



FUTURE ARRANGEMENTS FOR THE GAS TRANSPORTER CENTRAL AGENT

ANNEX E: LEGAL AND REGULATORY FRAMEWORKS PAPER

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Final report



ESP Consulting

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1. INTRODUCTION

1.1. Context

In January 2012 Ofgem issued a decision letter where it concluded that a “co-operative” 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

We have developed two primary options for cooperative corporate governance and funding arrangements for the central service provider going forward.

As part of our model development work, we have proposed an important change of paradigm. Whilst Xoserve was established primarily to deliver transporter licence and code obligations following distribution network sales, we have suggested that developing the future arrangements should begin with an assessment of the services that it provides to various parties.

As we have developed options for these arrangements, we have, however, recognised that at some point obligations and the supporting legal framework will need to be reconsidered, although we consider it important that such obligations are much more an outcome of a consideration of services provided, rather than an input to that consideration.

This legal and regulatory frameworks paper first sets out some initial options for changes to GT and Shipper licences to legally enforce different approaches to funding and governance arrangements (this involves different changes for different models). It then concentrates on potential contractual and code arrangements that could underpin the new license regime in the case of the full cooperative model.

We note, particularly as regards future contracting arrangements, that developing these arrangements goes beyond our terms of reference for Phase 1 of this project. As part of Phase 2 of the project, we will, however, be asked by Ofgem to develop licence conditions and identify industry code changes to enforce any new arrangements.

The purpose of this options paper is largely to demonstrate to industry participants the high level options of how new arrangements might be made to work, rather than at this stage to provide definitive proposals. We welcome industry participant feedback on whether we have identified the appropriate range of options and the key issues and principles which need to be considered.

1.3. Document structure

The rest of this document is structured as follows:

- Section 2 sets out what we are trying to achieve from the legal framework associated with a cooperative central service provider;
- Section 3 sets out our some initial proposals for changes to GT and Shipper licences to enforce different options for new funding and governance arrangements.
- Section 4 sets out options for potential contractual arrangements under what is termed the full cooperative model.
- Section 5 provides conclusions.

A short appendix summarises the existing legal framework and contracting arrangements and how the GT Agent role is defined within the Uniform Network Code (UNC).

2. WHAT ARE WE SETTING OUT TO ACHIEVE?

Ofgem's January 2012 decision sets out a requirement for cooperative governance and funding arrangements of data and information services, with the effective management and strategic direction of the monopoly IT services provider which delivers those services enforced through these governance and funding arrangements.

The analysis from the working group sessions have helped to confirm the benefits and indeed natural monopoly characteristics of a common provider of IT and information services to the gas industry. This reflects that while Xoserve's services can be categorised, their delivery through IS systems is interlinked and involves significant common cost.

Given such characteristics, and as described in the introduction, we are proposing an important change of paradigm; instead of considering Xoserve primarily as an organisation delivering certain licence and code obligations as the GTs' appointed agent, we believe it instead should be looked at as an IT services provider to the industry (albeit a monopoly one).

In this section we set out what we consider is required from future legal frameworks to support this overarching objective. We begin by outlining what we are trying to achieve from a first principles perspective, before considering the constraints that apply in this context.

2.1. First principles

2.1.1. Central service provider not an agent

We believe Xoserve should primarily be considered as a central IT and information services provider to the gas industry.

Our primary principle is, therefore, that Xoserve should, where possible, be defined within the legal framework as a service provider delivering IT and information services to the industry (i.e. GTs and Shippers), rather than being an appointed agent of the GTs or another industry group.

As Xoserve, at least for the majority of its core services, is a monopoly service provider, there also needs to be a means to protect the users of those services (and ultimately consumers) against the abuse of a dominant position.

Where current regulatory controls are removed, this will need to be enforced through the service provider's governance arrangements.¹

As a consequence, there needs to be a means within the legal and regulatory framework for the services being provided, that requires industry participants to control and manage the service provider in an economic and efficient manner.

2.1.2. Alignment of obligations and control

¹ In the case of the full cooperative model, this would be the company's Board.

Another core principle is that the party which is obligated to provide certain services, and therefore the management of the performance and financial risks associated with their delivery, should be aligned with those who are able to control the provision of those services. That is to say, wherever possible, there should be alignment of obligations, risks and control.

This is the case under the current arrangements, whereby the GTs have certain obligations under their licences and the UNC for the provision of services which they discharge through an appointed central agent, Xoserve.

The GTs are able to control the provision of these services (and manage the performance risks associated with service delivery requirements) by means of the Agency Services Agreement (ASA) with their appointed agent and through their ownership of Xoserve.

We believe a similar principle – although a different construct – must apply under any new service provider arrangements.

In the first instance, this would seem to imply that where the GTs no longer solely control the delivery body Xoserve, it would be inappropriate for them to also solely retain obligations for the provision of certain services under the UNC.

Given our first principle, that Xoserve should, where possible, be defined within the legal framework as a Central Service Provider as opposed to an appointed Agent, these obligations, at least from a first principles perspective, would seem to sit best with the Central Service Provider.

While GT Agency services are currently defined within the UNC (Section V 6.5.2), under the existing construct, Xoserve is not a party to the UNC. Were a realignment of service obligations sought within the UNC (to move them from the GTs as currently to a Central Service Provider), the Central Service Provider would seem likely to need to be a necessary party to the UNC in order to assume those obligations. Whether such an arrangement is required, or indeed practicable, would require further legal analysis.

We consider the implications of this approach (along with alternative options) as part of our discussion of contracting frameworks in Section 4.

2.1.3. Light touch regulation with appropriate step-in powers

A core objective of cooperative governance and funding arrangements is to remove strict regulatory controls over the service provider and to replace these with relatively ‘light touch’ regulation.

Given the criticality of the services provided by Xoserve to settlements, invoicing etc., there does, however, need to be appropriate step-in powers on behalf of the regulator to protect against gross misconduct and/or performance failure.

2.1.4. Legal clarity for a financeable business

The legal framework under new cooperative governance and funding arrangements needs to ensure that the business continues to be financeable.

Like any company, the service provider needs a supporting legal and contractual framework which provides clarity on service definitions (“what is required”), charging and invoicing processes (“how costs are to be recovered”) and liabilities.

2.1.5. Facilitate delivery

Another core principle is that the legal framework and governance arrangements of the service provider should facilitate the effective delivery of services and changes to those services, rather than, for example, frustrating delivery of UNC Modifications.

2.2. Constraints

The overarching principles and objectives outlined above could be achieved through licensing a monopoly service provider (as is being developed for the smart meter Data Communications Company (DCC)). There is however, no intention to enforce such a regime through the creation of a new service provider licence within the gas industry.

As a consequence, under any future cooperative model, these principles and objectives will need to be achieved through some alternative means, including existing licences and codes and changes to contractual arrangements.

Finally, although industry participants had differing views on this issue, one of the options for future funding arrangements is the capacity for the service provider to directly invoice Shippers and GTs for the core services it provides.

Depending on the decision on this issue, the legal and contracting framework may also need to have the capacity for direct invoicing of Shippers and GTs. This may require more fundamental changes to existing legal frameworks.

2.3. Summary

This section has sought to set out at a very high level, what we are trying to achieve from the legal framework of a cooperative central service provider from a first principles perspective.

This includes alignment of obligations, risks and control, Xoserve being defined as service provider (rather than the GT Agent as currently), protection of abuse of monopoly power but with light touch regulation, facilitation of delivery, and legal clarity.

3. LICENSING REGIME

We have developed two principal bases for cooperative governance and funding arrangements for the central service provider going forward. Different options would involve a different degree of change to industry participant licences.

3.1. Licensing regime under the light cooperative model

Under what we have termed the “light” cooperative model, there would be minimal change to the current arrangements, i.e. Xoserve continues to be owned and controlled by the GTs.

The only change to licences in this case are likely to be to require the appointed GT Agent to include a non-executive Shipper Board member and a Shipper Advisory Board as part of the company’s future corporate governance arrangements.

If, however, Ofgem were to allow a pass-through arrangement for Xoserve costs under the light model, there may also need to be changes to GT’s revenue restriction formula to allow for the pass through of Xoserve costs to regulated use of system charges.

3.2. Licensing regime under the full cooperative model

What we have termed the full cooperative model could be implemented under retained GT ownership (involving effective separation of ownership and control) or broadened to all participant ownership (for example, through establishment of a new Company Limited by Guarantee (CLG)). Under either approach relatively fundamental changes to both GT and Shipper licences would be needed in order to enforce the new regime.

This could include:

- Shippers, and not just GTs, being obliged under licence to participate in the control and operation of the service provider;
- Shippers and GTs possibly needing to be obliged under licence (and the UNC) to enter into a contractual relationship with the service provider (see Section 4);
- those who control the services provider, should participate in the company and manage it in an “efficient and economic manner”;
- GTs being allowed full cost pass through of the proportion of service provider budgets recovered from the GTs;²
- definition of principles of regulatory oversight to protect consumers, including step-in arrangements in the event of extreme performance failure; and

² Which could require an amendment of their revenue restrictions

- potentially some definition of the principles for governance, financing and funding of the service provider including budgeting approval.

In summary, our proposed approach would require that the licence obligations on all industry participants to be relatively high level and limited, namely to participate in the efficient and effective management of the company.

Service provider performance risk would be allocated to those who control the service provider (i.e. industry participants) through a licence condition to manage the company in an “economic and efficient” manner (or something similar).

3.3. Summary

Precise licence conditions would need to be fully defined in Phase 2 of the project. In this section we have sought to begin to set out initial proposals for how the licensing regime could work under both the light and full cooperative models.

The section which follows concentrates on potential changes to UNC obligations and contractual arrangements that could underpin the new license regime for the full cooperative arrangements. We assume that UNC obligations and contractual arrangements would remain largely unchanged with the light cooperative model.

4. CONTRACTUAL ARRANGEMENTS

This section considers possible options for the contractual and code arrangements to underpin the role that Xoserve would perform under a full cooperative model. We suggest that this emphasis translates into consideration of where industry obligations best sit.

We start with what we would consider to be the optimal set of arrangements if the development of contractual arrangements were to be approached from the theoretical perspective of the principles we set out in Section 2 (we term this the first principles option).

We then consider the practical implications of such an approach and given the issues identified, whether there might be alternatives that could provide a simpler solution given existing industry codes and other contractual agreements.

4.1. First principles approach

4.1.1. Current arrangements

As set out in Appendix A, currently the UNC recognises a “Transporter Agency” that fulfils various UNC activities as summarised in Section V 6.5.2. The range of those activities is expanded upon within Schedule 2 of the ASA that captures and categorises the services provided by the Agency.³ The detail of the UNC service requirements are dealt with throughout the various relevant sections of the UNC, expressed as GT obligations. In other words, the Central Agent is not a direct party to the UNC, although it is the vehicle through which the GTs deliver several of their UNC and other licence obligations.

The ASA is a contract between the Central Agent and all the GTs to provide services either directly to them, or on their behalf, to Shippers. However, any liabilities arising from the failure of the Agent to deliver the GT’s UNC obligations, largely remain with the GTs (the “Principals” in the relationship). Moreover, whereas the UNC sets out the obligations of the GTs, the ASA establishes the obligations between the GTs and their Agent, Xoserve, and helps ensure that the latter delivers the services specified, to all GTs.

4.1.2. Arrangements under a full cooperative model

Under the full cooperative model however, the GTs (collectively) would no longer have sole control of the industry service provider Xoserve, nor would the primary purpose of the company be to act as the GTs appointed agent. Rather, Xoserve would be the Central Service Provider to the industry as a whole, in its own right.

As a key design principle of the new arrangements is that obligations need to be aligned with control, it would, in our view, therefore seem inappropriate for the GTs solely to retain obligations for the provision of certain services under the UNC where they do not solely control the delivery

³ Including certain Non Code services.

body (Xoserve) that allows them to discharge those obligations. These obligations, at least from a first principles perspective, would seem to sit best with the Central Service Provider, as discussed in Section 2, potentially a necessary party to the UNC. However, those who control the Central Service Provider – the industry as a whole – would ultimately be responsible for it (not just the GTs).

The precise balance between what needs to happen as regards the Central Service Provider’s relationship with the UNC and how it delivers its services, as specified in the ASA, to give these arrangements legal effect, is then in essence a detailed legal structuring exercise. For instance, at one end of the spectrum:

- it may be that the content of the current ASA would be best folded in the UNC including detailed service descriptions, charging arrangements and liabilities; and
- at the other end, continuation of the existing GT ASA potentially expanded to incorporate Shippers as well.⁴

The relevant options would depend on what is being sought in terms of contractual relationships and governance, protection of invoicing and service provider liabilities.

For the avoidance of doubt however, under either approach, in order to maintain consistency with the proposed change of paradigm, this approach would involve the Central Service Provider being identified as the party responsible for delivering those services that it provides, so as to align obligations with risk and control.

This could require the Central Service Provider to be a party to the UNC and changes to the code itself (in terms of who is *responsible* for individual service requirements, rather than the requirements themselves) but would achieve the objective set out above of the Central Service Provider acting as principal (rather than agent) in the delivery of data, information and IT services to the industry.

4.1.3. Implications for licences

This approach would require (as set out in Section 3) that the licence obligations on all participants to be relatively high level and limited, namely to participate in the efficient and effective management of the company; other key obligations, such as to provide the company with whatever data it needs to fulfil its functions and to contract with it for the provision of services, would then either be in licence and/or in the code.

4.1.4. Non-code services and bespoke services

⁴ It should be noted, however, that it is not currently envisaged that any service line will change as a result of the proposed changes to corporate governance. Unless it were decided that the contractual relationship would be more of a direct one between the Central Service Provider and Shippers, it is not clear that the content of the ASA would need to change much, if at all. This is reinforced by the desire of some industry participants to retain a transportation charging arrangement, in which invoicing would be from Xoserve to the GTs and then to Shippers through a use of system charge. However, in a direct charging world, it may make sense to have more of a Shipper ASA, with the Shippers being the counterparties, rather than the GTs.

It is for consideration how the existing Non Code services might be incorporated within the approach outlined above (such as those related to GT licence obligations). Clearly one option is that for residual services (as with particular bespoke services requested by industry parties) some form of bilateral framework agreement between the service provider and service recipient is created, as with the current arrangements.

4.1.5. Implications for the UNC

As noted, the approach as outlined above, may require the Central Service Provider to become a party to the UNC and could require recasting of obligations within the code.

It has the potential, therefore, to change the dynamic of an agreement between GTs and Shippers by introducing a new (and important) party with obligations for delivering certain services. There are, therefore, likely to be certain risks from adopting such an approach.⁵

Having the Central Service Provider adopt obligations could also require the company to become much more a “creature of the code” that currently. While achieving alignment of obligations and control, there is a risk that the clear differentiation between delivery and UNC governance of service definitions becomes much more blurred. As highlighted by one participant at the industry working group that discussed this option, if Xoserve was a party to the code, it would also change the nature of its role in change management groups.

4.2. Alternative options

What then are the alternatives to the approach outlined above? Possible options that we have considered include:

- leaving UNC obligations with the GTs who would then contract with the service provider as currently through an amended ASA (to “back out” both their obligations and liabilities);
- revising the UNC obligations to align with the outputs of the services workgroup whereby there would be Shipper and GT facing services (depending on who is the service beneficiary) for which each respective group would have the obligation to provide the service and for which it would contract with the service provider to discharge that obligation.

We have looked at both options in considerable detail, both of which arguably characterise Xoserve as an Agent, albeit to the industry as a whole, rather than an empowered service provider in its own right. There are issues with both approaches.

As regards the second approach, the services analysis demonstrated that while primary beneficiaries can be identified, in most cases specific services provided by Xoserve impact a number of different industry constituent groups. Our view is that dividing up and reallocating current GT obligations in this way is unlikely to be feasible.

⁵ Notwithstanding that the task of recasting UNC obligations to accommodate the Central Service Provider would require a careful and detailed review of the code.

The first option has the benefit of requiring very few changes to the individual sections of the UNC, but, as set out, in contractual terms retains the service provider largely as the GT's appointed agent (a paradigm this project is seeking to move away from – although see subsection below).

Under the first option, while it may be possible to pass on GT liabilities arising under the UNC to the service provider through an ASA (through “back to back provisions”) it would need to be determined whether this would be an acceptable way forward for the GTs.

Enabling the Central Service Provider to invoice Shippers directly under the first option would also require their incorporation within the ASA, which would then need some form of modifications process in order to facilitate regime evolution and potentially avoid frustration of UNC Modifications.

A simpler alternative, therefore, would be to leave the ASA as a contract between the Central Service Provider and GTs only – this would rely on indirect Shipper invoicing via the UNC. Such invoicing could be as sophisticated (or as simple) as under any alternative framework, so this would not appear to be a substantive disadvantage.

4.3. Summary

Further work will be required on these issues as part of Phase 2 of the project. At this point we have sought to set out the spectrum of options to help support consultation on the funding and corporate governance arrangements set out in other parts of our report.

5. CONCLUSIONS

This short paper has sought to set out initial proposals for changes to GT and Shipper licences to enforce different options for cooperative funding and governance arrangements. It has then gone on to consider contracting models that could underpin new license regimes.

We would reemphasise that particularly as regards contracting arrangements, developing these arrangements goes beyond our terms of reference for Phase 1 of this project. The options as outlined are simply provided to support industry consultation.

The conclusion we take from this paper however, is that various options are available for how changes in funding and governance arrangements might be enforced through changes in the legal framework and contracting arrangements.

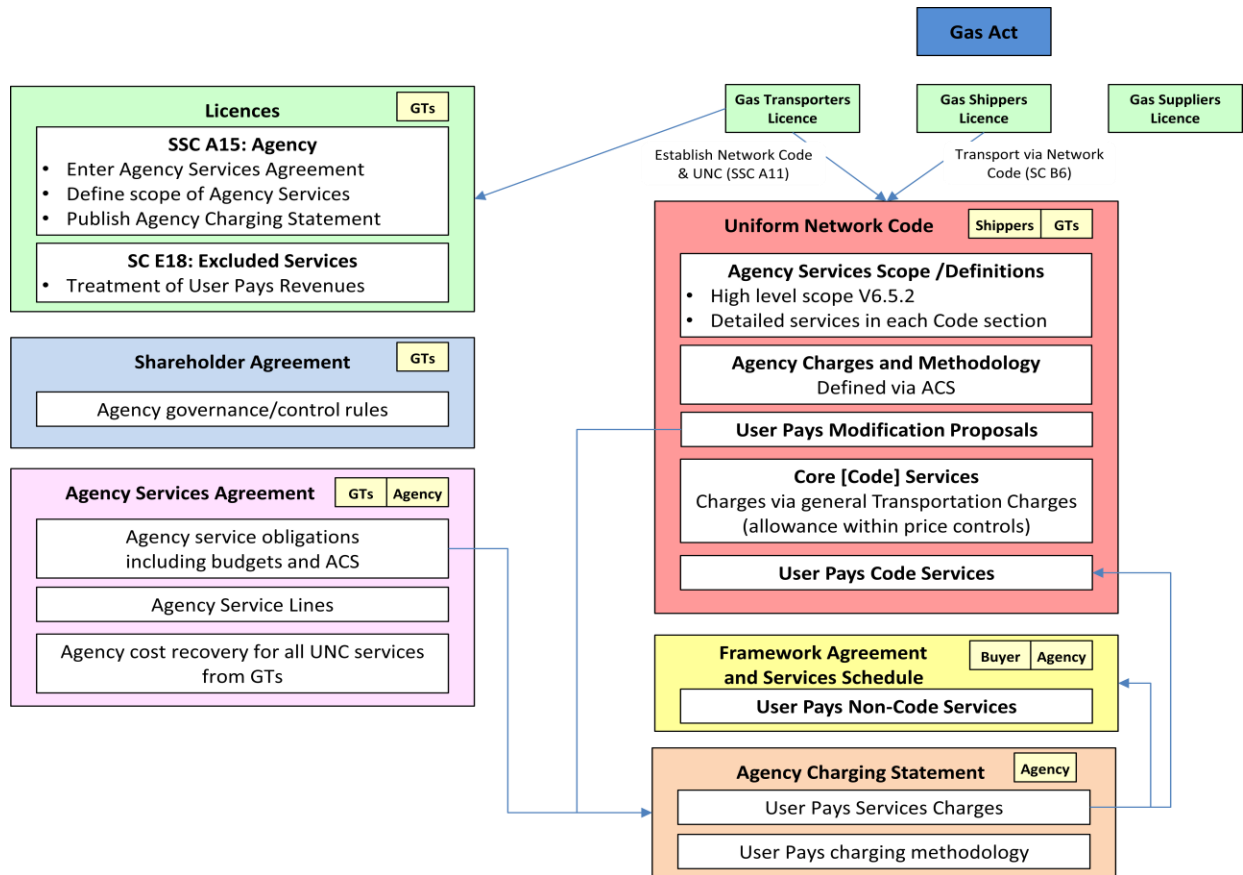
These issues need to be considered further through industry consultation and we would welcome industry participant feedback on whether we have identified the appropriate range of options and the key issues and principles that need to be considered.

APPENDIX A: CURRENT ARRANGEMENTS

Overview

Figure A1 provides an overview illustration of the existing legal and contractual framework for GT Agency services.

Figure A1: Current GT Agent legal framework



Source: CEPA, TPA and ESP

Current Agency Services

Currently the UNC recognises a “Transporter Agency” that fulfils various UNC activities as summarised in Section V 6.5.2. The range of those activities is expanded upon within Schedule 2 of the ASA that captures and categorises the services provided by the Agency . The detail of the UNC service requirements are dealt with throughout the various relevant sections of the UNC, expressed as GT obligations.

For new User Pays Code Services, the service requirements are also incorporated within the UNC, whilst the cost allocations and charging methodology that are set through the modification process should then be reflected in the updated ACS.

Current Charging

Schedule 7 of the ASA enables the Agency to recover the bulk of its costs from its GT owners by a combination of monthly invoices and annual adjustments, including the cost of providing Code User Pays Services. The GTs recover allowed revenues for the funding of Core Services from Shippers under the UNC through general transportation charges.

In addition, the GTs also collect payment from Shippers for Code User Pays Services via the UNC, and pass those payments (which are treated as Excluded Services income) back to the Agency. The ACS sets out the currently applicable charging methodology, actual charges and scope for User Pays (Code and Non-Code) Services, as well as defining the scope of Core Services (by difference).

In respect of Non-Code User Pays Services, Xoserve invoices and collects funds from Shippers and other service users directly.

Current Liabilities

Liabilities arising from the failure of the Central Agent to deliver the GT's UNC obligations, remain with the GTs (the "Principals" in the relationship).