Future arrangements for the Gas Transporter Central Agent

Office of Gas and Electricity Markets

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Final report

CEPA

tpa

ESP Consulting

CONTENTS

Executive Summary

Background and current arrangements

Xoserve was established at the time of Distribution Network (DN) sales to undertake agency functions on behalf of the Gas Transporters (GTs), primarily delivering relevant obligations regarding the operation of the gas wholesale and retail markets utilising centralised systems and data.

Xoserve is owned by the GTs, but provides services to the industry as a whole. As GT service obligations are delivered by Xoserve, this is a clear Principal-Agent relationship, in which the services which allows GTs to meet their obligations are provided by Xoserve.

There are a number of important documents that together define Xoserve's role. These include the licence obligations on GTs, detailed descriptions of these obligations in the Uniform Network Code (UNC) and the contractual terms under which Xoserve provides the services that allow such obligations to be met, set out in the Agency Services Agreement (ASA). Other relevant documents include Non-Code User Pays Services, covered by Framework Agreements between Xoserve and Shippers, and other services covered by various bilateral contracts.

The ASA captures and categorises the services to be provided as part of the GT Agent role. It is the primary means by which the GTs (as Xoserve's contractual counter-parties) are each able to control the discharge of their obligations through the collectively appointed Agent. Xoserve, however, bears only very limited liability to the GTs for its delivery of services, with the majority of such liabilities flowing back to its GT owners.

At the previous Gas Distribution Price Control Review (GDPCR) Ofgem changed the funding arrangements for the services Xoserve provides, introducing a Core Services and User Pays approach. Under this approach, regulated services provided by Xoserve are classified as:

- *Core services* – regulated services that it was deemed appropriate to fund using price control allowed revenues (c. 90% of Xoserve funding). Allowed costs associated with these services are recovered by the GTs across all customers through gas transportation charges.[1]
- *User Pays services* – regulated services that it was deemed appropriate to be funded by the user(s) requesting the service. Revenue from delivery of User Pays services is treated as excluded from GTs' price controls.

These arrangements have meant that for the GDPCR period, the GTs have been funded for the majority of Xoserve's activities through a combination of price controlled and excluded services revenues with Xoserve then recovering the majority of its costs related to Core and User Pays services from the GTs.

[1] Price control funding for GT Agent activities is fixed for a five-year period under the current transmission and gas distribution price controls.

Xoserve's governance arrangements include a Board whose directors are drawn from its shareholders and a non-executive Chairman who is not a director.

Issues with the current arrangements

Over time, the current arrangements have clearly enabled Xoserve to provide services to market participants. Nevertheless, differences of view have emerged between the GT community, who own and control Xoserve, and the Shipper community, who use a number of its services but who have little formal involvement in its governance.

In its May 2011 RIIO-GD1 strategy decision, Ofgem set out its intention to undertake a review of Xoserve's current funding, governance and ownership arrangements as described above.

Ofgem's review was in response to Shippers' concerns regarding whether the current arrangements would provide the required responsiveness and flexibility in funding and governance in the context of future industry changes, notably the roll-out of smart metering.

To support the review, in June 2011 Ofgem commissioned CEPA to initially undertake an independent review of the current funding, governance and ownership arrangements. We reported specific concerns, particularly raised by Shippers, over:

- Responsiveness to requests from the Shipper community, especially relating to change management.
- Lack of transparency regarding both the composition and basis for charges and also how decisions, including prioritorisation of activities, were taken.

We concluded that the current arrangements regarding funding and governance played a large part in determining these perceptions. For example, the price control arrangements do not incentivise GTs to give priority to Shipper change requests where these might create non-recovery risks or crowd out GT initiatives, and the funding arrangements, based on a five and now an eight year price control, are unsuitable for an IT business.

We also felt that the industry is facing a significant set of challenges going forward, including but not limited to EU requirements in areas such as balancing, the introduction of Project Nexus and the establishment of the Data Communications Company (DCC).

In September 2011, Ofgem issued an open letter consultation on Xoserve's funding and governance arrangements supported by CEPA's independent review findings and three options (A-C) within our report for alternative arrangements as a way forward.

Based on the responses to the consultation, and discussion at an industry round table event, in January 2012 Ofgem issued a decision letter where it concluded that there was a strong case for changing the current institutional arrangements of Xoserve and that option C, based on a more inclusive cooperative model, was to be the way forward.

Implementation project

In the January decision letter, Ofgem did not reach a conclusion on the details of the new arrangements for Xoserve. Instead, it proposed to establish an implementation project to determine the precise funding, governance and ownership arrangements within the ambit of option C (i.e. where governance lies with the wider industry).

Subsequently, in October 2012, a consortium of CEPA, TPA Solutions and ESP Consulting was appointed to develop more detailed proposals for these arrangements. Our work has involved a number of distinct phases, which relate to the various elements of Ofgem's option C decision and implementation project, including:

- Phase 1 – Cooperative (option C) model development.
- Phase 2 – Ofgem decision and licence and code changes.
- Phase 3 – Development of legal documents to give effect to the new arrangements.

This report and its recommendations are the output of Phase 1 of the project and will support a non-statutory consultation by Ofgem on the proposed way forward for the cooperative model. It has been informed by a number of meetings with the industry both bilaterally and in working and steering groups.

Options for the introduction of cooperative governance

Our project brief follows on from the Ofgem decision letter of January 2012 in which Ofgem decided that it wanted the industry to adopt a cooperative model for the provision of centralised data and information services.

In developing our proposals we have been guided by a number of core principles, in particular that: decisions about service provision should rest with the users of those services, largely but not wholly through industry governance arrangements; that costs of services should be recovered directly from users; that charges and costs more generally should be made much more transparent; and that obligations and risks should be aligned with funding and control.

Paradigm shift

Our review of Xoserve, coupled with an analysis of comparator bodies in various utility industries, indicates that an important paradigm shift is required to implement a cooperative model in the gas sector going forward. The role that Xoserve plays in the industry and the range of services that it offers suggests that it should be seen as a central service provider delivering services directly to customers rather than an agent delivering licence and code obligations on behalf of the GTs.

Seen in this light, important questions regarding issues such as control and regulatory arrangements need to be addressed. We did so by looking at three separate but linked areas: services lines (and their economic characteristics); funding and charging; and governance.

Service lines and their characteristics

Xoserve currently provides a number of services to GTs and to Shippers (on the GTs behalf). Our analysis indicates that many service lines impacted both GTs and Shippers, although not necessarily to the same extent, and that nearly all service lines rely on common centralised data and utilise several different systems to effect delivery.

The highly integrated nature of the services leads us to conclude both that there are economies of scale and scope in delivery through a common services provider, and that to attempt to bifurcate that provider between GT facing and Shipper facing services and governance would not be cost-effective. We therefore propose that a common service provision model should be retained under a cooperative governance model.

We also conclude that it is possible to distinguish service lines between parties and that it would be appropriate in future for services and charges to be organised in this way.

Funding and charging

Because under current arrangements GTs are funded for the majority of Xoserve costs ex-ante through price controlled revenues, whereas Shippers effectively are unconstrained in this regard (although the aggregate level of costs to end-consumers is clearly a concern), we consider that the existing controls create inappropriate incentives regarding change.

Under a cooperative model, therefore, we propose that in future Xoserve costs should generally be treated as a pass through. For this proposal to be effective, however, we need to establish appropriate oversight and safeguards.

We propose to do this through the following arrangements:

- *Greater cost transparency* through the focus on service lines and the development and publication of an annual budget, based on those service lines and submitted to all industry participants for review and approval.
- *Greater flexibility* through the creation of appropriate categories within the budget of three principal categories of cost:
    - business run costs covering the day to day operations of Xoserve and built around service lines;
    - change management costs to accommodate modification proposals and other potential changes to existing systems and services; and
    - demand / development costs to cover expenditure on major projects within the year and investment period.
- *Changed incentives* through the retention of under and over spends against budget on the balance sheet of Xoserve, rather than being charged in the first instance to customers. Over time, these retentions would either cancel each other out, would be taken into or out of any

reserve provisions or would trigger a refinancing, which would require industry approval and would prompt a letter to Ofgem explaining why actual costs had risen above budgeted levels.

- *New backstop provisions* including a limited right of appeal to Ofgem by participants who could point to specific reasons why a proposed budget would not enable Xoserve to deliver its contractual and other obligations and a step in provision for Ofgem to issue budget directions if it felt that cost levels were inappropriate for the services that Xoserve provides.

Under our proposals there are then several options for charging.

Although we propose an annual budget built around service lines, to provide transparency to the industry regarding costs, it would be possible for charges to continue largely on the current basis, that is for Xoserve costs to be absorbed within GTs transportation charges more generally. The alternative would be to move to cost-reflective prices, based on the application of appropriate cost drivers to structure charges for each service line. There are then different options for invoicing charges within the cost-reflective charging model.

There are pros and cons with both indirect transportation and more cost reflective and/or direct charging arrangements, and differing views amongst industry participant groups on the appropriate arrangements going forward:

- From a first principles perspective we suggest a cost reflective charging model is the more optimal approach and we consider this to be more consistent with Ofgem's January 2012 decision letter with cost causality/targeting benefits.

- We do, however, recognise that such an approach or a move to direct invoicing may increase costs, potentially impose charging incidence effects, and create complexity for industry participants and ultimately final consumers.

Given the differing views on this issue, and the potential impact on end-consumer charges, we suggest that this issue (along with the options for charging arrangements more generally) be made a question for industry consultation.

Governance

We have considered a number of factors relating to governance, such as control, ownership, participation, the role of the Board, risk management and financing. In doing so we had regard to an important principle, that there should be alignment of key factors such as obligations, control, ownership, performance risk and funding. Our primary conclusions are that:

- The arrangements should be broadened to accommodate a wider range of industry interests.

- To the extent necessary, *ownership* can be separated from control. If such a separation is made, however, then protections need to be introduced to ensure that the owners do not face risks that they cannot control.

- Control should be exercised at a high level by the Board of the company. There is a role for a meeting of all participants, however, primarily to review and approve the annual budget.
- Board membership should reflect industry participation. Ideally an equal number of non-executives should be drawn from the GT and Shipper communities, together with an independent Chairman, a small number of executives from Xoserve and possibly additional non-executives bringing specific expertise to the Board.
- The company should either be as now, a company limited by shares, or should be a company limited by guarantee.
- The company should be not-for profit although this should not prevent it being permitted to budget to earn presumably modest surpluses to provide some buffer for unanticipated events to reflect some of the risks of service delivery , and possibly to help fund future capex projects.
- Xoserve should continue either broadly as now or should be split into a small service procurer organisation which contracts out the delivery of services to one or more third parties.
- Risks should be borne by those best able to control them, subject to the constraints of the particular governance option chosen.
- Xoserve should be financed by those that control it, rather than those that own it, where the two are different.

We brought these conclusions together into two primary cooperative models, with a variant that could apply to each of them:

- 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** would involve all industry participant control of the central service provider Xoserve, with control 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 variant to each of these models is to mandate Xoserve, or for the industry to create a new central entity, that would contract out all the services that Xoserve currently provides. Xoserve itself would then become a relatively small but high level procurement and contract management organisation. We have termed this the **Contracted Services Alternative**.

To give effect to the Full Cooperative Model, there are different variants to allow control of the central service provider to rest with all industry participants rather than solely the GTs as currently:

- The GTs could continue to own the company, essentially in a nominal manner, but would be insulated from equity risk given that they would not have full control over the decisions of the Board (how this might be effected is discussed within our report).
- Ownership of Xoserve would be distributed across the industry (including Shippers and Transporters), with simple rules about shares and voting rights. This could, for example, be achieved through establishing a Company Limited by Guarantee (CLG).

We assessed all the above options and variants against a range of criteria and concluded that the Light Governance model was inappropriate, in particular because it inadequately addresses Shipper concerns and can be argued not to conform to Ofgem's preferred option C model. We also looked at a number of transition and implementation issues; on these we concluded that a number of matters needed to be addressed, that none had the potential to derail a successful and timely implementation and that the industry needed to establish an implementation team to carry forward consideration of a number of issues.

Overall our analysis indicates that all the above models are feasible, but that:

- The Light Cooperative model does not accord with the Ofgem decision on a cooperative model in a number of regards.
- Neither the Full Cooperative model, with all participant ownership, nor the introduction of the Contracted Services Alternative to any model, could be introduced except in a relatively long timescale.
- The Full Cooperative model, with GT ownership, could be introduced by April 2014 and, with proper separation of ownership and control, fully meets the requirements of the cooperative model.

We conclude that the industry should, therefore, consider moving forward on the basis of the Full Cooperative model, with GT ownership. We recognise that the range of choice is narrow, but we think that it arises from three principal drivers:

- Ofgem's decision to move to a cooperative model.
- Key external drivers, including new EU driven changes, Project Nexus and the introduction of the DCC.
- The need for more inclusive arrangements to be introduced sooner rather than later to enable the industry better to meet the challenges of these external drivers.

If the industry wishes to move to more fundamental change, then two options are apparent:

- Establish the Full Cooperative with GT ownership model first and then at a later point move on to either all participant ownership and/or the introduction of the Contracted Services Alternative.
- Maintain the status quo now and move later to develop arrangements over a longer timeframe for change of ownership and/or contracting out.

In either case we would be concerned not to move further too quickly, as fundamental changes could cut against the focus on the external drivers that we have identified. Indeed, we would also argue that maintaining the status quo would not be helpful for the industry as it gears up for the changes introduced by those drivers and that the more inclusive arrangements that we have proposed are a better starting point.

Legal and regulatory framework

As part of our Phase 1 work, we have also considered the legal and contractual framework that would be necessary to carry our proposals forward. Detailed work on these matters is the subject of the next stage of the cooperative model implementation project, but at this point we conclude both that options are available and that there is nothing that indicates to us that there are insurmountable problems that will not allow a satisfactory framework to be developed. The principles of the licence regime that may be required in both Shipper and GT licences to implement our proposed approach, is discussed within this report and its supporting annexes, however, these will need further development as part of Phase 2 of the project.

Recommendation

Our recommendation is that the industry should consider moving forward on the basis of the Full Cooperative model, with GT ownership, coupled with the arrangements we have developed for more inclusive funding and charging. The key elements of our recommended cooperative model are summarised in Figure E.1 below, along with the options for charging and invoicing that we propose are raised as a question for industry consultation.

Figure E.1: Summary of the key elements of our recommended cooperative model

	Governance	Description:	
Full Cooperative Model with GT ownership	Structure	Common service provider (one company) model	
	Ownership	GTs (nominal ownership)	
	Control	All industry participants (i.e. Shippers and GTs)	
	Performance risk	Allocated to all industry participants through financing and cost recovery arrangements	
	Financing	All industry participants	
	Board composition	3 GT and 3 Shipper members with senior Xoserve staff	
	Profit/not for profit	Not for profit, but with the ability to earn surpluses not for distribution *	
	Funding	**Description:**	
	Regulatory control	Some oversight of an annual budget. Step in powers in extremis. GT funded costs allowed for pass-through	
	Budgets	Budget built up from service lines	
	Budget pots	Costs are split into budgets for 'run' costs, change management and demand/development for larger projects	
	Variations from budget	Carried forward and held on the balance sheet. Funded by those who control Xoserve when a threshold deficit is exceeded	
	Charging	Indirect and reflects Shippers gas transportation network use of system	Cost reflective charges allocated to user groups using an appropriate allocation basis
	Invoicing	Current invoicing process. Xoserve invoice GTs and GTs invoice Shippers for transportation charges	Indirect (using existing GT invoicing arrangements) or charges levied as calculated, that is Xoserve would send invoices to Transports and Shippers

Source: CEPA, TPA and ESP

** 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.*

ASSOCIATED DOCUMENTS

Supporting documents

CEPA, TPA and ESP (2012): Future Arrangements for the Gas Transporter Central Agent: Annex A: Comparators Review

CEPA, TPA and ESP (2012): Future Arrangements for the Gas Transporter Central Agent: Annex B: Services and Obligations

CEPA, TPA and ESP (2012): Future Arrangements for the Gas Transporter Central Agent: Annex C: Funding and Charging

CEPA, TPA and ESP (2012): Future Arrangements for the Gas Transporter Central Agent: Annex D: Corporate Governance

CEPA, TPA and ESP (2012): Future Arrangements for the Gas Transporter Central Agent: Annex E: Legal and Regulatory Frameworks

Associated documents

Ofgem (2012): Open letter to Gas Distribution Networks on Project Nexus gas settlement reforms

http://www.ofgem.gov.uk/Markets/sm/strategy/Documents1/Open%20letter%20to%20Gas%20Distribution%20Networks%20on%20Project%20Nexus%20gas%20settlement%20reforms.pdf

Ofgem (2012): Open letter: Review of Xoserve – Ofgem's conclusions

http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/120116_xoserve_decision_letter.pdf

Ofgem (2011): Open letter consultation: Review of Xoserve

http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/xoserve_covering_letter.pdf

CEPA (2011): Review of Xoserve Funding, Governance and Ownership, Final Report

http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/CEPA_Xoserve%20Review%20_%20Final%20report%20_%20for%20publication.pdf

Ofgem (2011): Decision on strategy for the next gas distribution price control - RIIO-GD1 Outputs and incentives

http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/GD1decisionoutput.pdf

1. INTRODUCTION

A consortium of CEPA, TPA Solutions and ESP Consulting has been commissioned by Ofgem to develop options and recommendations for future funding and governance arrangements to support the range of centralised data services currently provided by the Gas Transporters (GTs) appointed agent Xoserve. This report will support a future consultation on these arrangements by Ofgem.

1.1. Ofgem's review

In its May 2011 RIIO-GD1 strategy decision,[2] Ofgem set out its intention to undertake a review of Xoserve's current funding, governance and ownership arrangements. The purpose of the review was to examine whether the current arrangements facilitated the provision of an efficient and high quality service, and one that is responsive to network users' needs, and wider industry change.

In July 2011, Ofgem commissioned CEPA to undertake an independent review of the current arrangements. Given a number of issues and challenges that were identified by the CEPA report,[3] in September 2011 Ofgem issued an open letter consultation which set out the potential options for change based on CEPA's review and the options set out in that report.[4]

The first option, Option A, set out changes aimed at optimising the arrangements within the current governance and ownership (i.e. owned by the GTs) framework. Option B and C involved more fundamental change, including establishing a separate licensed entity (Option B) or a more co-operative model (Option C).

In January 2012 Ofgem issued a decision letter, where it concluded that a "co-operative" model (i.e. Option C) represents the optimal set of future funding and governance arrangements to support the range of centralised data services currently provided by Xoserve.[5]

Ofgem's proposed model contrasts with the current arrangements where control over data services rests with the GTs, and the majority of costs are funded indirectly through their regulated network charges. Ofgem considered that Option C would best address the concerns expressed by the industry about their influence over decision-making, transparency and flexible funding, and would enable the industry to effectively respond to future challenges for data services.

1.2. Our terms of reference

In the January decision letter, Ofgem did not reach a decision on the details of the new arrangements for Xoserve. Instead, it proposed to establish an implementation project to determine the precise funding, governance and ownership arrangements within the ambit of option C (i.e. where the governance of services rests with the industry).

[2] Ofgem (2011): Decision on strategy for the next gas distribution price control – RIIO-GD1 Outputs and incentives

[3] CEPA (2011): Review of Xoserve Funding, Governance and Ownership, Final Report

[4] Ofgem (2011): Open letter consultation: Review of Xoserve

[5] Ofgem (2012): Open letter: Review of Xoserve – Ofgem's conclusions.

Our terms of reference require us to undertake this implementation project. This initially involved developing options for future co-operative arrangements and to then make recommendations based on our analysis and industry consultation. This included arrangements for the provision and funding of data and information services, corporate governance, ownership and control. This forms the content of this report.

In the next stage of the project, our terms of reference will require us to draft and develop licence conditions to give legal effect to the proposed new arrangements following a non-statutory consultation and decision by Ofgem. As part of this second phase of the work, we will also be asked to identify UNC changes to give effect to the new arrangements.

The project then has a third and final phase, involving the task of developing legal structures and documents to support these new arrangements, including the underpinning contractual framework. While developing these arrangements is not within our terms of reference, there are interactions with both the first and second phases of our work.

Following the conclusion of the project, or possibly in parallel with its later stages, the industry will need to establish implementation arrangements. Again this is an item that is outside our terms of reference, although we discuss certain transition and implementation issues later in this report.

1.3. Our approach

Our approach to the project has to date involved a number of distinct phases which relate to various elements of Ofgem's terms of reference.

Our initial work, focused on understanding better the things that Xoserve does and determining the range of matters that needed to be determined to enable a move to the cooperative model, of which there are various forms. To deal with other issues raised by the industry, we also considered charging structures and regulatory controls. We undertook the work through a variety of channels, including a number of meetings with the industry both bilaterally and in working and steering groups.

In developing our proposals, we were guided by a number of core principles, in particular that: decisions about service provision should rest with the users of those services, largely but not wholly through industry governance arrangements; that costs of services should be recovered directly from users; that charges and costs more generally should be made much more transparent; and that obligations and risks should be aligned with funding and control.

1.4. Report structure

The rest of this report is structured as follows:

- Section 2 provides a description of the current Xoserve arrangements, together with issues associated with those arrangements and future challenges to be met.
- Section 3 discusses a number of cooperative model options.
- Section 4 sets out our assessment of the options and our recommendations.

- Section 5 concludes.

A series of supporting technical annexes which are published as separate documents provide supporting analysis and detail of the issues discussed within this report:

- Annex A provides a review of funding and governance arrangements for comparable data, information and market facilitation service providers in the utilities industry.
- Annex B provides our analysis of the services provided by Xoserve including their demand and supply side characteristics.
- Annex C outlines our funding and charging proposals including our detailed analysis and illustrations of how these arrangements might work in practice.
- Annex D discusses options for corporate governance arrangements, focusing on the building blocks for different models and the revised proposals that arose from the working groups.
- Annex E then provides a more detailed analysis of the possible legal and regulatory structures to give effect to new arrangements.

Appendix A accompanying this report sets out a timeline of the milestones in the implementation project to date and the work programme going forward.

Appendix B then summarises the existing legal and regulatory framework for centralised data services as defined through a GT Agent role.

2. DESCRIPTION OF THE CURRENT ARRANGEMENTS

This section provides a description of the current Xoserve arrangements, together with issues associated with those arrangements and future challenges to be met.

2.1. Current arrangements

Xoserve was established at the time of Distribution Network (DN) sales. The GTs were provided with a licence obligation (Standard Special Condition (SSC) A15) to appoint an agency (the "GT Agent") for the common provision of certain services and systems to fulfil several of their obligations under code and licences. The GTs' obligation to appoint an Agent was satisfied through the creation and appointment of Xoserve in 2005.

2.1.1. Services and obligations

The range of centralised services and systems provided by the appointed GT Agent are defined primarily within the Uniform Network Code (UNC) and GT licences. Xoserve's business is the supply of many of the core information system and data services required for the gas industry to operate, both in terms of network and market operations, defined within these regulatory and commercial arrangements as GT obligations.

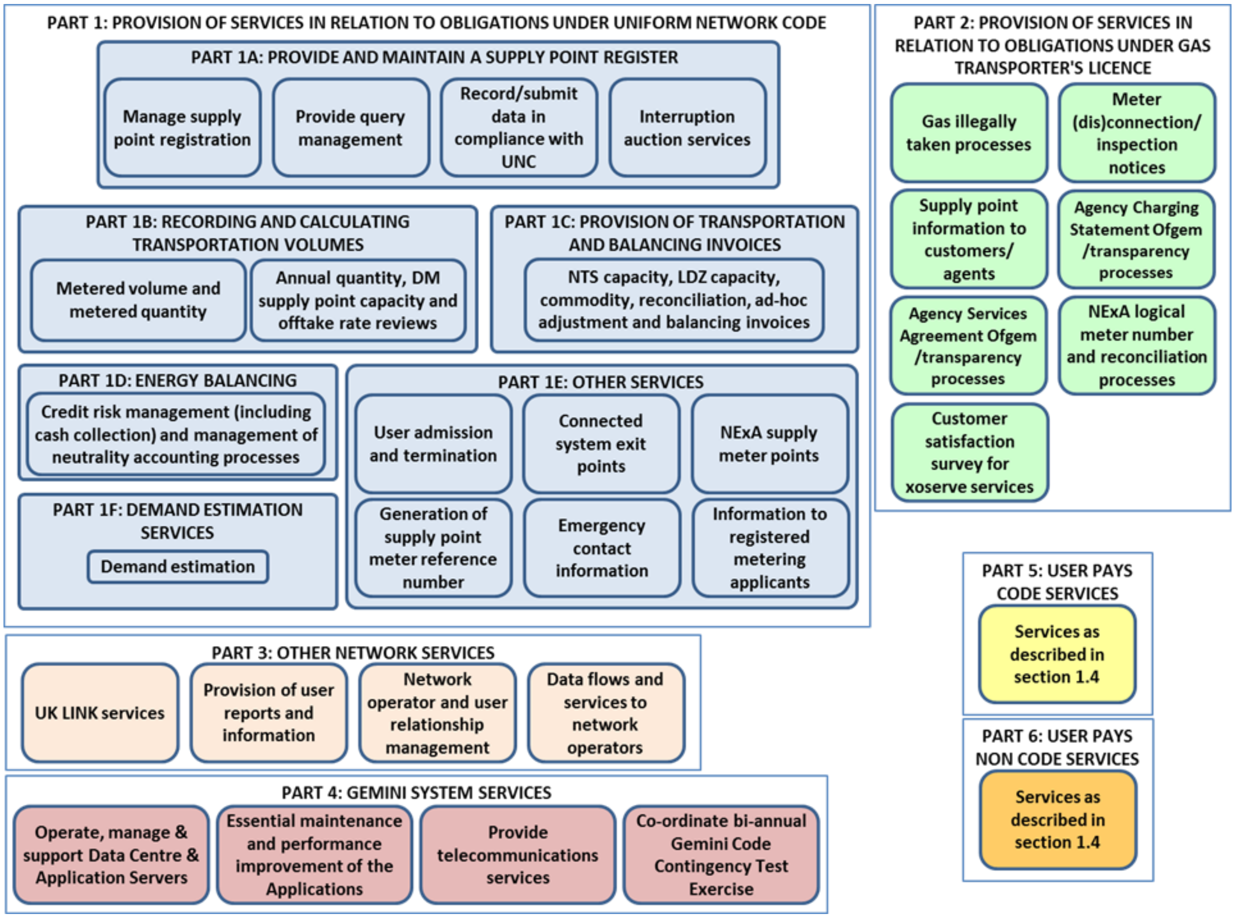
These regulated services comprise what are currently termed "Core Services", "Code User Pays Services" (User Pays Services for which the GTs have UNC responsibilities) and "Non-Code User Pays Services" (User Pays Services for which the GTs have licence responsibilities). Xoserve also currently provides various non-regulated services to Shippers and other customers under bilateral contractual arrangements.

Core Code and Non-Code User Pays GT Agent activities are currently set out within an Agency Service Agreement (ASA) between Xoserve and the GTs (see Figure 2.1 overleaf).

The ASA captures and categorises the services provided by the Agency and is the primary contract between the Agent and all the GTs to provide services either directly to them, or on their behalf, to Shippers. The ASA is the primary means by which the GTs (as Xoserve's contractual counter-parties) are able to control the discharge of their obligations through a collectively appointed Agent. Xoserve, however, bears only very limited liability to the GTs for its delivery of such services, with the majority of such liabilities flowing back to its GT owners.

Framework agreements between Xoserve and Shippers also apply for services for which GTs have regulatory licence obligations to deliver, but which sit outside GT UNC responsibilities (known as Non-Code User Pays Services). The company also provides certain services through additional bilateral contracts. These bilateral agreements are used for the specific customer service requirements which are provided directly to Shipper and other business customers. They are, however, only a relatively small part of Xoserve's business as compared to the regulated services provided to the GTs under the ASA.

Figure 2.1: ASA service lines and activities



Source: CEPA, TPA and ESP analysis

2.1.2. Funding and charging

Funding refers to the way in which Xoserve is remunerated for the services it provides. At the previous Gas Distribution Price Control Review (GDPCR) Ofgem changed the funding arrangements for Xoserve introducing a Core Services and User Pays approach. Under this approach regulated services provided by Xoserve are classified as:

- *Core services* – regulated services that it was deemed appropriate to fund using price control allowed revenues (c. 90% of Xoserve funding). The allowed costs associated with these services are recovered by the GTs across all customers through gas transportation charges.[6]
- *User Pays services* – regulated services that it was deemed appropriate to be funded by the user(s) requesting the service.[7] Revenue from delivery of User Pays services is treated as excluded from GTs' price controls.[8]

[6] Price control funding was fixed for a five-year period under the current transmission and gas distribution price controls and has been extended to eight years under RIIO-T1 and RIIO-GD1 (which will take effect from April 2013).

These arrangements have meant that for the GDPCR period, the GTs have been funded for Xoserve's activities through a combination of price controlled and excluded services revenue with the ASA and contracts for Non-Code User Pays Services providing the means for Xoserve to recover its costs related to Core and User Pays services.

2.1.3. Corporate governance and ownership

Xoserve is a limited company jointly owned by the GTs, with National Grid Gas plc holding around 51% of the A shares (in respect of the Distribution Networks owned by it) and all of the B shares (in respect of its National Transmission Business), aggregating to around 56.6% of the issued share capital of the Company (the Articles of Association of the Company provide that the A Shares and B Shares rank pari passu in all respects). Scotland Gas Networks and Southern Gas Networks (both under common group ownership) hold around 23% in aggregate of the issued share capital, Northern Gas Networks 10.4 per cent and Wales & West Utilities 10 per cent.

The balance of shares reflects the supply point portfolio sizes at the time of DN sales.

The company's corporate governance arrangements reflect this ownership structure. The Board of Directors is comprised of directors nominated by each of the shareholders. There is also a non-executive Chairman who is not a director. The legal holding company of Xoserve is National Grid Gas plc and its ultimate parent company is National Grid plc. There are however certain matters which require special majorities of either the directors or the shareholders, restricting National Grid's ability to unilaterally exercise its majority ownership position.

2.1.4. Implications of the current arrangements

The principal aims of the structure developed at DN sales were to ensure a continuity of National Grid Gas (then called Transco's) service provision and to ensure that the newly divested GDNs were not at a disadvantage to those that continued to be owned by National Grid.[9] As GT (code and licence) obligations are undertaken by Xoserve, this is a clear Principal-Agent relationship, in which GT obligations are delivered by Xoserve.

Key aspects of this include:

- As set out, very limited liabilities of Xoserve for failure to perform services under the ASA with the ultimate liabilities for failure to deliver service obligations borne by its GT owners (the "Principals" in the relationship).

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[7] Charges for Non-Code User Pays Services are levied directly on Users. Code User Pays Services are charged to GTs who, in turn, invoice Users. Charges for User Pays Services vary by demand for the services (as set out in the Xoserve User Pays Agency Charging Statement).

[8] One of the objectives of the User Pays arrangements was to introduce more flexibility into the funding arrangements that were established at DN sales.

[9] Further aims of the structure developed, were to minimise the impacts of the GDN sales on users, to avoid the need for the new GDNs to replicate IT systems, and to establish a business that could deliver non-regulated services additional to the UNC.

- A tight contractual framework, in particular the ASA, to help ensure that GTs were provided with the requisite level of contractual clarity to ensure GT Agency activities as set out in the UNC were fulfilled (and arguably, to reinforce protections for the minority shareholders).
- A Board comprising directors nominated by the shareholders of Xoserve (i.e. all GTs following DN sales) with which to ensure control of its operations, with the ultimate parent company, however, being National Grid plc (subject to the limitations on exercising its majority ownership position referred to above).

2.2. Issues with the current arrangements

As set out in the introduction, in its May 2011 RIIO-GD1 strategy decision, Ofgem set out its intention to undertake a review of Xoserve's current arrangements as described above.

This review was in response to Shippers' concerns about whether the current arrangements would provide the required responsiveness and flexibility in funding and governance in the context of future industry changes, notably the roll-out of smart metering.[10]

To support the review, Ofgem commissioned CEPA to initially undertake an independent review of the current arrangements.[11]

While we were not asked to review Xoserve's performance *per se*, we were asked to assess whether current funding and governance arrangements as set out above, have either supported or hindered the achievement of regulatory objectives.

Whilst in general there was a degree of satisfaction with the existing services provided by Xoserve, the review identified a number of concerns based largely on a perception of:

- first, *poor responsiveness* to requests made by Shippers – particularly for services driven by change within the sector and which perhaps are more challenging or requiring a greater degree of resource or more innovative approach; and
- second, a degree of unease and even suspicion, regarding a general *lack of transparency* in the arrangements, particularly as regards how charges for services are derived and their consequent value for money and how strategic decisions affecting the industry are taken.

We concluded that the arrangements put in place for Xoserve's funding and governance, in particular, helped to explain these observations.

The restrictions created by the ASA arrangements, the ambiguity that exists as regards customer relationships and the indirectness of payment flows, all contributed, in our view, to the observed lack of transparency and service responsiveness. Indeed, irrespective of the efforts made by Xoserve's management in improving customer management, these arrangements and structures were

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[10] See Ofgem (2011): Decision on strategy for the next gas distribution price control – RIIO-GD1 Outputs and incentives – Section 5

[11] CEPA (2011): Review of Xoserve Funding, Governance and Ownership, Final Report

likely increasingly to militate against success as Shipper and Supplier demands continue to increase as a result of changes within the sector (see discussion below).

We also concluded that such problems are compounded by Xoserve's funding arrangements in at least two ways:

- Because a large proportion of the costs of Xoserve are funded from GTs' price controlled revenues, and are not a pass through item, the GTs are not incentivised to support Shipper led initiatives, both because of the risk of under recovery of the associated spend and also because such spend may crowd out different GT initiatives.
- The funding arrangements are more suitable to a large capital network operator, rather than an IT and information services provider; for the latter it is extremely difficult to forecast with any precision funding requirements over a five, and now an eight, year time horizon. A more flexible means of funding would be more consistent with the investment requirements of such systems.

Finally, but perhaps to a lesser degree, we also noted that Xoserve's ownership and corporate governance regime have not been appropriately focused to address these problems and have thus also contributed to the observed problems. Whilst there is a logic to current ownership arrangements and Xoserve's board fulfil its fiduciary obligations, there is little evidence of a corporate ambition beyond meeting the core requirements of the ASA. The absence of ownership or control adds to the perceived lack of transparency on the part of other stakeholders.

In September 2011, Ofgem issued its open letter consultation which set out the potential options for change based on CEPA's review, and in October 2011 Ofgem held an industry round table discussion to consider the potential options.

Industry responses to the consultation, and the discussion and feedback from the industry round table event, helped to confirm the opinions amongst stakeholder groups that were identified through the initial CEPA review.

Most respondents to Ofgem's consultation believed that the current price control arrangements had provided strong incentives to minimise costs, and the arrangements worked well where the outputs/policy environment was stable. However, most respondents, including Xoserve, the GTs and Shippers, considered that more flexible funding arrangements (as opposed to a fixed 8-year ex-ante allowance) would be required for the next price control to accommodate uncertainty in relation to data services supporting the retail market.[12]

Most respondents also considered that the current arrangements did not provide sufficient transparency with regard to the costs associated with delivering change. The reasons cited included the small proportion of revenues accounted for by Xoserve as a total of GT price regulated revenues (less than 1%), and the lack of clarity of the funding and associated outputs agreed at the price control. Respondents also expressed concern about the User Pays model, including the weak

[12] See Ofgem (2012): Open letter: Review of Xoserve – Ofgem's conclusions, p. 3

incentives on GTs/Xoserve to develop User Pays services, a complex cost allocation process, and cumbersome recharging arrangements.[13]

With regard to the institutional arrangements, Xoserve and most GTs responses suggested they did not consider that the current corporate ownership and governance arrangements led to the prioritisation of GTs' interests. By contrast, most Shipper responses[14] suggested they considered that the limitations of the current governance arrangements – which confer day-to-day control to GTs – required more fundamental reform to ensure network users have sufficient control over the strategic decisions facing the gas sector and data service provision.[15]

2.3. Future challenges

Looking forward, the gas industry faces a number of changes from the need to adapt to a low carbon economy to delivering security of supply. Part of the challenge is moving towards new energy systems, business models and commercial arrangements which can utilise and support smart and advanced meter data and other strategic changes in markets and transportation systems.

Xoserve has an important role to play in delivering these changes, in particular, supporting new market arrangements such as proposed reforms to settlement arrangements,[16] delivery of Project Nexus[17] and delivery of strategic energy programmes such as the new regulatory and market framework for gas emerging from the third European energy package and the enablement of the smart meter Data Communications Company (DCC).

There was and continues to be, a concern expressed amongst stakeholder groups (again reflected in the industry stakeholder responses to Ofgem's 2011 consultation), as to whether the existing framework for central systems and services, defined through the GT Agency role, given the issues outlined above, has the flexibility and indeed capacity to accommodate these changes, particularly where change is driven by Shipper and Supplier requirements.

2.4. Ofgem decision

Based on the above, in its January 2012 decision letter Ofgem concluded that:

"*We consider there is strong case for changing the current institutional arrangements. As widely acknowledged Xoserve's day-to-day performance is good and improving. However, shippers have expressed dissatisfaction with the current institutional arrangements and the management of change. Consistent with most respondents, we have concerns*

[13] See Ibid.

[14] The main exceptions being the I&C Shippers and Suppliers (ICOSS) group and Scottish and Southern Energy (SSE) (which responded jointly with Scotia Gas Networks (SGN)).

[15] See Ofgem (2012): Open letter: Review of Xoserve – Ofgem's conclusions, p. 3.

[16] See Ofgem (2012): 'Open letter to Gas Distribution Networks on Project Nexus gas settlement reforms' http://www.ofgem.gov.uk/Markets/sm/strategy/Documents1/Open%20letter%20to%20Gas%20Distribution%20Networks%20on%20Project%20Nexus%20gas%20settlement%20reforms.pdf

[17] Project Nexus has been Xoserve's vehicle for defining the scope and the nature of Xoserve's future services that future IT systems might need to support.

about the inflexibility of funding arrangements associated with funding Xoserve through GT revenues, as well as the ownership and governance which rests solely with the GTs."[18]

Having considered the industry's views on whether incremental or more fundamental change was required to address the limitations of the current arrangements, based on the options A to C consulted on in the September 2011 open letter, Ofgem concluded that a cooperative model represented the optimal set of arrangements going forward:

"*We consider that* [a cooperative model] *represents the optimal set of arrangements. This is the only option that assigns control for the delivery of the data services supporting the supplier market to those that will principally rely on such services, i.e. shippers and suppliers.* [A cooperative model] *will also provide more flexible funding arrangements for new services by recharging the cost of such services to market participants (as opposed to fixing allowed revenues on an ex-ante basis). We also consider there is significant merit in removing Ofgem from the process of periodically determining outputs and associated funding levels. Under* [a cooperative model], *our role will be minimised.*"[19]

In the section which follows, we outline the options that we have developed regarding the introduction of a cooperative model based on Ofgem's decision.

[18] Ofgem (2012): Open letter: Review of Xoserve – Ofgem's conclusions, p. 3-4

[19] Ofgem (2012): Open letter: Review of Xoserve – Ofgem's conclusions, p. 6

3. OPTIONS FOR THE INTRODUCTION OF COOPERATIVE GOVERNANCE

In this section we summarise the options that we have developed regarding the introduction of various cooperative governance options.

3.1. High level approach

As discussed in the introduction, our project brief follows on from the Ofgem decision letter of 16th January 2012 in which the Authority decided that it wanted the industry to adopt a cooperative model for the provision of centralised data services.

In defining the cooperative model, we focused on funding, corporate governance and ownership. It is important to note that matters of industry governance, especially relating to UNC modifications, were not in our scope.

We came to the conclusion that Xoserve is a body that is tasked with delivering specific services required by GT licences or the UNC, and that it is for the industry, working through broader governance arrangements, that decides *what* it is that Xoserve does – our governance will focus instead on *how* Xoserve best delivers what is required of it.

Based on Ofgem's decision letter and the need to ensure any new cooperative arrangements were internally consistent, in developing our proposals, we were guided by a number of core design principles, in particular that:

- decisions about the future provision of data and information services should rest with the users of those services;
- the costs of services (wherever practicable) should be recovered directly from users to reflect a more direct relationship between the service provider and all its customers;
- charges and costs should be made much more transparent; and
- alignment of obligations and risk with control – corporate control aligned with those responsible for managing performance and delivery risk.

We were also conscious that simplicity and ease of implementation - particularly at a time where there are significant other changes on-going within the industry - were important design principles and that any risks and transition issues to implementation with different approaches would also need to be taken into account.

As required by our terms of reference, during the initial phase of our work we also undertook a relatively detailed review of arrangements for other data, information and market facilitation service providers within the utilities industry. The findings and conclusions of this review are summarised in Annex A accompanying this report.

One of the main findings which emerged from this comparator analysis was that the utilities industry (albeit to different degrees) has increasingly moved towards a central service provider model in relation to systems and processes that utilise common data and provide similar or identical services built around the processing of those common data. These businesses are often required to operate very transparently in the delivery of both their regulated and more commercial based services to a range of industry stakeholder groups.

Different funding and governance arrangements are then in place within this overall service delivery model. Given the criticality of the services being provided, there was also a degree of regulatory oversight and control, although the other comparator models in general had lighter regulatory oversight as compared to the existing arrangements for Xoserve.

We contrast our proposals for cooperative governance of Xoserve with other central service providers in the utilities sector as part of our assessment in Section 4.

3.2. Paradigm shift

Given these findings, in developing options a key question which we gave consideration to was whether in future, the services provided by Xoserve should continue to be on an agency basis on behalf of network operators (that is, gas transporters) or whether they should be supplied by a central industry service provider, controlled by the industry as a whole. This latter approach would represent a major shift of paradigm from how the gas industry currently operates, albeit one as discussed above which has already been accepted to varying degrees by other utility industries.

This might be seen as an evolution from something that was initially completely embedded within the vertically integrated Transco. Following the divestment of some distribution assets there is now a need to facilitate markets at wholesale / transmission and retail / distribution levels. Xoserve supplies the type of information that is integral to smooth operations within and between these different markets.

The implication of this latter approach is that Xoserve is less of an Agent, but more of a Principal in its own right: in other words, describing it as an agent would be technically incorrect: it is a Central Services Provider, rather than a Central Agent. This has a number of implications, including but not limited to:

- where regulatory and other obligations should sit; and
- control of the Central Service Provider.

Looking at Xoserve, we proposed that such a change of paradigm should be considered through this project, and, therefore, any future arrangements needed to begin with an assessment of the economic (both demand and supply) characteristics of the services which it provides to various parties, and the appropriate regulatory protections and corporate control arrangements for such a Central Services Provider.

While we understood that at some point regulatory obligations, such as those set out in licence and Code, would need to be reconsidered, at this stage of the project we considered it important that such obligations are much more an outcome of a consideration of the services Xoserve provides, and the optimal funding and governance arrangements of a Central Service Provider, rather than an input to that consideration.

3.3. Options

Having developed core design principles, we developed a set of options for cooperative arrangements consistent with those principles. This included the arrangements for the provision of data services, as well as budgeting and charging processes, options for corporate governance arrangements and potential regulatory arrangements.

3.3.1. Arrangements for the provision of data services

Our initial task involved considering the characteristics of the services provided by Xoserve, in particular, how they are used by GTs, Shippers and Suppliers, and the optimal structure for centralised data and information services under cooperative governance arrangements. In this respect, a key question that we were asked to address was the extent to which the common service provider model should be retained under cooperative governance arrangements.

Based on our own analysis and various feedback from industry consultations, we propose that common service provision should be retained where more cooperative governance and funding arrangements are adopted for those data and information and IT services going forward. This reflects our conclusions that:

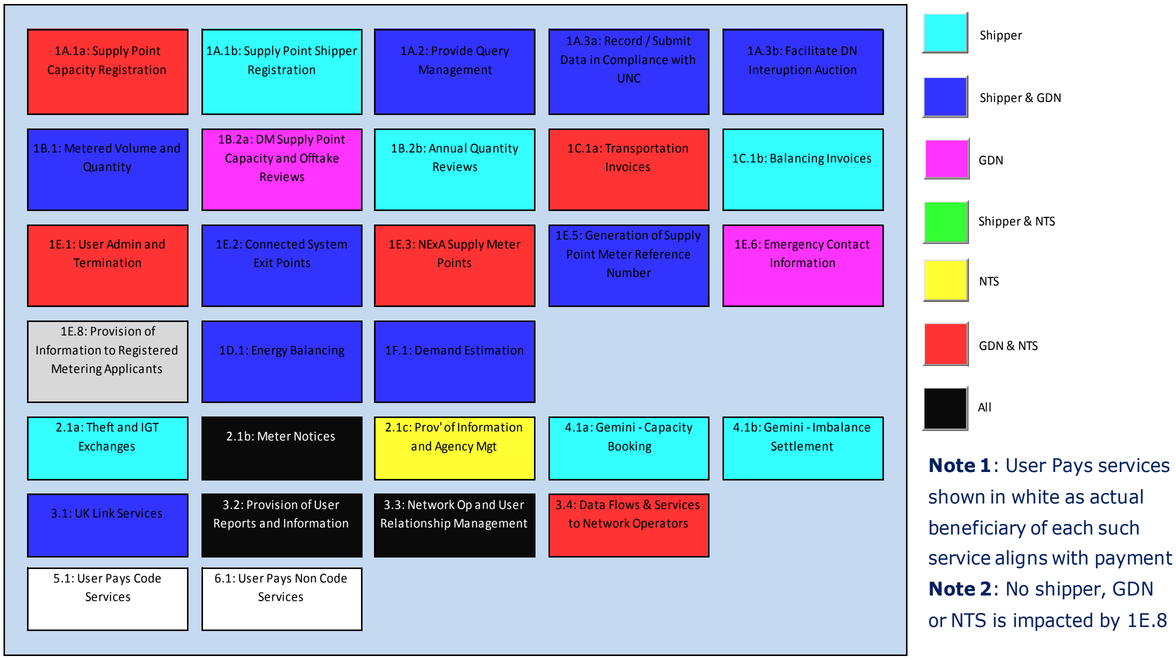
- a number of industry participants had highlighted their requirement for a *common* IT systems and services provider;
- while central service provider service lines can be categorised, and the primary beneficiaries of services in most cases identified, the majority of the service categories in the current ASA have a least some impact on more than one party or type of party (see Figure 3.1 overleaf);
- there are benefits (in terms of economies of scale and scope) from the retention of common service provision arrangements;[20]
- the costs and risks of separating or cloning the systems appeared significant, given the age, interconnected nature and custom design of those systems; and therefore
- partitioned corporate governance of the service provider by service line would be inappropriate, given how services are currently used and delivered.[21]

We also determined that the data and information services provided by Xoserve can be categorised along agency service lines and that the primary beneficiaries of the service lines can in most cases be identified. We therefore propose, consistent with our paradigm shift, that in future services be organised and charged in this way (see Section 3.3.2 below).

[20] Applying Xoserve's Activity Based Costing (ABC) methodology indicates that about 52% of operating 'run' costs are directly attributable to individual service lines and that the remaining 48% have to be allocated as they arise from shared systems and processes. There is, therefore, a high degree of common, and indeed fixed, cost in the supply of existing GT Agent services and activities which give rise to economies and scale and scope.

[21] Most services use four or more IS systems, so service delivery and the IS systems themselves are heavily interlinked

Figure 3.1: Impact of services on stakeholders[22]



Source: CEPA, TPA and ESP

Our analysis of the economic characteristics of the services which Xoserve provides which informed our conclusions is set out in Annex B accompanying this report.

Having proposed to retain the common service provider model, we then sought to develop funding and governance structures consistent with these arrangements.

3.3.2. Funding and charging arrangements

Funding is essentially about who pays for services, whereas charging relates to the manner in which costs are recovered.

As discussed in Section 2, limited transparency of costs (how costs and charges relate to budgeted service lines and major projects) and limited funding flexibility (in particular, the difficulties of determining IT investment requirements five to eight years in advance) were two of the key issues which were raised with the current arrangements whereby the GTs are funded for the provision of services by their central agent, Xoserve, through a regulatory allowance.

The objective for this project, however, is to move away from regulatory allowances and instead to design funding arrangements that promote transparency amongst industry participants and are fit for purpose for the funding of a data, information and IT services company. This was reflected in both the funding and charging arrangements which we developed.

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[22] To produce this analysis each stakeholder group was assigned a colour, which was varied from pale to strong with the average response score from that stakeholder grouping (pale being low, strong being high). The prime colours for each stakeholder being: Cyan – Shippers; Magenta – GDNs; Yellow – NTS. As more stakeholders were identified as impacted by different services, the colours were combined to indicate the balance of opinion over that component.

The options we developed (informed by feedback from various industry consultations and working groups) are set out in the subsections below. These cover four key dimensions including: extent of regulatory control; budgeting; cost allocation and charging; and invoicing. More detailed analysis of each of these funding dimensions is provided in the funding and charging annex (Annex C) accompanying this report.

Regulatory control

Given that one of the proposed benefits of a cooperative model, as set out in Ofgem's decision letter, was the potential to remove the regulator from the process of periodically determining outputs and associated funding levels, we gave careful consideration, based on our own analysis and feedback from industry consultations, to the question of the necessary extent of regulatory control over the cooperative funding arrangements of the central service provider.

We propose that the regulator should have some oversight of the annual budget and should have step in powers *in extremis*, as similar arrangements are in place for other regulated central service providers within the utilities industry.

For example, linked to our proposals on corporate governance (see below), it can be expected that different views will be expressed by different Board members under new arrangements, and it is possible that there will not be consensus over the proposed budget. In the annex on governance issues (Annex D) we suggest methods of resolving deadlock which could be used, amongst other things, to ensure that a budget was agreed.

However, such a process might leave one or more parties concerned that their interests were not properly reflected in the budget, so we consider that it would be appropriate for some ability to appeal to Ofgem, but only on substantive issues, say regarding the ability of the central service provider to fulfil its contractual or Code obligations within the proposed budget.

If the appeal was upheld, Ofgem would need appropriate powers to be able to direct budget modifications accordingly.

A more specific issue is the extent to which the central service provider's costs should be subject to some form of price regulatory control and therefore efficiency incentive.

If a separate service provider model for the GTs and Shippers were economic and practicable, and the cost element of GTs required services stable (i.e. without changing service provider outputs and therefore funding requirements) it might be feasible to retain the current regulatory control arrangements for those services required by the GTs for their businesses. However, our analysis of services (see above) clearly shows that both the use and delivery of individual services is currently highly integrated involving common cost.

Where a common service provider model is retained under cooperative arrangements, then the GTs and Shippers would need to collectively fund the common provider according to the agreed cost allocation and charging arrangements (see below). GTs however, are subject to regulatory price controls, while Shippers operate in a non-price regulated market.

Therefore, to ensure that both GT and Shipper constituency groups have the same flexibility to fund the common central service provider, and to avoid the tensions that exist under the current funding arrangements organised around price controlled regulatory allowances, we propose the full removal of regulatory price controls from all constituencies, with service provider costs recovered from the GTs therefore treated as pass-through items under their price controls.

This then raises the question of how to best impose budget discipline and promote cost efficiency from the service provider, in the absence of an ex ante price controlled regulatory allowance, which, as noted in Section 2, has historically provided strong cost discipline, albeit arguably at the expense of allocative efficiency.

We address this issue through the budgeting and charging arrangements that are discussed in the subsections which follow.

Budgeting

Under a cooperative model, there would need to be an annual budgeting process to replace the price control review which determines the large proportion of the funding for Xoserve's services under the current arrangements.

Our core proposals for how this could work are as follows:

- Budgets should be based on service lines. Whilst we accept that there is a significant proportion of costs that are shared, we consider that using an appropriate allocation methodology, such as the ABC approach currently in use in Xoserve, the costs of each service line can be determined.
- An *ex ante* budget should be developed and agreed annually. This budget would include:
  - *business run costs* for example, the day to day delivery and provision of data and information services;
  - *change management* costs to accommodate day to day engagement and diagnostic services to facilitate industry change (e.g. UNC modification development work including impact assessments up to the point of modification approval); and
  - *demand / development* costs that reflect major projects envisaged as in various states of development within the year - these costs would be supported by a longer term plan for the business.
- The industry would control expenditure, at a high level, through the approval of published annual budgets. The budget would be in the public domain to ensure total transparency and would be driven by industry requirements.

We propose that charges would be derived from the *ex ante* budgets (see subsection below). A key issue then is how variations against the *ex ante* budget would be managed given the issues around budget discipline and cost efficiency outlined above.

The options that we identified for potentially imposing cost efficiency through a cooperative budgeting process are as follows:

- Require transparency over budget setting and agreement to the budget from all parties. This reflects our proposals above.
- Seek to introduce incentives for the central service provider and those who control it to manage cost efficiency.

The necessary encouragement towards cost efficiency we believe is best exercised by careful scrutiny of the budget and the changes from previous years.

As described in Annex C, a report accompanying the annual budget should facilitate that scrutiny by providing relevant information on cost trends, key factors influencing input costs and so forth. Board members should be in a position to consider this against the same trends in their own IT departments, to improve their scrutiny.

As regards incentives, we propose that any variations against budget should be a matter for the central service provider and those who control it, with different rules to then determine who would bear what risk. As discussed as part of the corporate governance options below, performance and other risks should lie with those best able to control them.

However, as incurred costs would be recovered from the same users and parties who control the central service provider, hence the cooperative model, to achieve the intended allocation of risk, we needed to develop alternative arrangements focused on reputational risk as opposed to financial risk. We propose the following for consideration:

- Any cost variation within the central service provider is not passed through in its charges, which are therefore based on its *ex ante* budget, but are carried forward and held on its balance sheet, creating a financing cost.
- If the trend of adverse variations continues, the amount held on the balance sheet increases. At some point, triggered say by a threshold being exceeded, those who control the central service provider are required to fund the deficit.
- Such a funding could only be agreed in an Annual or Special Meeting of all members of the company and would of itself trigger a letter from Ofgem regarding future controls and clarification on budgeting overspends.[23]
- In the event that a deficit needed to be funded in such a way this would however, still be treated as a pass-through cost for all constituencies; the letter from Ofgem would create a reputational incentive for this event to be avoided.

[23] The analogy which was used in the industry working groups is that the threshold which triggers the letter to Ofgem would operate to a similar principle as the Governor of the Bank of England having to write to the Chancellor of the Exchequer to explain an event where the inflation target is missed.

We suggest that such a process would create circumstances that both management and owners would seek to avoid, which ought to ensure a sufficient degree of oversight by both.

If this proposal is adopted, further consideration is needed of how any deficit below the threshold for refinancing is funded. This may be possible simply through working capital management, if the amount is small, or through drawing on reserves if any have been established.

The other area of cost variation is agreed changes to the budget. We propose that such changes should be allowed only in carefully defined circumstances, to stop them being used to deal with other forms of cost variations.

Those circumstances might include:

- A change of scope for systems due to the introduction of approved modification proposals whose costs were not in the annual budget.
- A drawdown, using approved change control procedures, of an element of a previously agreed contingency amount – this would probably apply only to major projects.

We would expect that effective management and control of these arrangements would be enforced through the governance of the central service provider.

Further details on the different elements of the budgeted process outlined above, are provided in Annex C to this report.

Cost allocation and charging

Having established a budget based on service lines, the next issue is who should fund particular costs and how they should be recovered. Following industry consultation and feedback, there appear to be two options which could be adopted in this respect.

- <u>Option 1 – Transportation charges</u>

  The first option (which we have termed Option 1) would involve a continuation of the current arrangements where the majority of central service provider costs are recovered indirectly through GTs transportation charges (except incurred costs would now be a pass-through under the GTs price control arrangements under RIIO).

  This would mean that the central service provider would continue to be funded by the GTs but the costs are ultimately recovered from Shippers according to their use of system and the GTs charging methodologies and the costs ultimately passed through to the end-consumer. This would mean the service provider costs continue to be only a small percentage of the GTs transportation charges.

- <u>Option 2 – Service charges</u>

  The alternative (what we have termed Option 2) would be to develop more cost reflective charging arrangements by service line costs.

Having categorised the central service provider's services and activities and having proposed that different budgetary costs would be aligned to service lines using an agreed allocation methodology (such as Xoserve's existing ABC methodology) under this approach the principle of cost causality would be applied to develop service line costs into a set of central service provider charges.

We propose that the primary GT or Shipper beneficiary groups should be charged in the first instance for different service line costs. This would include business run costs and potentially also the change management budget. The demand/development for major projects we proposed would also be allocated to relevant user groups.

The principle we adopted, therefore, was that where direct costs can be clearly attributed to a service line they should be, with common costs being allocated using an agreed methodology. As such, the purpose of this exercise is not to determine a precise cost allocation methodology for different types of cost, but rather to agree the principle of such a rules-based approach.

Having identified categorised services and activities and allocated costs to industry participant groups, the next stage would be to develop those costs into a set of central service provider charges. These might differ by service line to reflect different cost drivers, for example, some service charges might be structured according to market share by supply point, whilst others might be by, say, commodity gas.

There was a general preference from industry participants at the working groups for aggregated charges as opposed to arrangements, for example, where charges would be broken down by service line. It was considered that a budget built up as described would provide the cost transparency considered required within the industry.

Consistent with the feedback we received from industry consultation, we propose that while charges would be cost reflective and aligned with service lines under Option 2, all users of the central service provider would receive only one single monthly invoice from the central service provider.

Invoicing

Under Option 1, the GTs would fund the central service provider and would recover these costs through invoicing of Shippers for transportation charges.

Under Option 2, there are two main approaches to invoicing the proposed aggregated charges:

- One approach is that charges could be directly levied as calculated, that is Xoserve would send (monthly) invoices to Transporters and Shippers. The mechanics of this approach would be dependent upon the contractual framework ultimately adopted. We have termed this 'direct invoicing'.
- The alternative would be to develop more cost reflective charges for Xoserve service lines and apply the existing user pays invoicing mechanism for cost recovery. Under this

arrangement the GTs would levy charges on Shippers, and pass these directly back to Xoserve. We have termed this 'indirect invoicing'.

Based on feedback from the industry working groups, it is clear that there are differing views amongst industry participants of the appropriate charging and invoicing arrangements for the cost recovery of budgeted central service provider costs, some preferring direct charges from Xoserve, others preferring the GTs use of system charges as currently. We consider this issue further as part of our assessment in Section 4.

Summary

Figure 3.3 (overleaf) summarises the high level key features and options of our proposed funding arrangements including the budgeting, cost allocation and charging model.

As illustrated, we have identified two options, with the arrangements around budgeting generally remaining common to both options with the key differentiating factor being the approach adopted to charging and invoicing.

Option 2 (Service charges) would need to be developed further during the implementation period. Until that is done, it will not be possible to determine precisely how the charges faced by each participant will change, if at all. We do not think that this should influence initial decisions on the appropriate way forward for service lines and funding, for the following reasons:

- Our proposals for full pass through mean that, whatever the changes, Transporters are not disadvantaged.
- Because the total costs of Xoserve are eventually borne by the Shipper community, at present through the charges that it pays to Transporters, in future either through the same arrangements or through a combination of Transporter and Xoserve direct charges, then overall the total costs to the Shipper community at large remain unaltered.
- It is possible that the charges to individual Shippers (and end-consumer groups) may alter if the costed service line analysis, using appropriate cost drivers, produces total charges that, whilst being unaltered in aggregate, vary between Shippers as compared to current arrangements. If so, and if the cost allocation analysis is broadly correct, this would indicate that in total current charges are not properly cost reflective. From an economic perspective, therefore, it would be better to move to the new charging arrangements; if the industry wished, however, it could introduce say a two or three year glide path to transition between the current and the new arrangements.

Figure 3.3: Proposed funding arrangements and options

<table>
<tr><th rowspan="9">Cooperative central service provider funding and charging proposals</th><th>Element</th><th>Option 1: Transportation charges</th><th>Option 2: Service charges</th></tr>
<tr><td>Overall approach</td><td>Transparent ex-ante budget with central service provider costs funded by the GTs who recover the costs from Shippers through their transportation charges.</td><td>Transparent ex-ante budget with costs aligned to service lines using an agreed (e.g. ABC) methodology. Cost reflective charges based on an ex ante budget.</td></tr>
<tr><td>Regulatory control</td><td colspan="2">Some oversight of the annual budget. Step in powers in extremis. Incurred costs funded by the GTs allowed for pass-through under their price controls.</td></tr>
<tr><td>Budget pots</td><td colspan="2">Costs are split into budgets for ‘run’ costs, change management and demand/development for larger projects. Budget built up for service lines.</td></tr>
<tr><td>Variations from budget</td><td colspan="2">Carried forward and held on its balance sheet, creating a financing cost. If the trend of adverse variations continues, the amount held on the balance sheet increases. At some point, triggered say by a threshold being exceeded, those who control the central service provider are required to fund the deficit.</td></tr>
<tr><td>Service cost allocation</td><td>According to the principles of the GTs transportation charging methodologies.</td><td>Where costs can be clearly attributed to a service line they should be, with common costs being allocated using an agreed methodology.</td></tr>
<tr><td>User group cost allocation</td><td>According to the principles of the GTs transportation charging methodologies.</td><td>Principles of causality should be applied where clear. Primary GT or Shipper beneficiary groups should be charged in the first instance.</td></tr>
<tr><td>Charging</td><td>Indirect and reflect Shipper use of the gas transportation system.</td><td>Cost reflective charges should be allocated with groups on an appropriate allocation basis.</td></tr>
<tr><td>Invoicing</td><td>Current invoicing process. Xoserve invoice GTs and the GTs invoice Shippers for Use of System charges.</td><td>Indirect (using existing GT invoicing arrangements) or charges levied as calculated, that is Xoserve would send invoices to Transporters and Shippers.</td></tr>
</table>

Source: CEPA, TPA and ESP

3.3.3. Governance

Dimensions

There are a number of dimensions to governance. Our proposals in this area link to the governance models that we present later. They are:

- To the extent necessary, *ownership* can be separated from control. If such a separation is made, however, then protections need to be introduced to ensure that the owners do not face risks that they cannot control.
- Control should be exercised at a high level by the Board of the company. There is a role for a meeting of all participants, however, primarily to review and approve the annual budget.
- Board membership should reflect industry participation. Ideally an equal number of non-executives should be drawn from the Transporter and Shipper communities, together with a small number of executives from Xoserve and possibly additional non-executives bringing specific expertise to the Board.
- The company should either be as now, a company limited by shares, or should be a company limited by guarantee (CLG).[24]
- The company should be not-for profit although this should not prevent it being permitted to budget to earn presumably modest surpluses to provide some buffer for anticipated events to reflect some of the risks of service delivery.
- Xoserve should continue either broadly as now (with some activities delivered internally and others outsourced) or structured as a small service procurer organisation which contracts out all (or a majority of) the delivery of services to one or more third parties.
- Risks should be borne by those best able to control them, subject to the constraints of the particular governance option chosen.
- Xoserve should be financed by those that control it, rather than those that own it, where the two are different.

The Board will provide overall direction and stewardship together with a constructive process of challenge to senior management. 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 would entail:

- 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.

[24] A CLG does not have share capital and its members are guarantors rather than shareholders. The member's liability is limited to the amount they agree to contribute to the company's assets if it is wound up (for example, the amount guaranteed can be as little as £1). See Annex A for details on CLGs and their application.

- 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.

Our supporting paper on governance (Annex D accompanying this report) provides more detail and discussion of each of the dimensions discussed above.

Options

Based on the above building blocks, two primary options for governance were identified, together with a variant that could be applied to each of them:

- GTs retain ownership and control, but in a light cooperative model that has changes introduced to provide a degree of cooperation.
- Control is exercised by all participants.

The variant to each of these options is where the central entity contracts with a service provider on whom most performance risks fall.

Table 3.1 summarises these 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** would involve all industry participant control of the central service provider Xoserve, with control 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 variant to each of these models is to mandate Xoserve, or for the industry to create a new central entity, that would contract out all the services that Xoserve currently provides. We have termed this the **Contracted Services Alternative.**

To give effect to the Full Cooperative Model, there are different variants to allow control of the central service provider to rest with all industry participants rather than solely the GTs as currently:

- The GTs could continue to own the company, essentially in a nominal manner, but would be insulated from equity risk given that they would not have full control over the decisions of the Board (how this might be effected is discussed below and in Annex D).

- Ownership of Xoserve would be distributed across the industry (including Shippers and Transporters), with simple rules about shares and voting rights. This could, for example, be achieved through establishing a CLG.

A key issue that arises in the Full Cooperative, with GT ownership model, is whether or not the ability exists to separate ownership from control and if so what are the consequences of this separation. As noted above, in our view:

- Such a separation is theoretically and practically feasible and examples exist elsewhere. Within the electricity industry, Elexon effected such a separation from its establishment and as noted in Annex D, CEPA has worked with an infrastructure fund that has enshrined rights for lenders as well as shareholders in its governance.

- There are a number of routes by which the separation can be effected. Further legal advice will be taken in Phase 2 as to whether this is the best way forward. At this point, we suggest as one possible way forward the introduction of changes to the Articles of Association of Xoserve as the simplest way to implement all participant control; such changes could specify Board composition and also that the relevant provisions can only be amended with the consent say of a majority of relevant parties.

- A key concern in such a separated model is that the owners do not become liable for activities undertaken by the controllers. In accordance with our principle of alignment, such liabilities ought properly to rest with the controllers of the company; this can be set out in relevant legal documentation that should provide appropriate guarantees to the owners that their position going forward is not compromised by a change in control, although the separate proposals on cost pass through should also provide comfort here.

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[25]</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[26]</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.

[25] Performance risks associated with the operation of the business, for example, overruns against budget, major systems failure (leading to damages) or major process failures leading to claims for damages. See Annex D for further discussion.

[26] Funding responsibility associated with changes to contracted service requirements. For example, if user groups request changes to the requirements for services but then subsequently change those requirements, who is responsible for funding the costs of the contracted service requirements?

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. More detail and discussion of these proposals and options is provided in the supporting governance paper (Annex D).

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

Two issues that were raised by participants at both 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.

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.

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. However, in many cases detailed arrangements, for example, how constituencies' vote to elect Board members, could be left to industry parties to determine. A potential question for consultation, therefore, is the extent to which aspects of the Board, such as person specification for Board member qualifications, should be made a part of Ofgem's decision and prescribed arrangements.

The financing of Xoserve must also be considered.

In all but the Light Cooperative model, the existing financing arrangements, especially the funding of all capital expenditure by the GTs, such funding then going into their Regulated Asset Bases (RABs) will no longer continue. In Annex D we discuss the options here; for example the industry could decide to fund capital expenditure on a pay as you go basis, it could seek ring fenced financing repaid over the life of the asset or it could seek proposals from service providers than involve the latter absorbing the up front costs and then recovering them through service charges. These options are not mutually exclusive and the industry could decide to apply different financing arrangements to different capital projects.

3.4. Summary

In this section we have set out the options (informed by industry consultations and working groups) regarding the introduction of cooperative governance and funding arrangements. We now turn to our assessment of these options and their variants and our consultant recommendations.

4. ASSESSMENT AND RECOMMENDATIONS

In this section we assess the various options described in Section 3 and we also consider transition and implementation issues.

4.1. Services

4.1.1. Assessment

One of our key findings was that while services lines can be categorised, and the primary beneficiaries of services in most cases identified, the majority of the 27 service categories in the current ASA have at least some material impact on more than one party. This conclusion reflects that the services required by the industry – currently delivered through Xoserve – facilitate markets at wholesale / transmission and retail / distribution levels, often in a highly interdependent way.

Another key finding was that the systems which support delivery are currently highly integrated, both from a process and data and physical (including security) perspective. Most services use four or more systems, so delivery and the systems themselves are heavily interlinked. While Xoserve have indicated that it would be possible to re-engineer IT systems physically, the costs and timescales associated with such an exercise would be significant.

These findings highlight the economies of scale and scope from the common service provider model, including that:

- suppliers and shippers are provided with a single point of contact (the "one stop shop" principle for service provision);
- there are consistent processes across the GDNs (although this could be enforced through alternative arrangements other than a common service provider model);
- duplication of systems is avoided and the interactions between systems and processes can be managed effectively; and
- the systems utilise common data centrally; it would be difficult to separate out the processing of such data into different systems operated by different parties.

NGGT has retained ownership of the Gemini system, whereas other systems are owned by Xoserve, and the support provided by Xoserve is defined in the ASA in terms of the Agent being an outsourced IT provider to NGGT rather than in terms of the services that Gemini supports. Xoserve's Gemini services therefore relate primarily to applications maintenance. Because of this, it is necessary to consider Gemini separately from other systems that Xoserve own.

NGGT noted that elements of Gemini functionality are integral to the operation of the National Transmission System. NGGT therefore wish to retain the ability to specify and deliver changes to the Gemini systems as and when required in order to satisfy its licence obligations, (including, if necessary, a re-evaluation of whether Gemini systems would be better operated and change managed internally by NGGT alongside its other core systems).

Of particular importance are legislative changes being developed in Europe. A number of changes to the GB gas market may be required to meet the requirements of the European Energy Markets third regulatory package, including measures to support and harmonise arrangements for trading across interconnectors and may (as is happening in electricity) drive towards a common market model across adjacent member states.

The UK's compliance with this European legislation is likely to drive strategic change to the transmission owned Gemini system in the next few years – the timely delivery of which may crowd out other Gemini developments. Effective facilitation of this change programme (and Xoserve's role in delivering that programme) needs to be supported rather than hindered by the funding, governance and legal arrangements of the central service provider.

Industry stakeholders indicated, through the working and steering groups, that they accept that such "mandated" change will need to take priority over other areas of change – whether for Gemini or other shared systems.

Provided such principles are recognised, and appropriate contractual arrangements are in place to reflect NGGT's interests and ownership of Gemini (particularly the systems links to transmission system operation), it could continue to be managed through a common service provider model, even where there are cooperative funding and governance arrangements going forward.

4.1.2. Summary - Service provision proposals

Based on the analysis in this report and its annexes, together with the feedback we have received through the industry working groups, we recommend that common service provision should be retained where cooperative governance and funding arrangements are adopted for those data, information and IT services going forward.

Our view is also that given the benefits and the interlinked systems for delivery under the current common service provider model, partitioned corporate governance of the service provider by service line is not appropriate while shared governance and funding of the entity is appropriate.

These conclusions are reflected in our recommendations for budgeting, charging and corporate governance arrangements.

4.2. Budgeting, cost allocation, charging and invoicing

4.2.1. Assessment

Under all our governance models we propose that this should be coupled with a significant increase in the level of transparency over matters such as costs and associated charges. Our core proposal is that an *ex ante* budget would be agreed and would underpin revised charging arrangements and that the budget would be built around costs for ongoing business, change management and major projects, as described in Section 3.

We propose that the budget would be built up from individual service categories to illustrate the costs that are involved in delivering those services. This will require a basis for the allocation of shared costs.

As discussed in Section 3, our preferred approach for the treatment of under and over recoveries of budgeted costs (i.e. variations against the ex ante budget) is that these should be held on the balance sheet of the central service provider and would need to be funded by those parties that control Xoserve when this exceeds a defined threshold.

We suggest that such a process would create circumstances that both management and owners would seek to avoid, which ought to ensure a significant degree of oversight by both. The incentive (at least as regards those who control the central service provider) would be in terms of reputational risk as opposed to financial risk.

There are several issues regarding the proposed model, in particular that it creates:

- an incentive to overstate costs in the budget, to create headroom for variations;
- pressure to release contingency funds to deal with cost overruns rather than genuine scope variations;
- pressure to adopt a profit motive for the central service provider, so as to provide a buffer to deal with unanticipated events; and
- potentially harsh penalties for relatively minor variations that will occur in the ordinary run of business.

There is no doubt that the proposed arrangements do create an incentive to overstate costs in budgets and have no direct financial incentive for cost efficiency by those who control the central service provider. The measures that we have proposed however, are designed in part to guard against this and include:

- assessments of cost trends, which ought to enable any excessive padding to be determined;
- the ability of Board members to compare such cost trends against their own experiences of IT costs; and
- the ability of the Board either to appoint independent experts as members, with skills say in IT and finance, or to procure such specialist skills on a case by case basis.

The variant to each of the governance models to contract out services also provides a mechanism to apply competitive pressures to costs. This could be extended (or even required by Ofgem) if there were concerns of gross inefficiency.[27] Another mechanism for promoting cost efficiency, linked to the approach suggested for managing budget variations, would be for GTs and Shippers to write contracts with the central service provider's management to reward them for meeting financial and performance targets as defined through the budgeting process.

[27] We also note that two-thirds of Xoserve's cost base are already contracted out under current arrangements.

Either or both of the contracting out and management incentive plans could be required by Ofgem as part of the licence conditions arrangements for the cooperative model.

We do accept however, that there is a risk of minor padding occurring, but we think that this is an issue for budgets generally and not our proposals in particular.

Another potential mitigating factor is that Shippers should have some incentive to minimise the costs of the central service provider for the following reasons:

- we might expect them to run the central service provider in the same way as other parts of their business (although the costs would be common to all Shippers); and
- to the extent that they have fixed contract positions, such contracts might also provide financial incentives to minimise cost.

We also note that the view that Shippers will bear down on cost is supported by their observed behaviour in recent price review processes, where they have invested significant resources in reducing network costs (like Xoserve, a common cost).

There is also a risk of 'raids' on contingencies to offset cost overruns. We do not see this risk as significant if there are appropriate change control processes in place, in which case changes would only be authorised where specific and identifiable drivers for such change had been accepted. If needed, it would also be possible to ring-fence individual major project costs so that any variations were not available for offset elsewhere within the central service provider. Such an approach requires further consideration, however, as it could itself create perverse incentives regarding such project budgeting.

We suggest that the central service provider should not be a for profit organisation. To be clear, we interpret the term profit in this context as working towards earning a surplus for distribution to members. We see nothing wrong with the central service provider planning some sort of surplus to provide a buffer against unanticipated events, as long as it was set at a modest level so as not to create such a large fund as to minimise other incentives to control costs. We do not think that the proposals create harsh incentives in relation to minor matters. We have suggested a threshold over which a refunding would be required, but that should be set at a level that would not capture relatively minor annual variances, which will occur. As the threshold is cumulative, it should allow headroom for variances in the normal course of business and as noted above, a modest surplus might also be introduced, to act as a further buffer.

Based on feedback from the industry working groups, it is clear that there are differing views amongst industry participants of the appropriate charging and invoicing arrangements for the cost recovery of budgeted central service provider costs, some preferring direct charges from Xoserve, others through the GTs transportation charges as currently.

We recognise that there are pros and cons with both indirect use of system and more cost reflective and/or direct charging arrangements:

- From a first principles perspective we suggest a service line charging model is the more optimal approach and we consider this to be more consistent with Ofgem's January 2012 decision letter with cost causality/targeting benefits.
- We do, however, recognise that such an approach or a move to direct invoicing may increase costs, potentially impose charging incidence effects, and create complexity for industry participants and ultimately final consumers.

We would note that a potential practicable way forward may be to introduce new arrangements by adopting a use of system charging cost recovery route, however, in the medium to longer term a transition is made to a more cost reflective and/or direct contractual and invoicing arrangement as discussed further as part of Section 4.4 and Annex E, which explore the options for the legal framework supporting the new arrangements.

In addition, if a move to cost reflective pricing altered the aggregate amount that individual Shippers pay to any significant degree, it may also be appropriate, as suggested in Section 3, to introduce say a three year glide path to transition between the current and new charging bases.

Based on the above analysis, the table overleaf discusses the suggested funding model in terms of the defined criteria for funding and charging (see Annex C). Our assessment is differentiated according to the two charging and invoicing options set out in Section 3.

Table 4.3: Assessing the funding model

Principle	Option 1: Transportation charges	Option 2: Service charges
Causality	Charging incidence and structures will reflect use of gas networks rather than central service provider data services.	The difficulty in allocating benefits to different groups means that there is a trade-off between causality and objectivity.
Objectivity	This will be clearer when precise cost allocation methodologies for different budgets are developed.	This will be clearer when precise cost allocation methodologies for different budgets are developed. Having the allocation of different budgets being done by ABC or in proportion to the use of system between groups, should however lead to an objective model.
Predictability & consistency	Central service provider costs continue to be a small percentage of use of system charges therefore predictability less of an issue.	Clear rules over cost allocation will be beneficial for both predictability and consistency. Predictability likely to be more important to Shippers than for Option 1 given costs would be recovered separately from transportation charges.
	Having charges based on ex-ante budgets rather than actual costs will mean greater predictability.	
Transparency	Having the budget in the public domain and a greater role for shippers are positive steps here.	
Adaptability	The splitting of the budget into different pots and the inclusivity of the budget setting process should mean that this model is adaptable to changes in the industry.	
Efficiency	Risks in this model are much more aligned with control. This gives the correct incentives, but approach means that there may be the incentive to overestimate costs. Regulatory and reporting protections would be in place to ensure that this does not happen.	

Source: CEPA, TPA and ESP

4.2.2. Summary - budgeting, cost allocation, charging and invoicing

Based on the analysis in this report and its annexes, together with the feedback we have received through the industry working groups, we suggest that charges for Xoserve services should be arranged around service lines, built up from a budget that is made transparent to the entire industry and considered annually by all participants. Full pass through of costs would be allowed, subject to a series of constraints managed primarily by the industry itself.

We do have concerns, however, if the funding arrangements under the 'light' cooperative governance model would be subject to GT pass through arrangements. While such an arrangement could be made to work from a practicability perspective, we find it hard to justify the principle of an arrangement where GTs retain sole control of the service provider, but the resulting costs are subject to price control pass through arrangements.

This conclusion would suggest that regulatory allowances for GT Agent services would need to be retained under the 'light' cooperative model. However, largely retaining the current arrangements (albeit with changes to corporate governance) would also not be without issue:

- retaining regulatory allowances has the disadvantage (as identified in our previous report) of retaining eight year price control arrangements without the flexibility to manage changing outputs and therefore funding requirements; and
- it also creates a risk of retaining a funding arrangement which industry participant groups and Ofgem have identified as not fit for purpose for a data and IT services company with a critical role in the delivery of key industry change programmes.

In our view, the only appropriate way to implement the Light Cooperative model would be either to retain the regulatory controls over charges, which we consider is inconsistent with our alignment principle, or to introduce the Contracted Services Alternative, which would take most of the cost risk away from participants but which has a number of other issues associated with it.

We note the different industry views on charging and invoicing arrangements. While our preferred approach is the service charging model, given the different views on this issue, and potential (albeit relatively immaterial given the costs involved) incidence impacts on end-consumer prices, we would suggest that this issue (along with the options for charging arrangements more generally) be made a question for industry consultation.

4.3. Governance

4.3.1. Assessment

Whilst it is debatable whether the light model is consistent with 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.

From the perspectives of inclusiveness and effectiveness, however, 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. The alternative, bringing in the small service procurement company approach, involves profound change in the short term and raises a number of other issues, such as TUPE and the possible crystallisation of pension liabilities, which may render this only for consideration in the longer term.

In the full cooperative models, 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, with GT ownership model, would involve more change as compared to the light model, and the Full Cooperative, with all participant ownership model, increases still further the degree of change. The contract services alternative to any of these models would require profound change. All models apart from the light, however, should ensure that quality requirements are identified and resolved through more inclusive and transparent governance arrangements.

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, to test the various options and elements related to governance.

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.

Table 4.4 below summarises the analysis of governance options in terms of these criteria.

Table 4.4: Analysis of governance options

<table>
<tr><th rowspan="2">Element</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>Transparency</td><td>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</td><td colspan="2">Transparency improved as shipper community involved in decision making. Board needs to define transparency requirements to ensure participant concerns are met</td></tr>
<tr><td>Inclusiveness</td><td>Shipper Advisory Board provides some ability for Shipper interests to be determined, but lack of participation in strategic direction and budget setting</td><td colspan="2">Constituencies should ensure that all participants are involved</td></tr>
<tr><td>Efficiency</td><td>Likely to be efficient through utilisation of existing arrangements. Possibility of GTs ensuring their concerns take priority</td><td>Slight risk of less efficiency, should be met by robust separation of ownership and control</td><td>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</td></tr>
<tr><td>Effectiveness</td><td>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.</td><td colspan="2">Some tension due to performance risks that participants will be required to bear</td></tr>
<tr><td>Cost mitigation</td><td colspan="3">Should be appropriate, although need to strike careful balance between protecting minority interests against ability to block change</td></tr>
<tr><td>Support competition</td><td colspan="3">Should be robust, although possibility of minor variants between models</td></tr>
</table>

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. Also consistent with DCC model.

Source: CEPA, TPA and ESP

4.3.2. Summary - Governance

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 but 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 other options and the contracted services alternative 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 perspective.

4.4. Transition, Implementation and Other Issues

There are a number of implementation challenges and transitioning and other issues involved with the different approaches that need to be assessed.

The aim of this assessment 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.

4.4.1. Transition issues

Table 4.5 summarises the transition matters that would need to be addressed for each option which are considered in more detail in the supporting paper on Corporate Governance options (Annex D). In the case of the Contracted Services Alternative, our transitioning 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[28] and, therefore, staff employment issues.

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

Table 4.5: 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

In summary, the more that ownership is both aligned to control and is shared amongst the industry, the greater the transition issues and, therefore, the more time is needed for them. In our view the Light Model and the Full Cooperative Model, with GT ownership, could both be implemented by April 2014, whereas the other options (both the Full Cooperative model with all participants ownership and the Contracted Services Alternative applied to either Light or Full Cooperative Model's) would take longer. In addition, it should be noted that choosing one of the options for implementation by April 2014 does not preclude a later move to a more aligned model (i.e. an all participant ownership arrangement) at a later date.

In relation to short term funding, Ofgem has decided to roll forward the current Xoserve funding arrangements into 2013/14 (the initial year of RIIO-GD1 and RIIO-T1) with any new arrangements then expected to apply from 2014/15. This regulatory allowance for 2013/14 includes that year's funding for Project Nexus and the UK Link Programme.

The decision to apply the RIIO regulatory allowance for the forthcoming financial year should mean that the interim arrangements are robust for 2013/14. Full implementation of our proposals could then apply from 2014/15. We set out proposals both for the regular setting of the annual budget and how that for 2013/14 should be tackled in Annex C.

4.4.2. Implementation issues

There are also a number of implementation issues that arise as summarised in Table 4.6; as a result the more radical options are unlikely to be advisable in the short term, although all are arguably viable in the longer term. Again, more detailed discussion and analysis of these issues is provided in the supporting paper on governance (Annex D).

Table 4.6: Implementation issues

Element	Light cooperative model	Full cooperative model	
		GT ownership	All participants ownership
Compensation for changes in Ownership	None	Limited if GTs retain existing Xoserve RAB costs, which should cover most of asset value	
Degree of change of Ownership	None	None	New shareholders in Xoserve, or new members of CLG
Contractual Arrangements	Probably none	Creation of new Shipper ASAs or amend existing ASA to embrace GTs and Shippers in a single contract	
Staff Matters	None	Very limited	Limited if employer remains Xoserve, more significant if CLG
Timeline	By April 2014		Likely to be April 2015 at the earliest
Impact on Major Projects	None	Positive	Possibly negative in short term due to degree of disruption, positive later
Costs (central only)	Low	Around £1.5m	Around £2m
Contracted Services Alternative (Key Differences Only)			
Contractual Arrangements	Creation of new contracts between central entity and service provider – possibly consequential changes to other contracts		
Staff Matters	Significant as most employees transfer and pension liabilities probably triggered		
Costs (central only)	Around £3.5m excluding pension costs, latter significant		

Source: CEPA, TPA and ESP

On the face of it, the *direct* cost and implementation impacts between the GT ownership and all participant ownership variants of the Full Cooperative Model appear to be relatively small. One of the reasons for this is that our cost assessment has focused on the costs of implementation at the centre with the all participants ownership model likely to impose more significant transaction costs across industry participants groups as this would involve a more complex transaction. Certain members of the Shipper constituency have suggested that the all participants ownership model could cause more significant implementation challenges within their wider corporate groups which has been accounted for implicitly within our assessment.

4.4.3. Other issues

A number of other issues also need to be considered. These include:

- *Treatment of liabilities*: we consider that this is a matter for the new Board. In principle the current arrangements, whereby Xoserve has relatively few liabilities, these being passed on to its present owners, could continue or instead the Board could decide that more liabilities should lie with Xoserve, although in that case there are arguments that this is a distinction without a difference, as in the event of any such liability arising the industry would still have to pay for it.
- *GT Invoicing*: this is a key commercial concern for GTs. 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.
- *Smart Metering and the introduction of the DCC*: at this point there is no detail on how the new arrangements will work in practice, for example whilst the DCC will have responsibility for SPA arrangements, whether it chooses to contract these out to Xoserve or to another third party is not clear. By creating more inclusive arrangements, we consider that our proposals will allow the industry to address these and other issues when more detailed aspects of the role of the DCC are defined.
- *Introduction of iGTs*: it is likely that the iGTs will be involved in terms of Xoserve providing services, either within the current UNC or some other contractual framework. It may be that iGT involvement would be contractual but if it was considered appropriate for iGTs to participate in the governance of Xoserve, this could be done in one of at least three ways:
    - By granting a Board seat to the iGT community, which would imply in terms of balance that the Shipper representation increased from three to four.
    - By allocating one of the then existing GT seats to the iGT community.
    - By expanding the GT community to include iGTs and leaving that community to determine voting arrangements for Board representation.
- *Further evolution*: it is important that the new arrangements are durable, whilst at the same time they need to be capable of change if appropriate. It is important to avoid frequent or minor change whilst retaining some flexibility. To address this point, we suggest that the arrangements are hardwired to the extent that it would take supermajorities in both Transporter and Shipper communities to effect a change to them.

More detailed consideration of these issues is provided in Annex D.

4.4.4. Summary – Transition, Implementation and Other Issues

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 Model with all participant ownership 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 Model with GT ownership 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.

4.5. Legal and contractual framework

The legal and contractual framework to give effect to any agreed changes to the current arrangements for Xoserve is the principal focus of Phase 2 of the implementation project. At this point, we consider briefly the principal issues that are likely to arise and options for their resolution; more detailed work will be conducted in Phase 2.

Our starting point is the principle of alignment. In this context this means in particular that obligations should rest with those best able to deliver them.

Given our proposed change of paradigm, that is that Xoserve should in future provide services to the industry rather than being an Agent for the delivery of GT obligations, on whom such obligations rest is a key consideration. We consider that there are two principal options, with variants to one of them.

One option is that obligations could continue to rest with the GTs, although some obligations might move to Shippers. In this case, we anticipate that Xoserve would be contractually obliged to deliver relevant obligations. Between them, GT and Shipper licences, the UNC and ASA (or whatever other contracts are put in place) need to set out that provided that participants contract with Xoserve for the delivery of such obligations and also that they participate, to the extent necessary, in the governance of Xoserve, then these obligations are seen to be discharged. Separate consideration has to be given to the delivery of these obligations by Xoserve, and what sanctions should be put in place to deal with non-delivery.

The alternative is for obligations to move to Xoserve. There are two variants here:

- Xoserve would take on certain obligations, although these would ultimately rest with the wider industry through cooperative governance arrangements. There would be limited obligations on participants in this regard, other than the requirement to participate, to the extent necessary, in the governance of Xoserve.
- Xoserve becomes a licensed entity to assume obligations. As this approach was rejected by Ofgem as part of its previous consultation and decision to adopt Option C, we have not considered this option further.

Beneath whatever model for delivery of obligations is chosen, revised licensing and contractual arrangements are required. We discuss each in turn.

4.5.1. Licensing regime

Under what we have termed the Light Cooperative Model, there would be minimal change to the current arrangements; that is, Xoserve continues to be owned and controlled by the GTs.

The only change to licences in this case is 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 would also need to be changes to the revenue restriction formula on GTs to allow for the pass through of Xoserve costs to regulated transportation charges.

What we have termed the Full Cooperative Model, could be implemented under retained GT ownership (involving effective separation of ownership and control) or all participant ownership (for example, through establishment of a new 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 may need to be obliged under licence (and possibly the UNC) to enter into a contractual relationship with the service provider;
- those who control the services provider, should participate in the company and manage it in an "efficient and economic manner";
- GTs should be allowed full cost pass through of the proportion of service provider costs recovered from the GTs;[29]
- definition of principles of regulatory oversight to protect consumers, including step-in arrangements in the event of extreme performance failure; and
- potentially some definition of the principles for governance, financing and funding of the service provider including budgeting approval and Board arrangements.

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.

As discussed in Annex D, 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).

We discuss the principles that support our proposed licensing regime as part of the supporting paper on legal and regulatory frameworks (Annex E).

[29] Which could again require an amendment of their revenue restrictions.

4.5.2. Contractual arrangements

The ASA is a contract between the 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 UNC obligations of the GTs remain with them (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.

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.

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.
- At the other, the existing GT ASA could be continue and potentially expanded to incorporate Shippers as well[30].

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 ultimately identified as the party responsible for delivering those services that it provides, so as to align obligations with control.

Finally we would propose that residual (non-code and bespoke services) be delivered through some form of bilateral framework agreement.

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. Further details and discussion on the options as outlined are provided in Annex E. We would welcome industry participant feedback on whether we have identified the range of options and the key issues and principles that need to be considered.

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[30] 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 transportation charge. However, in a direct charging world, it may make sense to include Shippers as counterparties as well as the GTs.

4.5.3. Summary – legal and contractual framework

The conclusion we take from this analysis (and the accompanying technical Annex E); 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. We do not consider that there are any insurmountable issues to be addressed, although the industry will need to determine at an early stage what sort of contractual structure it would consider most appropriate to underpin the new arrangements.

4.6. Comparator review

Focusing on the two options that appear capable of earlier implementation, the Light Cooperative model and the Full Cooperative model with GT ownership, the table overleaf considers key characteristics of each against relevant comparators. While there are differences in the arrangements for other central service providers to the utilities industry, we believe the Full Cooperative model has the closest alignment with similar organisations in other sectors.

Table 4.8: Cooperative models and comparator review

Element	Light cooperative model	Full cooperative model	Elexon	MRASCo	CMA
		GT ownership			
Structure	One company	One company	One company	Outsourced to service provider	Fully outsourced to service provider & systems integrator
Ownership	GTs	GTs	NGET, but provisions mean full separation of control from ownership	Split between MRA parties with each party receiving one share	Members (Scottish Water and Licensed Providers)
Control	GTs	All participants	All participants	All participants	All participants
Type of organisation	Limited company	Limited company	Limited company	Limited company	CLG
Financing	GTs	All participants	All participants	All participants	All participants
Board composition	GTs only (possible Shipper non-exec)	Board comprised of (say) 3GT and 3 Shipper members with option for senior staff and or specialists appointments as well	Independent chairman appointed by GEMA, 2 BSC Panel members elected by Panel, 2 Directors nominated by Chairman	Exec Committee contains 1 member from the Distribution Businesses, 2 members from suppliers and one from the BSC Agent (Elexon)	Chairman, CEO, Scottish Water representative all appointed by Water Commission and two Licensed Provider representatives
Performance risk allocation	GTs (but depends on cost pass through)	All participants	Joint liability between BSC parties	Joint liability between MRA parties	Gemserv and systems integrator/developer
Market risk allocation	Service users	Service users	BSC Parties	MRA Parties	Members
Profit / not for profit	Profit	Not for profit, but with ability to earn surpluses not for distribution	Not for profit	Not for profit	Not for profit
Other groups	Shipper Advisory Board	One or more User Groups	One or more User Groups	One or more User Groups	One or more User Groups

Source: CEPA, TPA and ESP

5. Conclusions

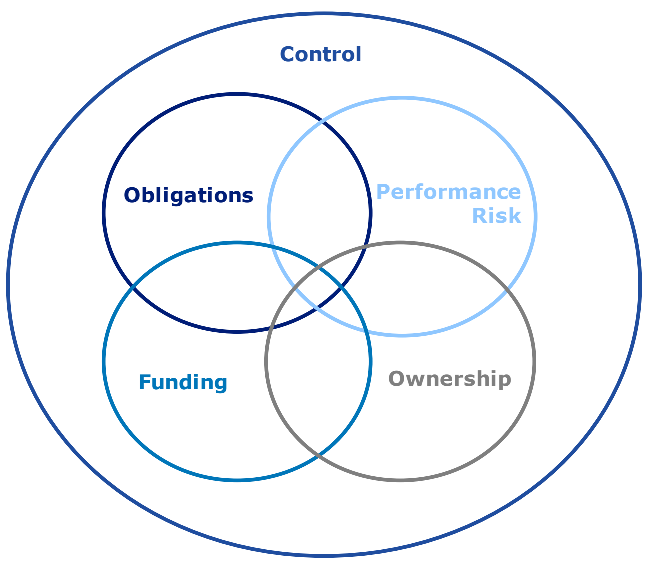
5.1. Recommendations

In our view the Light Cooperative model is not fully consistent with the Ofgem decision in January 2012 to implement Option C and it also contains a number of potential inconsistencies and a lack of alignment of our key principles of obligations, funding, services and control.

There are significant and in some cases profound implementation and transitioning issues, associated with the Full Cooperative model with all participants ownership variant, and any options which introduce at an early point the Contracted Services Alternative. It will take time to resolve these issues and implementation would not be possible by April 2014. In addition, our cost estimates are highly tentative at this point and would need further investigation if one of these longer term models was preferred for implementation.

We therefore recommend that attention in the short term should focus on the Full Cooperative model with GT ownership. The diagram below shows a high level assessment of this model against our alignment principles:

Figure 5.1: Alignment under the Full Cooperative model with GT ownership



- **Funding is** by all parties, with primary control at annual meeting that approves budget and Board oversight of expenditure across the year

- **Control** is exercised by representatives of all parties through Board representation, plus budget review in annual meeting

- **Obligations** ***either*** sit with all parties, in which case licence requires them to enter into contract with Xoserve for their delivery and to participate in efficient management of Xoserve, ***or*** sit with Xoserve, in which case primary licence provision is for all parties to participate in efficient management

- **Performance Risk** sits with all parties, who have means to control it. Industry can determine whether to insure relevant risks, or to offload some of them into Xoserve – where all participant control will contribute to their management

- **Ownership** retained by GTs, but Articles and other documents limit rights and risks

We conclude that the Full Cooperative model with GT ownership, is consistent with our alignment principles. We accept that it is the only option that we are recommending, at least in terms of implementation by April 2014, but as explained above, we are unable to recommend any other option at this time.

5.2. Next Steps

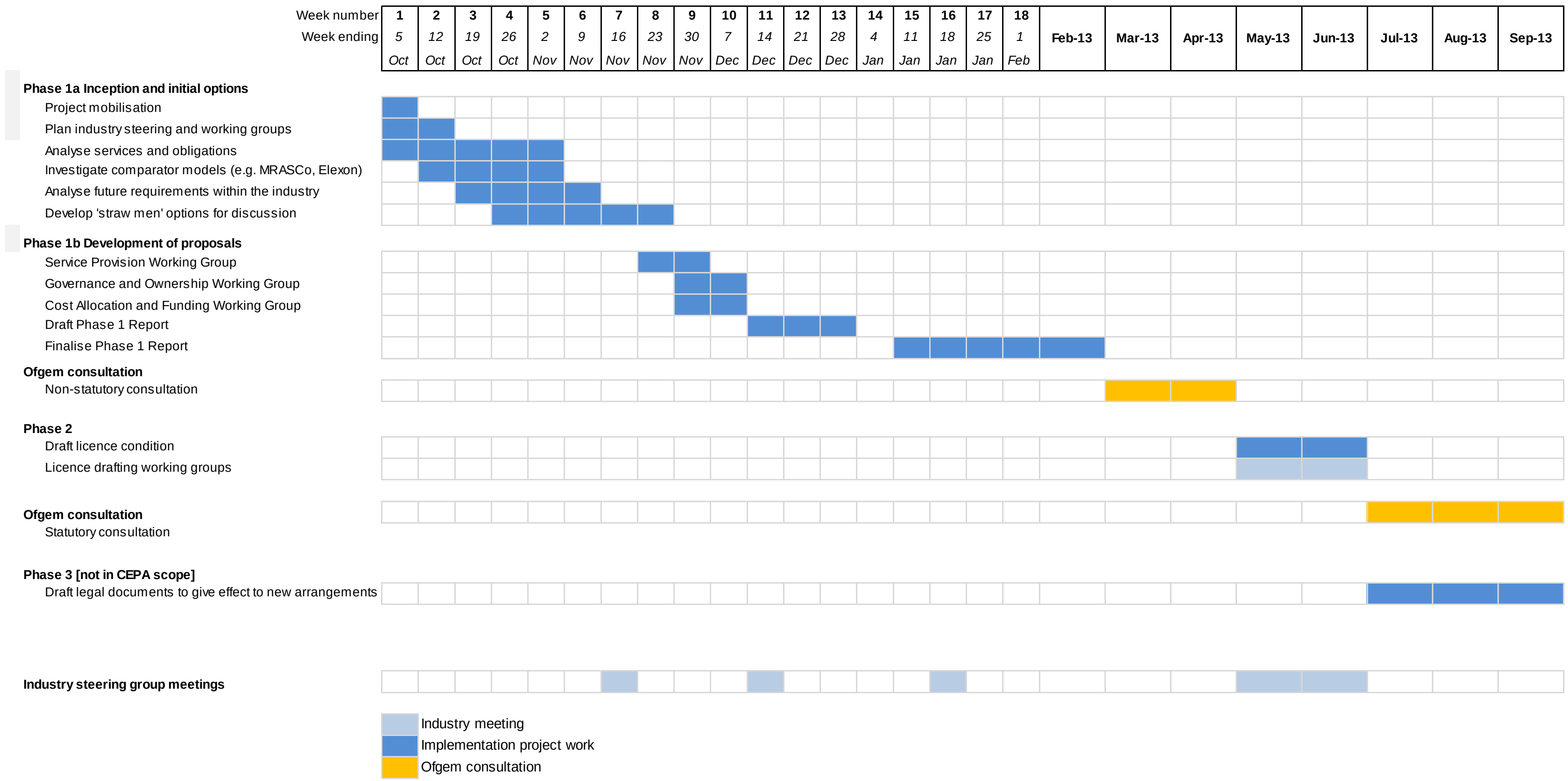
Appendix A sets out a timeline through to August 2013, at which point decisions on taking the project forward, are anticipated. The timeline shows a possible date for the first Ofgem decision, as a result of its consultation on the proposals in this document.

If the target implementation date of April 2014 is to be met, it is important that the industry establish an implementation group once that Ofgem decision has been taken, which can begin work in parallel with the later stages of the formal processes shown in the timeline. It is for that group to develop more detailed timelines and working arrangements but we suggest that its initial scope should consider:

- Setting up shadow Board arrangements, including a working group to agree on the composition of the Board and how each constituency will elect or appoint its representatives.
- Creating a project management group that should as a first step develop a project plan to deliver the new governance, funding and service line arrangements by April 2014.
- Establishing a financing group to consider how best to fund Xoserve from April 2014, especially given the likely financing requirements of Project Nexus and EU driven change to balancing and other arrangements.
- Establishing a budget group to begin work on the 2014/15 budget and at the same time consider appropriate approval procedures, including the level of detail to be disclosed and how best to arrange the proposed annual meeting of the industry to approve.
- Establishing a legal group to guide the preparation of draft legal documents to give effect to the new arrangements and in parallel to consider transition issues, including matters such as the approval of the 2014/15 budget possibly before the *vires* of the new Board are in place.
- Establishing a communications group to determine how best and how frequently to communicate to Xoserve staff the changes that are being introduced, separately how to communicate with industry participants more widely and finally when and how to communicate to other stakeholders, such as Xoserve's principal creditors, the changes that are being made and how these should not impact on Xoserve's creditworthiness (assuming that the financing group has addressed that issue).

This is clearly a substantial and important work programme and it is important that the industry accord it sufficient priority and allocate appropriate senior resources to bring it about.

Appendix A: Timeline and milestones

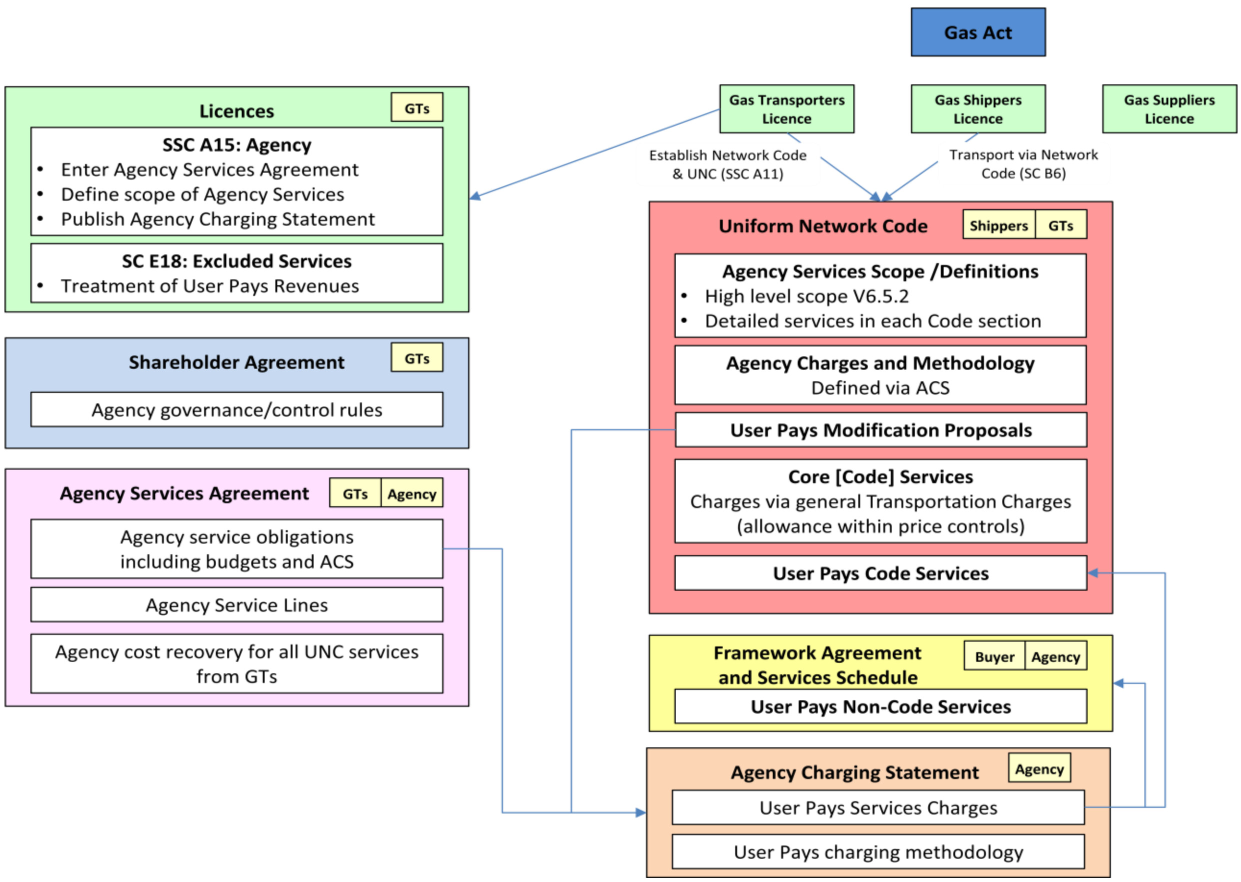


Appendix B: Existing arrangements

Overview

Figure B1 provides an overview illustration of the existing legal and contractual framework for GT Agency services.

Figure B1: 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

Any liabilities arising from the failure of the Central Agent to deliver the GTs UNC obligations remain with the GTs (the "Principals" in the relationship).