose that the arrangements include provision for a General Meeting of all parties entitled to elect members to the Board of the company and that the shareholders or the Board, as appropriate, are required to take into account any votes at such a meeting.

In terms of governance, the main alternatives for the General Meeting are for all participants to vote equally, or for voting to be weighted according to financing contributions. The latter is proposed for the General Meeting, on the basis that a key focus will be approval of the annual budget, where voting should follow commitment.

Further work is required on the details of calculating such financing contributions, and our initial thinking is that these should be related to the overall proportion of Xoserve's costs that each participant bears, perhaps on an ex post basis. Arrangements for the protection of minority interests are proposed at the Board level, rather than the Annual Meeting.

Board

It is suggested that most of the control of the company is exercised at the Board level.

It has been proposed that the Board should have relatively limited powers, confining itself to the fiduciary duties of Directors and similar matters. We do not accept this proposal, because we consider that it conflicts with our starting point, namely to consider Xoserve as a company delivering IT services to all gas industry participants, who should have a keen interest to ensure that it is properly managed and focused on matters of interest to the industry. We therefore envisage the Board providing overall direction and stewardship together with providing a constructive process of challenge to senior management.

In this model, the principal duty of the Board would be to ensure that Xoserve is capable of delivering the services that it is contracted or required to provide. In a company structure broadly as now, this entails:

- A clear understanding of the services provided together with a clear understanding of the IT systems and the associated processes that enable them to be delivered.
- Contracts with third party service providers that are specific in scope and enable the subset of services within the scope of each third party to be delivered within acceptable cost parameters.
- Procurement processes for such contracts that are efficient and which follow all legal requirements.
- Provision of other resources, especially staff, to deliver the services and where appropriate to undertake the processes that enable that delivery.
- Development of appropriate budgets, obtaining agreement to those budgets and managing resources within those agreed budgets.

Under a structure where Xoserve becomes largely a service procurer organisation, much the same list of requirements is apparent, although the emphasis would be more on contracting out and the issues associated with that rather than say running internal processes, as the latter would now be a matter for the service provider.

In either model the Board would also be responsible for taking critical decisions, such as those impacting reputational or financial risk, and for agreeing with the senior management the overall strategy of the company and the approach to key projects.

We consider that the above duties should apply to both the light and full cooperative models.

The following principles are proposed relating to Board governance:

- Appropriate constituencies should be formed and each constituency should be represented at Board level. We have proposed two, one for all Shippers the other for all Transporters however as discussed in Section 2.1 we propose that one of the GT Board member seats be reserved for NGGT.
- The Chief Executive and relevant senior managers of the common service provider should be Board members. It is for debate how many should be appointed, but we suggest that the focus should be on relevant skills and expertise to guide the Board on key deliberations in critical areas such as IT specifications and procurement and budgeting.
- The Board should have available relevant specialist advice. This could come from those elected by the constituencies or from senior management, but if not could arise either through the appointment of suitably qualified non-executives from outside the constituency population or through the appointment of appropriate consultants.
- The Board should have an independent Chair.

It would be difficult to apply these principles in full in the light cooperative model. In that model, we assume that Board arrangements would stay much as now, with some consideration given to Shipper views through the Shipper Advisory Group, which is discussed in the next sub-section. In addition, it would be possible to appoint additional Board members, from the senior management or from outside.

In the full cooperative model, the constituencies would elect Board members following a simple set of rules. It is suggested that the number of participant Board members be around six – this should provide a reasonable range of views but not create too large a body. If this was agreed, then the GT constituency and the Shipper constituency could each elect three members. The balance of membership would need to be reconsidered if the iGTs were to become UNC participants or a group of participants that were entitled to elect a Xoserve Board member. It is for further discussion how members would be elected; if for example the SPAA rules were followed, at least for the Shipper constituency, this would mean one Shipper one vote.

It is for debate how the Board assures itself of appropriate specialist advice. As noted earlier, this could be available from elected members or if relevant senior managers are appointed to the Board. We suggest that the initial Board chooses if it wishes to seek external advice as well, in which case it could choose to appoint additional independent Board members or instead retain external advisors on a case specific basis. It is suggested that the skills on which the Board will require advice should be those outside the mainstream activities of gas transportation and shipping. Initial analysis indicates that advice on IT matters generally, and IT procurement and specification of services in particular, is one area for independent or external expertise, and finance and accounting matters is another.

If the Board is composed as suggested above, then arrangements need to be considered in relation to tied votes. There are several ways of dealing with this:

- The Chair could have a vote to resolve any tie. This is a common arrangement in a variety of organisations.
- The status quo could prevail. This is not recommended for at least two reasons. First, there may be issues where the status quo is inappropriate, for example a split over who should succeed a retiring Chief Executive. Secondly, we consider it better that an issue is considered on its merits, rather than necessarily defaulting to the status quo.
- No special arrangements are put in place, to encourage the Board to deal with issues and seek compromises.

It is for debate as to the tenure of Board members. We do not think it appropriate that all tenures should expire at the same time, and consideration should be given to staggering initial appointments to ensure an ordered set of elections, with say, an average three years tenure. The alternative, which can be argued on cost of administration grounds, is for all tenures to expire at the same time. We think that this approach may pose risks of volatility in Board membership and strategy, which is why we favour a more measured approach.

If Board members are appointed for say three years, consideration also has to be given to whether or not it should be possible to remove a member before his or her tenure expires. The normal grounds for removal of a member, such as insolvency, would presumably apply, the more difficult issue is if performance should also be grounds for early departure. The problem is how performance is perceived; with such a provision, it may be possible to remove an effective member whose stance was at odds with some of his or her constituents, without it there is little or no sanction for poor performance. Overall, as we have proposed that members should represent constituencies, we suggest that it should be the right of each constituency to remove a Board member, providing a relatively high no confidence threshold was achieved.

Two additional issues that were raised by participants at the industry working and steering groups were Board member qualifications and remuneration.

With regards Board member qualifications, we consider this to be an issue that should largely be left to the industry and its constituencies to decide, although as the Board will be expected to provide strategic direction, and to exert control in the case of the full cooperative model, Board members drawn from industry constituency groups will clearly require some seniority. Given Xoserve's business – the supply of many of the core information system and data services required for the gas industry to operate – we would also expect Board members to have experience in areas of IT, gas industry regulation, procurement and finance.

Based on feedback from Ofgem, we understand that it would expect to prescribe broad arrangements for Board membership as part of its decision, following consultation, and potentially as part of the supporting licensing regime. An question for consultation therefore is the extent to which a person specification for Board member qualifications should be made a part of these prescribed arrangements.

We propose that remuneration for Board members should be adopted to ensure that a variety of industry participants are able to propose Board members, and that Board members' roles, as far as is practicable, are separated from their day to day role and positions within industry constituency groups and organisations.

Sub Committees

There is a choice between resolving all matters at Board level or instead creating sub committees to discuss and vote on specific matters, with the Board then being required to endorse the decisions of such sub-committees. We suggest that in general it would be preferable for the Board to exercise control and therefore do not recommend sub-committees with defined powers that could cut across those of the Board. We envisage two different sorts of sub-committees, however, associated with the different governance options that are emerging[4]:

- In the light cooperative model, we consider it essential for a group to be formed to act as a conduit for Shipper views; without such a group it might be difficult to argue that the model is cooperative even within a narrow definition of that term. We therefore suggest that a Shipper Advisory Board be established. This Board would focus on the delivery of services to the Shipper community. Whilst it could not vote budgets it could define the service lines that it requires, in response to which the Xoserve Board could develop a budget that amongst other things would contain resources for the delivery of those services.
- In the full governance model, the more inclusive arrangements should negate the need for an Advisory Board. There is still the option of forming one or more User Groups, however; these could provide advice to Xoserve on user experiences with the existing systems and suggestions for improvements.

It is possible for the remit of the User Groups to be extended beyond that typical in IT services, where such groups provide feedback on applications to the providers of those applications. For example, as well as providing feedback on services generally, such Groups could also set out what they wanted Xoserve to deliver over say one and three year periods and then comment on the draft budget produced by the company. If the remit is extended, however, we consider it important to

[4] Here we are concerned with sub-committees related to representation of a range of participant views. We assume that existing Xoserve Board sub-committees, such as those relating to finance and credit, will continue.

ensure that ultimate control still rests with the Board of the company and the precise powers of the User Groups will need careful definition.

Minority interests

There are a number of ways in which minority or particular interests can be safeguarded. The following are suggested for further consideration against specific issues:

- Requiring a 100% vote to be effective. This provision effectively means that any single party can veto a change. This is a potentially restrictive safeguard in a multiparty set of arrangements and it is suggested that it is only used in narrowly defined circumstances
- Requiring a vote of more than 50% to be effective. This is a less onerous provision than requiring a 100% majority. It is the basis by which a number of matters are currently controlled within Xoserve and those matters, and possibly others, could be subject to such a provision. For example, the separation of ownership and control could be protected by such voting rights, as noted earlier.
- Including safeguards in contracts. Rather than requiring special voting majorities, some matters could be included in contracts. Whilst this would mean that unanimity was required for any changes, that unanimity would be restricted to the matters contained in the contract. For example, given that NGGT owns the Gemini system, and has interests in the efficacy of that system that go beyond UNC matters, this may be an appropriate vehicle for those interests to be protected. For this provision to be effective, however, the relevant contracts should not be subject to the change procedures contained in the UNC.
- Appealing to Ofgem. There are a number of matters under the Code governance arrangements whereby parties can appeal to Ofgem. It would be appropriate to retain some sort of right of appeal in relation to Xoserve matters, but the areas under which an appeal could be made need to be limited, to avoid both frivolous or unimportant matters being appealed and also creating in effect Ofgem as the final decision maker in most matters.

It is for further discussion as to what sort of issues should be subject to the various protections outlined above.

2.7.1. Regulatory governance

Regulatory oversight of charging is described in the Charging and Funding annex (Anne C). In this subsection we consider what other regulatory controls are appropriate. Two in particular are considered:

- Step in powers.
- Oversight of budget approval process.

The arrangements set out in this section focus on self-governance. Xoserve is a central organisation providing services to all gas industry participants and generally those participants should manage its affairs in a way that is advantageous to customers. Any step in powers should therefore only be considered as an extreme measure, where for whatever reason the company is considered manifestly to have failed and also that its governance is unable to deal with that failure. Because any step-in provisions involve taking rights away from participants, it would appear that Ofgem is the only body to whom such powers should be available. If such powers are felt to be necessary, even if only as an ultimate backstop, then the circumstances and manner in which they may be exercised need to be defined.

Current regulatory controls on charges feed-back through to financing and control as they set limits for the amounts that can be recovered and hence incentivise control arrangements to minimise any risk that those amounts are insufficient. As noted in our earlier report, some participants also consider that the regulatory controls discourage Xoserve from fully serving Shipper interests.

The proposed new set of controls will allow budgeted Xoserve costs as a pass through item for GTs, with separate allocation of performance risks. If budgeted costs are a pass through, some form of regulatory oversight is appropriate to ensure that participants as a whole do not impose unnecessary costs on customers. One key element here is the approval of the annual budget, where it might be argued that Ofgem should have final approval powers, to ensure that the budget did not impose undue costs on customers. We would argue that such powers are inappropriate, both because it would re-impose a regulatory allowance approach and also because it could discourage the industry from taking tough budget decisions, instead passing the responsibility back to the regulator.

Instead we suggest that the annual budget should be accompanied by a report tracking cost changes over time and justifying the budget proposed. Ofgem would not have approval rights, but could comment on the budget if it wished, and could use its step in powers if it felt that the industry was not paying sufficient attention to customer interests. It may also be appropriate for some intermediate level of intervention short of actual step-in, for example it may be appropriate for Ofgem, should it wish, to set a cap on the increase of the Xoserve budget in a particular year.

These issues are considered further as part of the separate paper on funding arrangements and charging (Annex B).

2.8. Summary

In this section we have set out the building blocks for governance options under a cooperative model. In the section which follows we develop these into a set of overall bases or packages for governance under such new arrangements.

3. IDENTIFICATION AND ASSESSMENT OF CORPORATE GOVERNANCE OPTIONS

3.1. Identifying the main corporate governance options

Options were initially developed as "straw-men" in the November Steering group presentation. Based these and then supplemented by additional analysis and feedback, two principal corporate governance options have been identified and developed further:

- GTs retain ownership and control, but in a *light cooperative* model that has changes introduced to ensure that it does become 'cooperative'; and
- all participants have some form of control in a *full cooperative* model.

Table 3.1 (overleaf) summarises these two options and also compares them to the status quo, the current arrangements. Key points to note are as follows:

- The **Light Cooperative Model** involves minimal change to the current arrangements; that is, Xoserve continues to be owned and controlled by the GTs as currently. The Board might co-opt a non-executive Shipper member and a Shipper Advisory Board would be created to provide a forum for the Board to understand Shipper issues and concerns regarding the services that Xoserve provides.
- The **Full Cooperative Model** has two alternative approaches:
  - The **Full Cooperative Model, with GT Ownership**, would involve a *separation of ownership from control*, with the latter exercised primarily through a Board that had representatives from across the industry, drawn from two constituencies, Transporters and Shippers. The Board could choose to appoint additional members from the senior management of Xoserve and/or independent experts. The GTs would continue to own the company, essentially in a nominal manner, but would be insulated from risks to their equity, given that they did not have full control over the decisions of the Board.
  - In the **Full Cooperative Model, All Participant Ownership**, ownership of Xoserve would be distributed across the industry, with simple rules about shares and voting rights. As in the model under GT ownership, in this model the Board would again be drawn from the Transporter and Shipper constituencies, with the ability to include additional expertise.

A further *variant* to each of these models is to mandate Xoserve, or for the industry to create a new central entity, that would contract out the services that Xoserve currently provides with an arm's length service provider on whom most performance risks fall. Under this approach, applied to either the *full* or *light* cooperative models, the company structure would be a small service procurer organisation which contracts out all (or a majority of) the delivery of services to one or more third parties. As illustrated in Table 3.1, we have termed this the **Contracted Services Alternative.**

Table 3.1: Governance options

<table>
<tr><th rowspan="2">Element</th><th rowspan="2">Current arrangements</th><th rowspan="2">Light cooperative model</th><th colspan="2">Full cooperative model</th></tr>
<tr><th>GT ownership</th><th>All participants ownership</th></tr>
<tr><td>Structure</td><td colspan="4">One company</td></tr>
<tr><td>Ownership</td><td colspan="3">GTs</td><td>All participants</td></tr>
<tr><td>Control</td><td colspan="2">GTs</td><td colspan="2">All participants</td></tr>
<tr><td>Type of organisation</td><td colspan="3">Limited company</td><td>Limited company or CLG</td></tr>
<tr><td>Financing</td><td colspan="2">GTs</td><td colspan="2">All participants</td></tr>
<tr><td>Annual meeting</td><td colspan="2">No budget oversight (Board responsibility)</td><td colspan="2">All participants</td></tr>
<tr><td>Board composition</td><td>GTs only</td><td>GTs only (possible Shipper non-exec</td><td colspan="2">Board comprised of (say) 3GT and 3 Shipper members with option for senior staff and or specialists appointments as well</td></tr>
<tr><td>Performance risk allocation</td><td>GTs</td><td>GTs (but depends on cost pass through)</td><td colspan="2">All participants</td></tr>
<tr><td>Market risk allocation</td><td>Mainly GTs, some service users</td><td colspan="3">Service users</td></tr>
<tr><td>Profit / not for profit</td><td>Profit</td><td colspan="3">Not for profit, but with ability to earn surpluses not for distribution [1]</td></tr>
<tr><td>Other groups</td><td>None in terms of wider industry focus</td><td>Shipper Advisory Board</td><td colspan="2">One of more User Groups</td></tr>
<tr><td>Minority interests</td><td colspan="4">Specific protections (which might vary between models)</td></tr>
<tr><th></th><th colspan="4">Contracted Services Alternative</th></tr>
<tr><td>Structure</td><td>One company</td><td colspan="3">Two companies; Central entity contracts with (independent) service provider</td></tr>
</table>

Source: CEPA, TPA and ESP

Note 1: The company would not be established on the basis of earning profits on its activities to be distributed to shareholders, but would be permitted to budget to earn presumably modest surpluses to provide some sort of buffer for unanticipated events to reflect some of the risks of service delivery. If the Board chose, more substantial surpluses could be budgeted, for example, to build a fund to finance a forthcoming major project.

3.1.1. Shipper Advisory Board and User Groups

Under the Light Cooperative model there would be a Shipper Advisory Board. As described above its primary focus would be to determine the services that Shippers require from Xoserve.

In the case of the Full Cooperative model there would be one or more User Groups. Their primary focus would be to provide feedback on user experience of services provided and, as discussed as in the supporting paper on funding and charging arrangements (see Annex C) the User Groups may also have a role in identifying and progressing major projects.

3.1.2. Board membership

Table 3.2 below provides more detail on Board membership under each of the governance packages. The comments on the Contracted Services Alternative apply only to the central entity and not to the arm's length contracted service provider.

Table 3.2: Governance options – further details

Element	Current arrangements	Light cooperative model	Full cooperative model	
			GT ownership	All participants ownership
Board Members Industry	Based on current arrangements, with five industry members in total.		Based on constituencies, split 50:50 GTs and Shippers. Within these two groups (GTs & Shippers) equal voting rights except for any minority protections. Around 6 industry members in total. One GT seat reserved for NGGT.	
Board Members Management	None	Chief Executive Office and small number of senior managers with relevant technical skills and expertise appointed to Board. For further discussion whether on certain matters such members have voting rights.		
Board Members Additional	Independent Chair	Independent Chair. Board can decide whether to appoint additional Board members with specific skills, such as IT/Procurement and Finance/Budget and/or ability and budget to hire external experts as required		
Experience and remuneration	As currently		Would expect Board members to have previous Board experience and IT, regulation and procurement skills. Board member remuneration.	
	Contracted Services Alternative			
Differences	Central entity as above under each option. Service provider at arms length under contract, could be independent and its Board arrangements are not a matter for the industry.			

Source: CEPA, TPA and ESP

3.1.3. Performance risk allocation

A key design principle of any new arrangements is that obligations and performance risks need to be aligned with control.

Ofgem has noted that our proposals on funding arrangements, involving pass through of costs outside regulatory control, might not be appropriate in the case of the light model, due to a lack of cost oversight and scrutiny by Shippers. We largely support this view (see supporting paper on funding arrangements) and believe, therefore, that regulatory allowances are likely to need to be retained in some form under these arrangements. This would satisfy the principle that performance risk lies with the parties who control the service provider, but may mean that the light model is inconsistent with the objective for more flexible funding arrangements.

In the full cooperative model, while costs would be an allowed pass through, reputational incentives would be created through budgetary over runs and the proposal is that a licence condition should be imposed on those who control the central service provider to participate in the company and manage it in an "efficient and economic manner".

However, a problem with all of the above models is that performance risk, including the risk of catastrophic failure, lies with those that control Xoserve. Whilst cost pass through (in the case of the full cooperative mode) means that this risk is effectively passed on to customers, it may be that in the case of a serious failure such a pass through would not be permitted by Ofgem, to the extent that it could enforce such a decision.[5]

To avoid this risk (both for industry participants and final consumers), the Contracted Services Alternative would create a central entity that would contract out all the services that Xoserve currently provides, and within the terms of the contract ensure that the service provider bore performance risk. This is similar in principle to arrangements in other parts of the utilities sector including the MRA Service Company (MRASCo) in electricity and the Central Market Agency (CMA) for retail water and wastewater services in Scotland.[6]

3.2. Assessment

Based on the above analysis, Table 3.3 below discusses the proposed governance options in terms of the defined criteria.

[5] This would need to be facilitated through the "economic and efficient" licence condition.

[6] We review governance and funding arrangements for a sample of comparator organisations in a separate supporting paper (see Annex A).

Table 3.3: Analysis of governance options

Element	**Light cooperative model**	**Full cooperative model**	
		GT ownership	**All participants ownership**
Transparency	Board needs to define transparency requirements to ensure participant concerns are met. May need some minority interest provisions to ensure, for example, that Shipper concerns are addressed	Board needs to define transparency requirements to ensure participant concerns are met	
Inclusiveness	Shipper Advisory Board provides some ability for Shipper interests to be determined, but lack of participation in strategic direction and budget setting	Constituencies should ensure that all participants are involved	
Efficiency	Likely to be efficient through utilisation of existing arrangements. Possibility of GTs ensuring their concerns take priority	Slight risk of less efficiency, should be met by robust separation of ownership and control	Placing most powers in hand of Board should ensure efficiency, but only if Board members exert appropriate degree of monitoring and control and are able to reach consensus
Effectiveness	Potential tensions between proposals from Shipper Advisory Board and willingness of GTs to fund them, but should be reduced by charging proposals. Risk that GT interests take precedence.	Some tension due to performance risks that participants will be required to bear	
Cost mitigation	Should be appropriate, although need to strike careful balance between protecting minority interests against ability to block change		
Support competition	Should be robust, although possibility of minor variants between models		

Element	Light cooperative model	Full cooperative model	
		GT ownership	All participants ownership
Define services clearly	Generally should be acceptable, depending on where services are defined and who is responsible for definitions		
Provide appropriate quality	GTs and Shippers will separately define quality requirements. As noted above, potential for cost tension should be eased by charging arrangements	Inclusive nature of arrangements should ensure that quality requirements are identified and resolved	
Degree of change	Minimal	Some change, but no change of ownership	Significant change
Read across	Xoserve closest example	Elexon closest example	Elexon closest example

Element	Contracted Services Alterative (Key Differences only)
Efficiency and Effectiveness	Possibly most efficient and effective since responsibilities allocated to parties best placed to bear them
Define services clearly	Most robust, since clear service definition essential to contracting out model
Degree of Change	Involves profound change and as a result may trigger TUPE and pension liabilities
Read across	MRASCo, SPAA & CMA closest examples

Source: CEPA, TPA and ESP

Whilst it is debatable whether the light model is consistent either the Ofgem decision to progress Option C, the principal benefit of this approach is that by utilising the existing arrangements the degree of change is minimal with some associated change management benefits. It would, therefore, be simple to implement, an issue we consider further in Section 4 below.

From the perspectives of inclusiveness and effectiveness, the light model, in our view, falls considerably short of the full cooperative model. By requiring - in principle - the continuation of regulatory controls, this would support efficiency and cost mitigation but as noted above, may not provide the flexibility of funding and outputs considered necessary going forward. It would also not align at all well with our proposals to place Xoserve on a broader footing within the industry, because as a consequence of the regulatory controls faced by the GTs they would naturally require something approaching the current level of oversight and may not wish to incur additional costs demanded by Shippers if such costs might not be recovered in full.

In the full cooperative model, inclusiveness and transparency are created through all constituencies having a more empowered role within the corporate governance architecture. Efficiency and effectiveness would be dependent upon the company's Board members exerting the appropriate degree of monitoring and control. Effectiveness may also depend on how those who control the central service provider choose to manage performance risk.

The full cooperative model would involve relatively significant change compared to the light model, while the alternative sub-option would require profound change. Both models, however, should ensure that quality requirements are identified and resolved through more inclusive and transparent governance arrangements.

3.3. Summary

In this section we have brought together the governance building blocks outlined in Section 2 to develop two primary cooperative models, with variants that could apply to each of them or within each of the models. The Light Cooperative Model involves minimal change to the current arrangements, whereas the Full Cooperative Model would involve all industry participant control of the central service provider. In the case of the Full Cooperative Model, these arrangements can, in our view, be effected either through all industry participant ownership or a arrangement that retains GT ownership but ownership is separated from control.

4. Implementation and transitioning assessment

Having developed and considered each of the governance options from a building block and first principles perspective, this section now turns to practicable considerations, including the implementation challenges and transitioning issues involved with the different approaches. The aim of this analysis is not to analyse detailed implementation tasks from the perspectives of different stakeholders, but rather to identify whether there are any significant unmanageable issues associated with any of the corporate governance options set out, which would essentially amount to being a "show-stopper" for the option in question.

4.1. Transition issues

The table below sets out the principal transitioning issues that we have identified with each of the governance models. It indicates a significant difference in terms of ease of implementation between the Light Cooperative Model and the Full Cooperative, with GT Ownership Model, as compared to the other model variants. In the case of the Contracted Services Alternative, our assessment has focused on its application to the Full Cooperative Model, as the transitioning issues if applied to the Light Cooperative Model, would relate primarily to the extent of outsourcing compared to existing arrangements[7] and, therefore, staff employment issues.

Table 4.1: Transitioning issues

<table>
<tr><th rowspan="2">Light model</th><th colspan="2">Full cooperative model</th></tr>
<tr><th>GT ownership</th><th>All participant ownership</th></tr>
<tr><td>▪ Very few</td><td>▪ Change of Articles of Association to enshrine new rights of non-owners and limit exposure of owners
▪ Potential changes to the Joint Governance Arrangements Agreement (JGAA)</td><td>▪ Probable change of Articles of Association and creation of Shareholders Agreement (Ltd Co)
▪ CLG documentation (CLG)
▪ Consideration of whether or not any compensation to be paid to current owners
▪ Staff concerns over issues such as pension rights
▪ More fundamental issues, such as pension rights and who owns what IP, if CLG option</td></tr>
<tr><th colspan="3">Contracted Services Alternative (if applied as part of the Full Cooperative model)</th></tr>
<tr><td colspan="3">▪ As Full Cooperative Model, All Participants Ownership, plus:
o Compensation and issues of where IP and other key ownerships lie
o TUPE and associated employment issues
o Risk of crystallisation of pension rights
o Separation of functions and definition of terms of service contract</td></tr>
</table>

Source: CEPA, TPA and ESP

[7] We note that Xoserve currently outsources around two thirds of its cost base.

Looking first at the Light Cooperative Model and the Full Cooperative, GT Ownership Model, in relation to transition:

- The structure would not change. The services provided by the central service provider would continue to be provided by one company.
- The type of organisation would not change, the existing company limited by shares would continue.
- Ownership would not change, and would continue by the GTs in the same shareholding proportions as now.
- Control would either remain much as it is (Light Cooperative Model) or would change to encompass all participants (Full Cooperative, GT Ownership Model). There are various mechanisms to achieve this change, for example amending the company's Articles of Association to enshrine the right of Shippers to appoint a specified number of Board members and to require a consensus, or at least a large majority, of Shippers and GTs, the latter as shareholders, to change those rights. Whatever mechanism was introduced to effect the separation of ownership and control would require the consent of the current owners.
- By changing the funding and charging model to allow full pass through of costs, however, the principal risk of the separation of ownership and control, namely that non-owners through decisions taken at the Board impose risks on shareholders, is removed. If the mechanism is relatively simple, such as that proposed above, then it would be possible, subject to the consent of the current owners and licence condition (revenue restriction) changes, to introduce the relevant changes by April 2014.
- In the Light Cooperative Model, there would be little change at Board level, although there is the possibility of including a Shipper non-executive member. In the Full Cooperative, GT Ownership model, to give effect to the separation of ownership and control, the Board would be the principal focus for control and would include Shipper representatives. We envisage a Board of around 10 or so persons, including six industry representatives, drawn equally from the Shipper and GT communities, together with a small number of senior managers from Xoserve providing relevant expertise in Board discussions, and perhaps additional independent expert Directors. We suggest that the industry members of the Board are appointed first, and the nascent Board can then determine what additional expertise from the company and perhaps externally is required. The appointment of the industry members should be through the relevant constituencies – the processes may differ between the Transporters and the Shippers, and we suggest that each constituency first agree how it wishes to appoint Board members and then effect such appointments. If the industry begins detailed work on the relevant appointment process, we consider it feasible to complete that work and have the new Board in place by April 2014, and perhaps earlier.
- In the Light Cooperative Model, there would be little change to financing arrangements. In the Full Cooperative, GT Ownership Model, financing is suggested to be a mixture of

elements, such as bank loans guaranteed by participants, individual funds for major projects and/or service providers absorbing development costs and then amortising them through service charges over the life of the asset. These arrangements may take time to implement and we suggest this form part of the initial scope of an industry implementation group, as discussed in the main report.

- Ofgem has decided to roll forward the current Xoserve funding arrangements into 2013/14 (the initial year of the RIIO submission) with any new arrangements. This regulatory allowance for 2013/14 includes that year's funding for key investment programmes such as Project Nexus and the UK Link Programme. This provides comfort to the industry that budget considerations should not become problematic in 2013/14. Nevertheless, to the extent possible, we suggest that the industry should be involved in the budget setting process and we consider how the first year budget could approached in greater detail in the supporting paper on funding and charging arrangements (see Annex B). For 2014/15, we would propose that the industry create shadow arrangements, as part of an industry transitioning / implementation group, to build the budget as proposed, and to use approval procedures, perhaps in shadow form, to approve the budget.

- Performance risk allocation should not be an issue for 2013/14, as this risk would continue to lie with the GTs, and it would be reasonable to assume that they would continue to protect against such risk much as now.

- We suggest that the industry establish three User Groups, namely Gas Transmission, Gas Distribution and Shippers. In the first year, these groups would not have any formal powers, but would be constituted to provide feedback to Xoserve in relation to services and could also act as the focal point for major projects. We discuss Nexus separately in more detail later, but it could become a key matter for the Shipper User Group.

Looking at the Full Cooperative, All Participants Ownership Model, and the Contracted Services Alternative, it is apparent that a number of issues in addition to those discussed above would need to be resolved in order to achieve full implementation. In particular:

- Ownership would change from current arrangements and agreement would need to be reached with the existing owners over what if any compensation was payable.

- All parties would be required to become shareholders in Xoserve, if the Limited company structure was retained, or instead would be required to become members of a new CLG if that were established instead.

- More fundamental changes to relevant documentation would be required, either to amend the Articles of Association and also create a new Shareholders Agreement if the Limited Company is retained, or to create the documentation to establish a CLG.

- Under both options there would be staff concerns to address over pension rights, and in the case of the CLG it is likely that pension liabilities would be triggered by the change of ownership (further legal advice would be needed here) which could add significantly to short term costs

- A further issue related to the CLG would be to resolve who owned what IP and other assets.

Given enough time and the careful creation of transitional structures, it should, however, prove possible to resolve all these issues.

We consider some of the specific issues identified above in the subsections which follow. In Appendix C we have also used a common framework to summarise how each of the governance building blocks might change under the different models.

4.1.1. Compensation for any changes in Xoserve ownership

Issues associated with any change of Xoserve ownership are discussed in the following section. First, we consider the value of Xoserve and how that value should be reflected in any change in ownership.

Xoserve does own valuable Intellectual Property (IP) in the majority of the systems that it operates, with the exception of Gemini, and also owns most of the hardware on which the systems run. Our understanding of the financing of Xoserve at a high level is that the GTs provide finance for the development of major new systems, and that finance is recognised as appropriate for inclusion in their Regulated Asset Bases (RABs) on which they earn a return on and of capital. If this understanding is correct, then we would argue that there is relatively little value in Xoserve in a strict accounting sense per se, the value being already held by the GTs, and that therefore compensation for any change of ownership should be minimal. This argument, however, rests on the proposition that the existing amounts relating to Xoserve within the RABs of the GTs should remain in place; if the GTs were required to remove such amounts from their RABs, then it would be appropriate to compensate them for that.

In a broader sense than balance sheet amounts, Xoserve contains value for all industry participants, through the skills and expertise of its staff, the processes that they operate and the roles that they fulfil in the industry. That value should be retained through whatever changes are proposed to move to a cooperative model. Whilst arguments can be put forward that the creation of this value by the GTs should result in compensation should ownership change, we would counter that the GTs have already been compensated and that it would be inappropriate to provide further compensation for their stewardship of a monopoly body whose costs are included within transportation charges.

4.1.2. Ownership transition

Ownership transition issues differ between the governance options that have been identified:

- Light Cooperative. Formally ownership would not change in this model.
- Full Cooperative, GT Ownership. Formally ownership would not change in this model. The GTs would need to be comfortable with the arrangements for the separation of ownership

from control and as noted earlier the removal of performance risk should be an important guarantee that the new Board will not place the owners in a position of financial exposure.

- Full Cooperative, All Participants Ownership. There are two variants in this model. In the first, the corporate entity remains as today and to effect a change of ownership, either new shares would have to be created or the existing owners would have to sell or transfer some of their shares to other participants. Assuming that agreement could be reached with the current owners over such a change, further detailed advice would be required on the tax and other consequences of the various ways in which that change could be effected. In addition, such a change would require all participants to acquire one or more shares in Xoserve, which may cause issues for some. In the other variant of this model a new company, presumably a CLG, would be created. This would have members instead of shareholders, which might make it easier for some existing participants to take part. The creation of the CLG would raise complex issues of who owns what, however; either it would have to contract with some sort of shell of the existing Xoserve, which still owned IP and other assets and licensed their use to the CLG, or the ownership would have to be transferred, which might create tax and other liabilities. Pension and TUPE issues, discussed later, would also arise.

- Full Cooperative, Contracted Services Alternative. In this model a new CLG is created and this contracts with an arm's length entity for the provision of services. This would involve splitting Xoserve between these two new entities. The underlying nature of the arrangements would probably require the existing assets of Xoserve to transfer to the CLG, and for the outsourced, arm's length part of Xoserve then to operate them under licence as part of its commercial arrangements with the CLG. Those staff that stayed with 'outsourced' part of Xoserve would have their existing employment and pension rights protected, although it is possible that the separation and focusing of performance risk might encourage the owners to seek a sale to a more suitably qualified third party. Those staff that transferred to the new CLG would have to be offered similar employment terms as we assume that TUPE will apply. Overall, this option will be complex to deliver and whilst we see it as a longer term aim should the industry wish to partition itself from performance risk, it is unlikely to be feasible in the shorter term.

Under all models the rights of the current owners have to be respected. Whilst we have not taken detailed legal advice on the point, we have not identified specific powers to enable Ofgem to force ownership changes on Xoserve. It would be a matter for the owners to discuss with the regulator, given that there are advantages to them as well as to Shippers were moves to more cooperative models undertaken.

4.1.3. Contractual arrangements

Contractual arrangements are discussed as part of the specific supporting paper on regulatory and legal frameworks (see Annex E). The conclusion we make in that paper is that various options are available for how changes in governance arrangements might be enforced through changes in the legal framework and contracting arrangements.

A key issue is which party should be identified as the party that is responsible for delivering the services that Xoserve provides.

One approach is that this should be the central service provider going forward (given the proposed change of paradigm) - there are, however, risks, and potentially implementation challenges, with such an approach and alternative (potentially simpler) approaches may be available.

Clearly changes to contractual arrangements would be more pervasive under the full cooperative and contracted services alternative adding to the cost and complexity of transition. These issues will be resolved in Phase 2 of the project.

4.1.4. Staff matters

We have been told that Xoserve staff are concerned over future arrangements and that there is a risk of an exodus, should the current, in particular, ownership, arrangements change. We accept that this risk is apparent, but note the following:

- In the case of the Light Cooperative Model and the Full Cooperative, GT Ownership Model, there is no formal transfer of ownership.
- Many participants in the industry have been through changes of ownership, and providing that appropriate assurances are given to staff, the active supervision and control of any potential exodus should be something that senior management should address.

In practice, we appreciate that concerns will also exist over changes in funding and change in Board composition which may have a possible impact on internal staffing and organisational arrangements. However, we consider there to be a number of practical measures that can be adopted by the industry to help alleviate staff concerns:

- As discussed in the main report, early creation of an industry implementation group involving Xoserve staff.
- Early creation of shadow Board which can determine what responses should be made to staff concerns.

Following transition an early statement by the new Board, once constituted, as to its intentions and the implications for staff would be helpful.

4.1.5. TUPE issues

If there is no change of ownership, as in the Light Cooperative and Full Cooperative, GT Ownership Model, TUPE issues are unlikely to arise. We do not consider that they would arise in the Full Cooperative, All Participants Model, as the same company would be employing the same staff under the same terms.

TUPE would arise under the Contracted Services Alternative and if the All Participants model involved a switch to a CLG. Providing that terms and conditions of employment were not altered, however, we do not consider that significant costs would arise from the application of TUPE, particularly as we assume that the new company or companies would want to retain experienced staff.

4.1.6. Pension matters

Pension matters vary considerably between options. In those models where the existing structure is retained, existing advice is that the current pension position would not change and that therefore provisions for pensions should continue unaltered.

If there is a change of employment, however, as would arise if a CLG is created or if some Xoserve staff members are employed by a different organisation, then pension liabilities might crystallise and potentially significant transition costs might arise. This issue may be mitigated over time, depending on the position in the relevant pension fund, and expert advice would be needed to understand the relevant costs associated with the relevant options.

4.2. Timeline for transition

Transition to any new arrangements will take time, more so if there is an evolution that encompasses limited change to begin with and more substantial change later.

It is in our view for the industry to determine an appropriate pace of change once agreement has been reached on the initial model. In terms of transition, therefore, we will look primarily at moving to whatever model is first adopted.

Transition will be encompassed within a timeline that Ofgem has already set out at a high level. Broadly, it is anticipated that any necessary licence modifications to effect change will be in place by October 2013. A period thereafter would be required to introduce consequential changes, for example to the UNC, new contractual arrangements and perhaps Xoserve's Articles of Association. The likely delivery point for the four options then varies:

- The Light Cooperative model, although in our opinion not necessarily consistent with Ofgem's decision letter regarding Option C, nevertheless has the potential to be implemented by April 2014.
- The Full Cooperative, with GT Ownership model, where ownership is divorced from control could in our view be implemented by April 2014. This model has the flexibility to be moved onto one of the other models at a later date should the industry agree to do this.
- The Full Cooperative, with All Participants Ownership Model, and the Contracted Services Alternative (if applied as part of Full Cooperative model arrangements) cannot, in our view, be implemented before say April 2015 at the earliest and possibly later (see discussion on transition issues above).

It is for debate whether an agreement to defer implementation for at least two years, until an ordered transition to the Full Cooperative, with All Participants Ownership, or the Contracted Services Alternative is possible, is consistent with the Ofgem decision letter.

A model that seeks to divorce ownership from control (at least from a transitioning perspective) therefore has its attractions. The above analysis indicates that if the changes that we propose, particularly those under what we term the full cooperative model with GT ownership, ought to be capable of implementation by April 2014.

We suggest that the industry, working in collaboration over our proposals and the outcome of Ofgem's consultation, could begin shadow arrangements much earlier, to give participants the opportunity to become more involved prior to the formal changes that are required. Such arrangements are discussed in our main report.

4.3. Impact on specific major projects

If the transition to new arrangements is made, major projects will clearly be impacted. In Appendix C we have considered two such projects, Nexus and EU driven changes to Gemini, discussing their further progress under existing and proposed new arrangements.

These projects are selected as both have relatively pressing deadlines that may be impacted by changes to the governance of Xoserve; a number of other projects that are less pressing are considered separately in a later section.

The comparison of options against the *status quo* in relation to major project risk depends in large part on which option is adopted. As noted earlier, we suggest that the Full Cooperative Model with GT ownership appears to be appropriate for implementation by April 2014.

There are a number of reasons why we consider our proposals are likely to offer a better risk profile in relation to major projects, including:

- The creation of more inclusive governance arrangements that should provide a better channel for participant interests to be reflected.
- The provision of a change management budget that will provide appropriate resources to enable full impact assessments to be undertaken.
- The ability of all participants to consider budgets that include amounts relating both to change management and to major projects.

4.4. Costs of transition

As with the transfer of ownership, the costs of transition vary between governance models and the principal categories of cost. For simplicity, we assume that there would be relatively limited costs involved in the Light Cooperative model, and assess below only the costs of the other options. It is difficult at this stage to put forward detailed costings, so we present our initial thinking for consultation with the industry. This analysis is summarised in Table 4.2 overleaf.

Table 4.2: Transition cost assessment

Cost	Full Cooperative		
	GT Ownership	**All Participants Ownership**	**Contracted Services Alternative**
Structural	Requires changes to Articles of Association and potentially the existing JGAA, probably less than {£0.1m] at the centre	Requires changes to Articles of Association, potentially JGAA and issue or transfer of shares, probably less than [£0.2m] at the centre	Requires creation of new CLG and separation of staff and assets between that company and existing Xoserve. Legal costs for creation and separation perhaps [£0.5m] at the centre
Compensation	Little or no compensation as ownership does not change and risk is diminished	Potential for compensation due to change of ownership, but if RABs are left unchallenged should be minimal	Complex as separation of Xoserve and some assets will transfer to CLG. Again, however, if RAB left unchallenged should be minimal
Contractual Arrangements	Depends upon model chosen. At one end of the spectrum, this may need some consequential licence and UNC changes and development of new Shipper ASA; costs likely to be significant, but probably less than [£0.5m] at centre. At the other end of the end of spectrum, much more significant changes to UNC, may cost towards [£1m] at centre.		As other options, plus addition of costs to specify services and create one or more new contracts between CLG and Xoserve. Additional costs likely to range above [£0.5m]
Staff	Some risk of staff exodus, but limited by no change of ownership. Some recruitment costs, if well managed may not be much more than normal turnover costs	Similar to GT ownership, but possibility of higher rate of staff loss. Again if well managed, may be able to contain costs but recruitment budget likely to be higher	Possibly significant costs involved in separation into two entities due to TUPE and more importantly crystallisation of pension rights. Costs not known at this point, likely to run into several £m
Change of Governance	Creation of new Board and establishment of annual meeting to review budget will impose costs on participants, probably limited opex at centre, no more than [£0.1m]		
Project Management	Depends on whether or not external advisors are appointed, as opposed to say an industry working group. If external, possibly maximum of [£0.5m]	Scale of change would probably require external consultants, with a cost of say [£1m]	Significant project management costs, given complexity of issues to be addressed. Costs likely to be in order of [£2m]

Source: CEPA, TPA and ESP

Table 4.3 summarises the tentative costs presented above.

Table 4.3: Summary of transitioning cost assessment – Full Cooperative Model (£m)

Cost	Full Cooperative		
	GT Ownership	**All Participants Ownership**	**Contracted Services Alternative**
Structural	0.1	0.2	0.5
Compensation	?0	?0	?0
Contractual	0.5 – 1.0	0.5 – 1.0	1.0 – 1.5
Staff	?0	?0	Several £m
Governance	0.1	0.1	0.1
Project Mgt	0.5	1.0	2.0
TOTAL	**1.2 – 1.7**	**1.8 – 2.3**	**2.6 – 4.1 + pensions**

Source: CEPA, TPA and ESP

In summary, if the above analysis is correct, with some rounding the direct costs at the centre to introduce a Full Cooperative Model, with retained GT Ownership, are likely to be in the range of £1.25m to £1.75m, largely driven by differing levels of legal costs, related to potential changes to the ASA and / or UNC. The costs of a Full Cooperative Model, with All Participants Ownership, would be greater, perhaps around £2m. The Alternative Sub Option would cost in the region of £2.5m to £4m, excluding pension liabilities; the latter could be substantial.

As noted above, the above costings are extremely tentative at this stage and we would welcome comment on them, particularly on differences between options.

4.5. Xoserve's ability to handle fundamental change

A number of participants have commented that a change to current arrangements at the present time would be disruptive given the substantial changes that are faced by the industry; for example, the progression of Nexus, the introduction of EU driven changes, primarily at the transmission level, and the changes that will arise from the role of the DCC. We agree that these changes are significant and that Xoserve has an important part to play in them. We consider that, properly implemented, our proposals could improve the position of Xoserve to play that part. In particular, we consider that the current financial arrangements discourage Xoserve from leading industry discussion, rather than supporting it, because of the nature of the cost controls that are currently imposed. In our view, having both a change management budget and pass through of costs should encourage Xoserve to take a more proactive role in the key developments that the industry is facing. In addition, having a Board with a broader range of membership should allow the industry to set out in greater detail what it expects from Xoserve and provide it with the resources to deliver those expectations.

Set against these considerations is the potential degree of change and in our view the GT Ownership model minimises the amount of change, at least in the short to medium term, and enables a relatively swift progression to the new arrangements. The pursuit of other models is more complex, at least in the short term, and may be more difficult to achieve when considered against other change programmes.

5. OTHER ISSUES

This section considers some specific issues that the industry working groups has asked us to consider with regards different governance models in our final report. We consider in turn:

- allocation of liabilities;
- protection of GT invoicing;
- effect on creditors;
- delivering a significant code review;
- changes to Gemini that are NGGT driven;
- changes to Gemini that are not NGGT driven;
- introduction of the DCC;
- introduction of iGTs; and
- further evolution.

5.1. Allocation of liabilities

Section 19 of Part 6 of the ASA (Liability, Exit and Accession) states that the Service Provider (Xoserve) shall have no liability to it or any party for any loss, damage or harm sustained or incurred by the Network Operator as a result of any failure whatsoever of the Service Provider to provide the services to the service standards or the performance indicators.

This means that under the current arrangements any financial liabilities arising from the failure effectively to meet any UNC standards or service falls onto the GTs with little or no recourse. This risk is managed currently by GT ownership and stewardship of Xoserve. Under more cooperative arrangements risks should be aligned between participants. This implies that future ASAs or whatever contracts exist between Xoserve and the parties to whom it provides services should either:

- limit all liabilities as at present, in which case each participant bears all risk of Xoserve failure; or
- include terms that require Xoserve to be liable.

The argument in favour of the current approach is that placing liabilities on Xoserve, if this is a company whose risks are shared by all participants, is relatively meaningless as any penalties would be borne by those receiving them. This may or may not be correct in individual cases; it may be possible, for example, to identify circumstances where one or more parties suffers losses out of proportion to their share of the funding of such losses.

We suggest that the industry should determine how it wishes to treat this issue of liabilities, particularly how the costs of any catastrophic failure that affected participants differentially would be managed. Whichever approach is chosen, the fact that such risks exist and may be borne by participants is a sharp incentive to ensure that the central service provider is well managed at Board level.

5.2. Protection of GT invoicing

From a GT perspective, the most important service delivered by Xoserve is the production of invoices. Ensuring the quality of the invoice production process, within a context of dilution of corporate control, is a key concern. At present the GTs have ASAs that set out, amongst other things, service standards relating to the production of invoices.

Going forward, we suggest that relevant terms of such ASAs remain in place and, to the extent possible, some form of traffic light monitoring (if not already in place) is introduced, for example highlighting any failure, however slight, to meet appropriate standards. The GTs may also want other safeguards, for example:

- Any modification proposal that might impact on invoice production would need to identify that fact and the impact assessment should include adequate resources for activities such as testing.
- Any proposal for a change of platform that might impact invoice production being similarly treated.
- The annual budget setting out clearly the service lines associated with the production of invoices and the costs of delivering such services.

We suggest that a combination of contractual terms, together with appropriate contract oversight arrangements and the 'backstop' of GT representation on the Board of Xoserve, should give sufficient comfort here.

5.3. Creditors

An issue that was raised at a working group meeting on implementation was the effect on creditors with changes in corporate governance and funding arrangements. Provided robust contractual, financing and funding arrangements are put in place in the case of the Full Cooperative Model, we consider that the impact on creditors from the new arrangements is likely to minimal to none. However, we appreciate this is an issue that requires effective management during transition and, therefore, propose that it is made one of the issues to be managed through the proposed industry implementation group outlined in the main report.

5.4. Delivering a Significant Code Review

We consider that our proposals enable both the industry and the central service provider to handle Significant Code Reviews (SCRs) more effectively than under current arrangements. In particular, the provision of a change management budget allows the relevant costs of a SCR to be accommodated, if known in advance, and the incentive not to approve relevant resources, inherent in a price control formula, is removed.

If the SCR occurs in year and the change management budget did not contain appropriate resources, then as suggested in Appendix 2 an in-year pass through, treated in the same way as the correction factor in a regulated price control, would again provide sufficient resources to enable the review to be undertaken properly.

5.5. Changes to Gemini that are NGGT driven

Changes to Gemini that arise from the UNC modification process would be managed in the normal manner and we discussed the relevant protections for NGGT in those circumstances in Section 2.3.1, when considering EU driven change.

NGGT may wish to propose changes to Gemini that are outside of UNC governance, for example a technical change relating to software or hardware, or changes to those elements of Gemini that do not fall within the UNC. As the owner of the software NGGT is potentially free to choose either Xoserve or an appropriate third party to undertake the relevant changes. There are two separate elements to these changes:

- To the extent that Xoserve were commissioned to undertake the changes, an agreement with appropriate terms would need to be reached, covering matters such as what costs incurred by Xoserve were reimbursed by NGGT, timescales, testing and acceptance procedures. NGGT would then determine separately how such costs would be recovered.
- To the extent that any changes had an impact on service lines that Xoserve offered to participants other than NGGT, an assessment would need to be undertaken to understand that impact and how it would be managed. Rules would need to be developed, if not already in place, on how to deal with issues such as costs incurred by Xoserve on behalf of third parties other than NGGT.

In either case, the fact that the central service provider has a specific change management budget should facilitate the provision of relevant resources as required.

5.6. Changes to Gemini that are not NGGT driven

It is possible that proposed changes to Gemini could arise from sources other than NGGT. Two examples might be:

- Changes elsewhere in the suite of systems that Xoserve operates that required consequential changes to Gemini.

- A decision to re-platform all or most of the Xoserve systems and in which the most cost effective technical solution is to re-platform Gemini as well, or at the very least change some of the communications between it and other systems.

In these and in other cases, changes that arise from the modifications process should be dealt with as an integral part of that process and, as noted earlier, the creation of a change management budget should enable sufficient resources to be made available.

If changes arise outside of the UNC modifications process, then their implementation would have to recognise NGGT ownership of Gemini. We have already suggested that a contract should exist between NGGT and Xoserve regarding Gemini, and that contract should contain appropriate terms.

For example, we suggest that NGGT should be required to cooperate with any externally driven changes to Gemini, providing that its reasonable costs of cooperation, which would include things like commissioning changes and leading or supervising testing and acceptance activities, were met by participants. The development process itself would need to make provision for things such as the updating of relevant system documentation and any consequential changes to interface arrangements.

5.7. Introduction of the DCC

Whilst policy decisions regarding the DCC and the Smart Energy Code (SEC) have been taken, much detail remains to be determined. At this point we will make the following assumptions about aspects of the DCC that will have a significant impact on Xoserve:

- The DCC and the SEC will be set out in more detail over the next two years or so.
- The DCC will have responsibility for Supply Point Administration.
- The DCC is likely to contract out the provision of SPA services to third parties.
- Open questions remain over issues such as the impact of the DCC on Shippers as opposed to Suppliers.
- Whether or not service provision remains in Xoserve, it will need access to relevant SPA data for purposes other than SPA.

Taken together, these assumptions imply one of two broad outcomes:

- Significant change to Xoserve following the DCC contracting with a third party to provide SPA services to the gas industry.
- Much more limited system change with service provision remaining as now, but instead new contracts between Xoserve and the DCC regarding such services.

In either case there are likely to be changes to the UNC, but we assume that these will be handled through existing or special modification processes. As in other scenarios, the ability for the central service provider to provide resources to undertake impact assessments, and possibly other services associated with change management, is likely to improve the industry's ability to respond to such changes.

Within Xoserve itself, the two broad outcomes imply very different changes in terms of service provision, communications between systems and the form and nature of service contracts. We suggest that our proposals enable the industry to tackle these changes in a more considered manner than under current arrangements, in particular:

- The broader governance arrangements enable Shippers, who face significant change as a result of the introduction of the DCC, to be directly involved in considerations of such change.
- The pass through charging arrangements remove a significant degree of risk that would otherwise be imposed on the GTs in relation to changes that were of more substantial interest to Shippers.

There are other issues that may need to be addressed, for example if Shipper SPA services were provided by a third party other than Xoserve, they may not wish to have a prominent role in its governance. This is an issue of further evolution, on which we comment later.

5.8. Introduction of iGTs

IGTs currently lie outside the arrangements that have been discussed in this and other papers. Going forward there are proposals for them to become a more unified part of gas transportation arrangements, rather than operating similar but slightly different models for things such as charging. There are at least two ways that Xoserve could provide services to this community:

- Individual contracts for services, in a standard form, could be used to stipulate a common basis for services and the charges between iGTs and Shippers. Those contracts would effectively be a form of User Pays, except that these Users would not be parties to the UNC.
- IGTs could become UNC parties, either with separate schedules that defined their obligations and services, and/or adherence to relevant standard sections.

If individually contracting, then our proposals do not hinder the development of such contracts. They would be submitted to the Board on an 'in principle' basis, and the Board would need to be satisfied either that the costs charged to the iGTs did not involve cross subsidy, or if that was inherent in order to obtain the advantages of more common arrangements, that all relevant costs were recovered in one way or another.

Introducing the iGTs as UNC parties raises more general questions of governance. There are several ways that iGTs could be accommodated within our proposals, particularly with regard to Board representation, for example:

- The GT constituency could be expanded to include the iGTs.

- The GT constituency could be split into three equal parts: NGGT; GDNs; and iGTs, each being permitted to appoint one Board member.
- A new iGT constituency could be created, although in that case further consideration would have to be given regarding an increase in the number of Shipper seats to four.

Other arrangements are also possible, for example the iGTs could be permitted to send one representative to attend Board meetings, who could speak but not vote, although if the iGTs are paying Xoserve for services it does not seem logical to make them essentially second class citizens.

We consider that relevant governance changes to the Board of Xoserve resulting from any introduction of iGTs should be a matter for the industry to determine. There would need to be backstop arrangements if agreement cannot be reached, however, and these are discussed below under further evolution.

5.9. Further evolution

There are at least two areas where further evolution of the governance arrangements may be required, namely the establishment of the DCC and the introduction of iGTs. Whilst we have identified possible outcomes in both cases, it will be up to the industry to determine how best to tackle these issues based upon the particular details at the time. The same broad conclusion applies to any other external changes that affect governance.

To ensure that the arrangements have the capability to evolve requires striking a balance between:

- Hardwiring the arrangements so that they cannot easily be changed.
- Permitting sufficient flexibility so that they can be changed where necessary.

A second balance must be struck between the protection of minority interests and avoiding the ability of individual parties to veto change.

Bringing these two together, we suggest that there should be provision for proposals to change the Articles of Association of Xoserve, where we have suggested that the rights of non-shareholders be enshrined, but that there should be limits on that provision to ensure that it is not used to pursue sectional interests or concerns of disaffected parties. The following framework could be used for this purpose:

- Ofgem having a power of direction for changes in the Articles for the express purpose of dealing with governance issues.
- Any participant being able to propose a change to specified clauses in the Articles dealing with governance. Proposals would have to have a formal basis, for example that they better enabled relevant objectives to be achieved than the then current clauses. Such proposals would only be carried forward if a majority of the representative members of the Board agreed.

- If the Board did agree, the proposals would be put to votes within the Transporter and Shipper constituencies.
    - If 75% majorities of each constituency, voting separately by number and by proportion of Xoserve costs met in the previous financial year, were achieved, the Articles would be changed.
    - If 75% majorities were obtained in at least two of the four constituencies, the proposals would be put to Ofgem which could, if it chose, exercise its power of direction to enforce the change
- If the threshold of 75% majorities were not obtained in at least two constituencies, the proposals would be dropped.

The parameters in the above framework could be varied prior to their introduction if participants agreed, for example, the size of the thresholds and how many different votes were required.

We accept that this framework is cumbersome, but we consider that it needs to be. The industry presumably wants stability in the central service provider and it should not wish to see a readily simple process to amend something as important as the Articles of Association of that service provider.

An alternative approach would be to include the Articles of Association as a Schedule to the UNC, and thus apply the UNC modification process to them regarding any proposed changes. We do not think that this is an appropriate route, however, as unless a different process was applied that contained elements of our proposed framework, there is the risk of repeated interventions and modification proposals that would not be appropriate for the Articles.

5.10. Summary

A number of implementation, transition and other issues have been identified. We do not consider that any of these are insurmountable, although some of them would argue against the Full Cooperative, with All Participant Ownership Model, or the Contracted Services Alternative being introduced in the short to medium term.

In our view, if a cooperative model is to be introduced, this could be done by April 2014 if the Full Cooperative, with GT Ownership Model, is chosen, providing that appropriate steps are taken soon to begin the implementation programme. This date is also feasible for what we have termed the Light Cooperative Model.

6. CONCLUSIONS

This supporting annex has set out options for future cooperative corporate governance arrangements. It has set out a number of issues and building blocks for consideration and then possible bases or 'packages' of governance arrangements which we have then gone on to test against our assessment criteria. For each of the models, we have then identified and provided a high-level assessment of the implementation and transitioning issues.

Overall we find it hard to reconcile what we have termed the 'light' cooperative arrangements to be consistent with Ofgem's decision to progress Option C. The principal benefit of this approach would seem to be that it utilises the existing arrangements and we are sceptical as to whether it has the capacity to deliver against industry requirements, in terms of greater transparency, funding flexibility and responsiveness to change, particularly as regulatory funding allowances are likely to need to continue under this approach.

In contrast the full cooperative model (and its various sub-options) we find to be wholly consistent with the vision and objectives for cooperative governance arrangements as set out in Ofgem's decision, at least from a first principles perspectives.

There are, however, significant and in some cases profound implementation and transitioning issues associated with the full cooperative models, particularly with regards the Full Cooperative, All Participants Model, and what we have termed the Contracted Services Alternative.

We therefore recommend that attention in the short term should focus on the Full Cooperative, GT Ownership Model. If the industry considers it appropriate to move further towards one of the other models at a later stage, then an appropriate review point can be established as part of the new arrangements, and initial consideration of how to mitigate the above issues can be undertaken. Issues such as allocation of performance risk are likely to influence such decisions.

APPENDIX A: SEPARATION OF OWNERSHIP AND CONTROL

A.1. Introduction

We have developed two principal bases for cooperative governance options for the central service provider going forward.

Whilst a number of industry participants initially indicated to us that they felt that ownership and control should be precisely aligned, it is apparent that the Governance Working Group took a different stance and generally considered that the two can be separated.

Under what we have termed the "full" cooperative model, we therefore proposed a sub-option that would involve notional ownership of the service provider by the GTs but control of the company would rest with the wider industry through its corporate governance arrangements.

This appendix sets out the stated objective from separating ownership from control ("what are we trying to achieve from this construct") followed by options for how the divorce of ownership and control might be achieved in this context.

A.2. Objectives

It is important to note that the option of notional GT ownership of the service provider (Xoserve) being divorced from control is one of a number of options that we have identified. It is, however, a particularly important one as it has the potential to achieve the benefits of the full cooperative model whilst limiting some of the transition costs and risks. It also appears to be the only option other than the Light Cooperative model that can be implemented in full by April 2014.

In principle, it is seeking to replicate the corporate governance arrangements that might be expected were a cooperative service provider set up from scratch, say under a Company Limited by Guarantee (CLG) structure. This means that the company is run on behalf of and controlled by its members and control is exercised through the Board.

At a principles level we consider this to involve:

- industry inclusiveness and control of the day to day operation of the business exercised through the company's Board;
- non-executive Director industry representatives (from both GT and Shipper constituencies) appointed to the Board, acting as the de facto members or shareholders of the company;
- ensuring that those who control the service provider Xoserve bear the performance risk from the operation of the company; and
- the annual budget for the service provider, once agreed by the Board, being presented at an all industry participant meeting for approval.

As the GTs (while a constituent group under the full cooperative model) would remain shareholders in the company, the objective is also that the shareholders must be prevented from exercising control over the company except through its Board members and even then control would be shared with the Shipper community.[8]

A.3. Options

What then are the options for divorcing ownership from control in the case of Xoserve Ltd? There are various mechanisms that might be used to effect such a separation; however, our preferred approach would be:

- for the rights of constituent groups that are not owners (that is, Shippers), to sit on the Board of Xoserve and therefore to exert partial control through voting rights, to be enshrined in the Articles of Association of the company; together with
- a provision that the relevant sections of the Articles dealing with those rights cannot be changed without the consent of those holding the rights.

We have seen this arrangement put in place in other contexts where for example the lenders of senior and subordinated debt to an infrastructure fund were given certain rights over the governance of the company. In terms of Xoserve Ltd this might work as follows:

- while the rights of the GTs as Xoserve Shareholders would endure, their ability to enforce control would be constrained by the Articles of Association of the company;
- the purpose of the company as set out in that constitution would be to conduct IT and information services on behalf of the gas industry (or something of the same effect);
- the company's existing Articles would be amended to enshrine the right for Shippers and GTs each to elect three non-executive members to the Board (or whatever other number was considered appropriate);
- the Board as set out in the revised Articles of Association would be responsible for the strategy and policy of the company;
- every Board Director would have one vote, and a resolution of the Board would be passed if it was agreed by all Directors present or there was a majority of votes cast in favour of the proposed resolution[9]; and
- as proposed above, there would be a relevant section of the Articles dealing with those rights which cannot be changed without the consent of those holding the rights, including three Shipper appointed Directors on the Board of the company.

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[8] The only exception to this would presumably be if *in extremis* Ofgem required the shareholders to step in to address gross misconduct or performance failure as is the case with National Grid and Elexon.

[9] The main part of this governance paper discusses a number of options for resolving a tie. These include an independent Chairman voting to resolve the tie, the status quo prevailing or no special arrangements being put in place, to encourage the Board to deal with issues and seek compromises.

There would also need to be *in extremis* arrangements for the owners to step in, perhaps only under instruction from Ofgem, if for whatever reason the then current governance was seen to be manifestly failing.

This might again be enshrined in the company's Articles of Association.

As industry members would not be Shareholders in the company, the budget could not be approved through a formal AGM.[10] It may however, be possible for the Articles of Association to be used to require that the Directors of the company present and consult with the industry on the budget through an agreed annual meeting. The Board would however, retain ultimate control for approving the budget under this model.

Elexon (acting as the BSC Co) provides an alternative construct where ownership (by National Grid) is effectively divorced from control.

While a similar construct could be considered for Xoserve, we think there are benefits with our proposed approach outlined above. This would mean that the right to appoint Directors would be enshrined in the Articles and could not be changed without the consent of those holding the rights, which does not appear to be the case with Elexon.[11]

The Elexon governance construct is also closely interlinked with the BSC, which is why the company's five Board of Directors include a Chairman who is also the Panel Chairman, two industry panel members and two Directors nominated by the Panel Chairman (after consultation with the Panel). The Chief Executive of Elexon is also not a Director of the company.

In contrast, under our proposed model of divorcing ownership from control, industry constituent groups would have a direct means of influencing Director appointments. As we have proposed Xoserve senior management be part of the Board, industry appointed Directors should also be able to exert effective control of the company through its Board arrangements. That said, we have not yet considered whether those Board members who are not drawn from the Shipper and Transporter communities should have equal voting rights, nor whether certain reserved matters, other than changes to the Articles of Association, would require more than a simple majority.

A.4. Conclusions

As set out in the main section of this paper, the arrangements by which ownership and control are separated would need to be carefully defined to ensure that relevant legal obligations regarding ownership were properly discharged without risk to the ultimate owner. There would also need to be *in extremis* arrangements for the owners to step in, perhaps only under instruction from Ofgem, if for whatever reason the then current governance was seen to be manifestly failing.

[10] This would for example be possible under an all industry participants CLG construct.

[11] National Grid does appear to have the right to amend the Memorandum of Articles of Association of Elexon however it can only exercise that right in accordance with the provisions of the BSC or any direction of the Panel consistent with the provisions of the BSC.

APPENDIX B: PERFORMANCE RISK

B.1. Introduction

We have developed two principal bases for cooperative governance options for the central service provider going forward.

What we have termed the "full" cooperative model involves full pass through arrangements for budgeted costs and alignment of performance risk with those who would control the central service provider, which in the full coop model, is the wider industry.

While budgeted costs are a simple pass through arrangement, slightly more complex arrangements are proposed for budget over and under runs:

- We have proposed that if these exceeded an agreed threshold held on the balance sheet, the deficit would need to be funded by those who control the central agent and would trigger a letter from Ofgem on future arrangements.
- In the event that a deficit needed to be funded in such a way this would however, still be treated as a pass-through. The letter from Ofgem creating a reputational incentive for this event to be avoided.

The implication is that because all costs are a pass through, that rather than those who control the central service provider bearing performance risk for the company, it is largely consumers who actually bear the costs of performance failure.[12]

This appendix considers the issue of performance risk allocation under the full cooperative model, and proposes a couple of options for how the intended allocation of performance risk (aligned with those who control the central service provider) might be achieved under the full cooperative model. We begin with a short discussion of what we mean by performance risk.

B.2. What do we mean by performance risk?

As set out in the main section of the paper, there are a number of forms of financial risk associated with a business such as Xoserve's of running IT services for third parties. These include: market risks (utilisation of services); and performance risks.

We have proposed under any form of future cooperative funding and governance model that market risks should be allocated to users of the central agent's services. For performance risk, a number of types of risk need to be considered. For example:

- overruns against budgeted costs for core and more bilateral 'user pays' services;
- major systems failure leads to claims for damages; and

[12] The assumption being that those who control the central service provider still bear some reputational risk if the event, for example, of a major systems failure.

- major process failure leads to claims for damages (e.g. GT invoicing).

Clearly other eventualities can be envisaged. The above list highlights some of the key events that are likely to drive performance failure from a common central service provider of IT systems and services to the gas industry.

B.3. What is the concern?

The proposed cooperative funding arrangements treat costs as pass through. As set out in the introduction, although we have sought to create a reputational incentive through the proposal to retain overruns on balance sheet, ultimately industry participants would still have the ability to pass on costs from central service provider performance failure to final consumers.

While this is a concern from the perspective of protecting consumers in general, it potentially also undermines the effectiveness of a full cooperative model as it weakens the incentive for the industry to manage risk effectively. We are seeking industry cooperation in the effective management and development of IT service delivery within the gas industry, including risk.

B.4. What are the options?

What then are the options which might be considered to better achieve the intended alignment of performance risk with those who would control the central agent (industry participants) under the proposed "full" cooperative model? Three primary options would seem to be available:

- Option 1 – Specify as part of the governance model, that certain types of cash-calls from the business would not be allowed for pass-through.
- Option 2 – Impose a licence condition on those who control the central service provider to participate in the company and manage it in an "effective and economic manner".
- Option 3 – Require the Contracted Services Alternative model (where Xoserve is structured as a small service procurement organisation) so that performance risk is outsourced to a service provider thereby allocating risk away from the consumer.

The second option would offer the ability for Ofgem to levy penalties (under licence) should industry participants seek to pass on costs from performance failure (e.g. a major systems failure from poor management) onto the consumer.

B.5. Discussion

Option one is essentially a rules based approach to regulation. Ofgem would need to specify "what is" and "what is not" allowed for pass-through. This would mean industry participants potentially have some clarity of the central agent performance risk they are taking.

A problem with this approach – as with all "rules" based approaches to regulation – is that there is a risk that those subject to regulation seek to comply with the "letter of the law" rather than following appropriate conduct.

Another problem (as highlighted in our funding and charging paper) is that option one potentially creates tensions between the Shipper and GT constituencies, as Shippers are not price regulated and have the ability to pass on costs to consumers in a liberalised market, while GTs face a revenue cap. It would be a difficult, if near impossible, approach to enforce given that Ofgem does not have regulatory controls over shipper and supplier pricing.

In contrast, option two has the advantage that it allows the flexibility of the pass-through model and a reputational incentive of retaining over runs on the balance sheet for relatively minor performance failures. This protects against events, for example, such as opening expensive offices.

However, major performance failure (the key events being mismanagement of delivery of a large IT project or major operational systems failure) would sit with those who control Xoserve as the Authority would have the capacity (in extremis) to impose financial penalties.

By not specifying "what is" and "what is not" allowed for consumer pass through, this potentially incentivises those who control Xoserve to manage the central service provider according to a standard of conduct expected from a cooperative industry service provider.

The problem is this creates a new form regulatory risk for industry participants[13] – essentially performance risk becomes a regulatory risk similar in concept to capex being disallowed by the regulator from the RAB (ex post) because it is seen as inefficient.

This discussion of options 1 and 2 highlights one of the main attractions of the contracted services alternative. It potentially allows a reallocation of performance risk to the service provider, and thereby provides a mechanism for protection of consumers (and industry participants) under a full coop model.

B.6. Conclusions

This issue will need to be considered further through industry consultation. What we have termed the Contracted Services Alternative model would provide the most effective means of ensuring that performance risk sits with those who control and are able to manage that risk. However, as discussed in the main section of the paper, transition to this structure would take time.

This suggests that the primary means (at least in the short term) of achieving the intended allocation of performance risk, is for Ofgem to be clear to industry participants (who would control the central agent) that pass through of major performance failure costs to consumers would not be tolerated.

At the same time we expect that Ofgem does not want to create the impression that fines under licence could be applied on a regular basis to 'claw-back' budget overruns. This would be inconsistent with the objective of moving away from regulatory allowances.

Therefore, a more appropriate basis for introducing the concept would be to simply note that Ofgem expects those who control the central service provider to manage and bear the costs of

[13] Essentially a form of ex post regulation.

major performance failure. This would be captured through the proposed “economic and efficient” licence condition under new arrangements.

This concept would need to recognise that there are some very major IS upgrade projects in the pipeline, and as a result there may need to be some tolerance of budget overruns. Given the risks, the central service provider might also be encouraged to outsource performance risk wherever possible.

As a final thought, we note that Xoserve already outsources around two thirds of its operating cost base. It may be that within the existing outsourcing arrangements the performance risk that consumers actually have to bear under any new arrangements is relatively immaterial.

Appendix C: Transition Issues

In this appendix we use a common framework to consider transition issues. These are discussed against the various elements of the four governance options described in Section 4.

Light Cooperative Model

Element	Light Cooperative Model	Commentary
	GT Ownership	
Structure	Single Company	No change
Type of Organisation	Limited Company	No change
Ownership	GTs	No change
Control	GTs	No change
Board Composition	GTs only, possibly Shipper non-Executive	Limited change, although open to owners to appoint Board members who can contribute to management of IT service provider rather than represent company interests
Financing	GTs	Limited risk in practice due to pass through, unless Ofgem determine that this is not appropriate for this model
Annual Meeting	None, unless GTs decided to invite parties	In this model, questions over purpose of any such meeting and whether it had any real ability to, for example, insist on changes
Performance Risk Allocation	GTs	Limited risk in practice due to pass through, unless Ofgem determine that this is not appropriate for this model
Market Risk Allocation	Service Users	Limited risk in practice due to pass through, unless Ofgem determine that this is not appropriate for this model
Profit / Not for Profit	Profit	Not consistent with proposed not for profit for distribution approach, unless owners chose a different objective for the company
Other Groups	Shipper Advisory Board	Questions over whether this has any real authority (cf annual meeting)
Minority Interests	Specific Protections	If any, would presumably seek to address Shipper concerns over any real ability to influence affairs of company
Principal Transition Issues	Very few	

Source: CEPA, TPA and ESP

Full Cooperative Model, GT Ownership

Element	Full Cooperative Model GT Ownership	Commentary
Structure	Single Company	No change
Type of Organisation	Limited Company	No change
Ownership	GTs	No change
Control	All Participants	Need special arrangements, say constitution that enshrines Shipper Board representation
Board Composition	Board comprised of (say) 3GT and 3 Shipper members, with option for senior staff and/or specialists appointments as well	Key issue is industry's ability to appoint people who can contribute to management of IT service provider rather than represent sectional interests
Financing	All Participants	Limited risk in practice due to pass through
Annual Meeting	Approves Annual Budget	Cannot be AGM, as Shippers not shareholders. Need to create special meeting, again enshrined in constitution
Performance Risk Allocation	All Participants	Limited in practice due to pass through
Market Risk Allocation	Service Users	
Profit / Not for Profit	Not for Profit, but with ability to earn surpluses not for distribution	Will need careful control and management to ensure that this does not create 'comfort zone' fund
Other Groups	One or more User Groups. Primary focus is to provide feedback on user experience of services provided. May also have role in identifying and progressing major projects	Further debate needed. Important that Board retains effective overall control and that these do not undermine its authority
Minority Interests	Specific Protections	Proposal is that one Transporter Board seat be confined to NGGT plus protections for Gemini through contract
Principal Transition Issues	Change of Articles of Association to enshrine new rights of non-owners	

Source: CEPA, TPA and ESP

Full Cooperative Model, All Participants Ownership, Limited Company

Element	Full Cooperative Model All Participants Ownership	Commentary
Structure	Single Company	No change
Type of Organisation	Limited Company	No change
Ownership	All Participants	Requires all non-GT parties to take one or more shares in Xoserve.
Control	All Participants	To be described in Shareholders Agreement, assume powers to appoint Board with similar composition as in GT Ownership option
Board Composition	Board comprised of (say) 3GT and 3 Shipper members, with option for senior staff and/or specialists appointments as well	Key issue is industry's ability to appoint people who can contribute to management of IT service provider rather than represent sectional interests
Financing	All Participants	Limited risk in practice due to pass through
Annual Meeting	Approves Annual Budget	Can now be done at AGM
Performance Risk Allocation	All Participants	Limited in practice due to pass through
Market Risk Allocation	Service Users	
Profit / Not for Profit	Not for Profit, but with ability to earn surpluses not for distribution	Will need careful control and management to ensure that this does not create 'comfort zone' fund
Other Groups	One or more User Groups. Primary focus is to provide feedback on user experience of services provided. May also have role in identifying and progressing major projects	Further debate needed. Important that Board retains effective overall control and that these do not undermine its authority
Minority Interests	Specific Protections	Proposal is that one Transporter Board seat be confined to NGGT plus protections for Gemini through contract
Principal Transition Issues	• Probable change of Articles of Association • Creation of Shareholders Agreement • Consideration of whether or not any compensation to be paid to current owners • Staff concerns over issues such as pension rights	Most of these issues appear to be manageable, but are likely to take more time to resolve than in the GT Ownership option. Key issue for some Shippers will be requirement to become shareholders in Xoserve

Source: CEPA, TPA and ESP

Full Cooperative Model, All Participants Ownership, CLG

Element	Full Cooperative Model All Participants Ownership	Commentary
Structure	Single Company	No change
Type of Organisation	CLG	Significant change, likely to trigger TUPE issues and questions of who owns what IP
Ownership	All Participants	Requires all non-GT parties to become members of the CLG
Control	All Participants	To be described in whatever documents establish CLG
Board Composition	Board comprised of (say) 3GT and 3 Shipper members, with option for senior staff and/or specialists appointments as well	Key issue is industry's ability to appoint people who can contribute to management of IT service provider rather than represent sectional interests
Financing	All Participants	Limited risk in practice due to pass through
Annual Meeting	Approves Annual Budget	AGM of members
Performance Risk Allocation	All Participants	Limited in practice due to pass through
Market Risk Allocation	Service Users	
Profit / Not for Profit	Not for Profit, but with ability to earn surpluses not for distribution	Will need careful control and management to ensure that this does not create 'comfort zone' fund
Other Groups	One or more User Groups. Primary focus is to provide feedback on user experience of services provided. May also have role in identifying and progressing major projects	Further debate needed. Important that Board retains effective overall control and that these do not undermine its authority
Minority Interests	Specific Protections	Proposal is that one Transporter Board seat be confined to NGGT plus protections for Gemini through contract
Principal Transition Issues	• CLG documentation • Compensation and issues of where IP and other key ownerships lie • TUPE and associated employment issues • Risk of crystallisation of pension rights	These issues are more complicated than in the Limited Company model. They will need careful planning and time to address

Source: CEPA, TPA and ESP

As this model is a subset of Option 3.3, the only difference being a CLG instead of a Limited company, those rows that have not changed between the two assessments have been marked in grey

Full Cooperative Model, Contracted Services Alternative

Element	Full Cooperative Model Contracted Services Alternative	Commentary
Structure	Single Company	No change
Type of Organisation	Limited Company	No change
Ownership	All Participants / Third Parties	Requires all parties to be a member of a CLG. This is separate from outsourced service provider, to which most Xoserve staff likely to transfer
Control	All Participants	To be described in CLG documentation, assume powers to appoint Board with similar composition as in GT Ownership option
Board Composition	Board comprised of (say) 3GT and 3 Shipper members, with option for senior staff and/or specialists appointments as well	Key issue is industry's ability to appoint people who can contribute to management of IT service provider rather than represent sectional interests. This model also has a different focus to the others, as all services are contracted out
Financing	All Participants	Limited risk in practice due to pass through and presumably terms of contract
Annual Meeting	Approves Annual Budget	AGM of members
Performance Risk Allocation	Third parties	Contract terms need to be very specific here, as this is principal reason for this option
Market Risk Allocation	Service Users	
Profit / Not for Profit	CLG Not for Profit, but with ability to earn surpluses not for distribution	Will need careful control and management to ensure that this does not create 'comfort zone' fund
Other Groups	One or more User Groups. Primary focus is to provide feedback on user experience of services provided. May also have role in identifying and progressing major projects	Further debate needed. Important that Board retains effective overall control and that these do not undermine its authority
Minority Interests	Specific Protections	Proposal is that one Transporter Board seat be confined to NGGT plus protections for Gemini through contract
Principal Transition Issues	• CLG documentation • Compensation and issues of where IP and other key ownerships lie • TUPE and associated employment issues • Risk of crystallisation of pension rights • Separation of functions and definition of terms of service contract	These issues are more complicated than in the Limited Company model. They will need careful planning and time to address

Source: CEPA, TPA and ESP

APPENDIX D: IMPACT ON MAJOR PROJECTS

D.1. Introduction

If the transition to new arrangements is made, major projects will clearly be impacted. In this appendix we consider two such projects, Nexus and EU driven changes to Gemini, discussing their further progress under existing and proposed new arrangements.

D.2. Project Nexus

Project Nexus is well into the requirements definition stage. It already has separate governance arrangements through the Project Nexus UNC workgroup, which has helped in the detailed specification of requirements, and modifications to the UNC have recently be submitted to the Joint Office that seek to implement the requirements identified under Nexus.

We assume that as well as determining appropriate UNC and perhaps ASA changes the project will soon move into more formal documentation to support a Request for Proposals from suitably qualified Systems Integrators. We also assume that significant expenditure will not be committed until towards the end of 2013/14, when contracts for implementation are awarded.

We also assume that Ofgem's expectations are regards of reform of gas settlement arrangements (as set out in its 31st July open letter to the GDNs) will continue to need to be met.[14] These include that:

- new systems are in place and operational by end-2015 (these must be capable of making effective and efficient use of smart and advanced meter data as its availability increases);
- there is fully-resourced commitment on behalf of the industry (GDNs and the users of settlement systems) to the delivery of Nexus; and
- there is a robust framework for the assessment of proposals that can take account of potential changes to the governance and funding of the central service provider over the same period.

If this broad description is correct, then we would argue that our proposed arrangements are no worse than the current arrangements and potentially offer a better resolution of a potential funding problem. Indeed, they appear wholly consistent with Ofgem's view that delivery of Nexus should take account of proposed changes to the funding and governance of Xoserve.

Here, as in other areas, we anticipate that requirements to be placed on Xoserve would arise from modification proposals recommended by the UNC Panel and approved by Ofgem. Those modification proposals should include relatively detailed impact assessments that set out the costs involved in the proposals, broken down by financial year, and we have proposed a specific change budget for such assessments. Because of this, the budget amounts would be defined through the

[14] See Ofgem (2012): Open letter to Gas Distribution Networks on Project Nexus gas settlement reforms available here.

modification process rather than requiring separate approval by the Xoserve Board or industry participants more generally.

Therefore, up to the approval stage of Nexus related modifications:

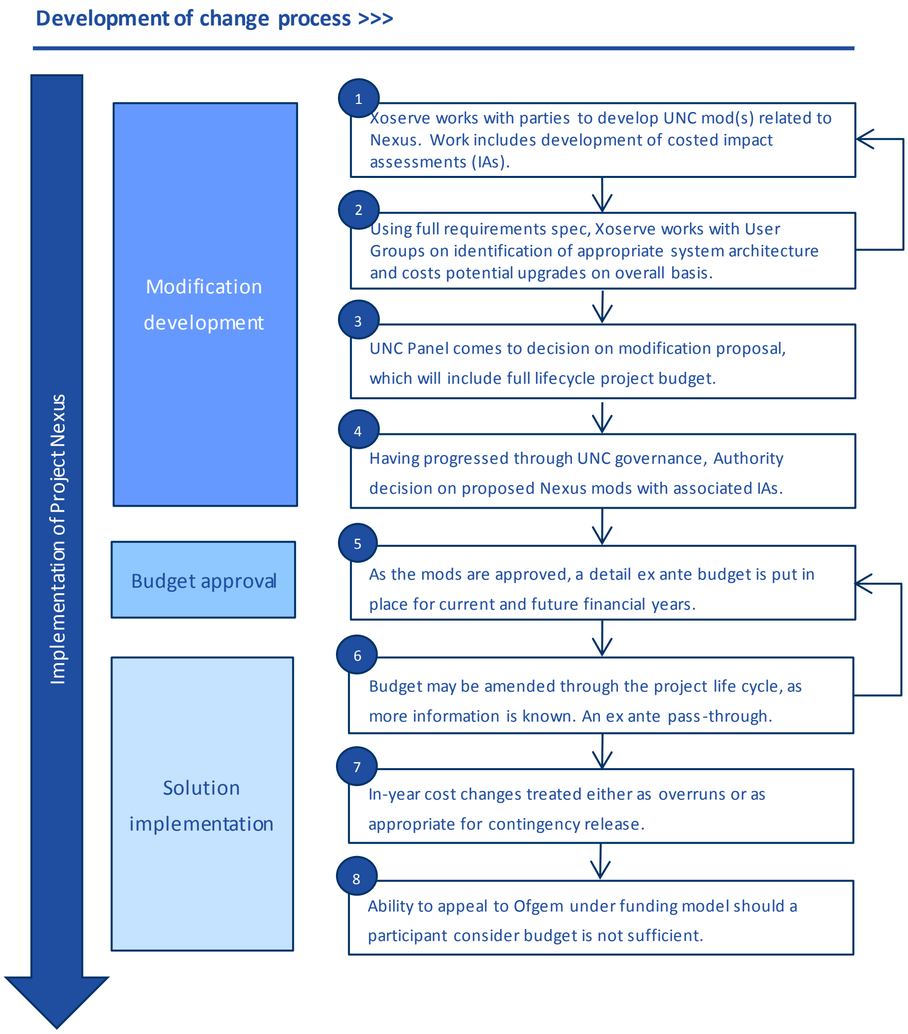
- Xoserve would work with relevant parties on the Nexus modifications, including developing one or more costed impact assessments (IAs);
- Xoserve would include appropriate amounts in the shadow annual budget(s), derived from whatever form the IA is then in;
- the industry, working with Xoserve, would decide what level of contingency to approve as part of the major projects budget for Nexus;
- the full Nexus budget, broken down to an appropriate level of detail, would then become an important element in the IA.

Provided the Nexus modifications are approved by Ofgem:

- a detailed budget would then be in place for life of Nexus broken down by financial year to form part of the annual budgeting process;
- the budget would contain appropriate levels of contingency as agreed amongst industry participants through the modification process; and
- over the life of the project the budget would be resubmitted each year to the industry for approval. Any cost changes other than contingency release would have to go through appropriate approval processes.

Figure C.1 illustrates how the arrangements might work in practice. This approach needs further consideration in relation to our proposals on shadowing, given the possibility that major decisions will need to be taken towards the end of 2013.

Figure D.1: Development of Nexus change process



Source: CEPA, TPA and ESP

D.3. EU Driven Change

A number of changes to the way in which gas transmission arrangements work are coming from the EU. We understand that high level requirements have been defined and that soon work will move into more detailed requirements including any necessary changes to systems, particularly Gemini.

In the current model, NGGT as a Board member will have oversight of the cost arrangements under which Xoserve will deliver the required changes to Gemini. In the full cooperative model, we accept that oversight would be different, but we do not consider any changes to be profound.

The starting point is that Gemini is owned by NGGT. We suggest that a contract should be created between NGGT and Xoserve, insofar as one does not exist already, that sets out appropriate obligations and responsibilities between the parties regarding Gemini. That contract would stipulate how changes to Gemini are managed and processes for approving and then developing systems changes and the testing and user acceptance of those changes.

As with other changes that fall within the UNC, Xoserve is only empowered to deliver them following approval of relevant modification proposals. As noted earlier, those proposals will include impact assessments that cover, amongst other things, the costs of the change and the timetable for its implementation. The contract for Gemini should ensure that NGGT can check that the costs identified in the impact assessment for the relevant changes are included in the overall Xoserve budget. Through its day to day working with Xoserve with regard to system changes, it can also determine if timelines are being followed and through its testing programme it can check that quality is appropriate.

These interactions mean that NGGT's oversight of any changes to Gemini will be the same as today. If there is a concern, it may be over its ability to ensure that priorities are maintained and that the Gemini programme does not slip. In this regard, a significant element of the prioritisation should arise from the modifications process. To the extent that choices as to priorities can be made by Xoserve, then that would be a matter for its Board, on which NGGT has a seat.

The flow diagram for EU changes is essentially the same as that for Nexus, although timelines might vary somewhat.