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Consultation on implementing new funding, governance and ownership arrangements for Xoserve, the gas transporter central agent

We are seeking your views on changes we are proposing to Xoserve's funding, governance and ownership arrangements. Xoserve provides a range of essential services to support the GB gas industry including billing services, managing the booking of capacity, running the gas settlement systems and managing the change of supplier process.[1]

The deadline for responses is 26 June 2013 and responses should be sent to Joanna Campbell (joanna.campbell@ofgem.gov.uk). We invite your views by posing a number of questions which we have summarised in appendix 1. We encourage those who wish to respond to read the associated consultant's report (see the associated documents) to gain a more comprehensive understanding of the arrangements we are consulting on.

This consultation letter follows our decision of January 2012 which explained the reasons for reforming the funding, governance and ownership arrangements for Xoserve on the basis of a co-operative model.[2] In summary, we concluded that the key aspects of a co-operative model are that it should allow wider participation by users[3] in key decisions about the future provision of services, and that the costs of delivery should be recovered directly from users (as opposed to fixing GTs' allowed revenues on an ex-ante basis). For further background to Xoserve and this consultation see appendix 2.

This consultation now describes options for how a co-operative model can be applied in practice. We present the key findings and recommendations from our consultants, Cambridge Economic Policy Associates' (CEPA's)[4], and our preliminary recommendation. Focusing on the three building blocks of a co-operative model, our preliminary recommendation and the reasons for it are summarised as follows -

A. **Delivery of services** - the integrated systems and services that are provided by Xoserve, for both gas transporters (GTs)[5] and shippers, should be retained as it ensures economies of scale and scope are achieved.

B. **Budget setting, cost allocation and charging** - there should be collective industry responsibility for funding the central service provider. We propose that this is introduced by establishing more flexible and transparent funding arrangements with

[1] See: http://www.xoserve.com/
[2] Open letter: Review of Xoserve – Ofgem's conclusions (January 2012): http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=345&refer=Networks/GasDistr/RIIO-GD1/ConRes
[3] "Users", in the context of this consultation, refers to GTs and shippers.
[4] In partnership with TPA Solutions and ESP Consulting.
[5] In the context of this consultation, GTs collectively refers to the Gas Distribution Networks (GDNs) and National Grid Gas as owner of the National Transmission System (NGGT).

the removal of cost recovery through the GTs' capped price controlled revenues. These arrangements would be established through all users participating in an annual budget process, establishing processes for managing variations and direct recovery of costs from users. We also propose a range of additional measures that could be put in place to ensure cost control is maintained.

C. **Corporate governance and ownership** - governance arrangements should achieve an alignment of performance risk and control. Proposed new governance arrangements (including new Board arrangements) would allow shippers and GTs to collectively share corporate control of the central service provider, and in doing so, assume the performance risk of the company. Divorcing ownership from control is the most practicable means by which to implement a new co-operative model and therefore we recommend that GTs remain the owners of the central service provider.

We recognise that putting in place new arrangements that reflect our final decision will take time (see section D below). We intend to provide support and guidance where required but consider that implementation cannot be a success without input from industry participants, most importantly the GTs, shippers, and Xoserve.

The building blocks of a co-operative model

The options and recommendations in the report were developed by CEPA in collaboration with the gas industry through a number of working groups. CEPA's report includes a discussion of the building blocks for the introduction of a co-operative model, which we summarise below. These are: how services should be delivered; corporate governance and ownership; and budget setting, the allocation of costs and charging. It is important to note that these building blocks are not independent of each other. For example, we will discuss issues with combining some funding options with models for corporate governance.

We summarise the key findings of the report below, focusing on key areas where we are particularly interested in stakeholders' latest views. We also present our preliminary recommendations.

A. What a co-operative model means for - delivery of services (p.13-14, 28-29 and Annex B)

Current arrangements

Xoserve provides a number of services to GTs and shippers. Primarily these services are provided on behalf of the GTs to allow them to meet their obligations within the licence and the UNC. Contractual terms under which Xoserve provide these services are set out in the Agency Services Agreement (ASA). This is an agreement between Xoserve and the GTs and is the primary means by which the GTs discharge their obligations.

Options for change

CEPA's report discusses the optimal structure for centralised data and information services under new arrangements. It considers whether service delivery should be split between different entities dependent on the beneficiary of each service line, eg by establishing one shipper facing entity and one GT facing entity.

The benefit of splitting service delivery is that it would allow each party (the shippers or the GTs) to fund and control those services where they are the main beneficiary, but not to fund or control other services. The drawback is the cost and complexity of splitting systems if they are highly integrated. The analysis of the feasibility of such a split includes an assessment of the level of integration of the systems and services which the central service provider delivers.

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Preliminary recommendation

CEPA's analysis suggests that the central service provider's systems are highly integrated with the majority of services relying on more than one system. While it is possible to identify the main beneficiary of each service line as one of the three user groups (GDNs, NGGT or shippers), a number of services benefit more than one user group. This leads us to recommend that there are both economies of scale and scope in retaining a single service provider. It is likely to be a costly and timely process to separate GT and shipper facing services given that a number of systems would need to be duplicated.

The Gemini systems have been highlighted as one area where different arrangements may be appropriate. NGGT has highlighted that elements of Gemini functionality are integral to the operation of the NTS and therefore it wishes to retain the ability to specify changes to the Gemini systems as and when required in order to meet its obligations. The working groups discussed this prioritisation of modifications and initial views were that this is recognised and could therefore be incorporated in co-operative arrangements.

Transition and implementation

We do not consider that the recommended approach will result in any transitional issues as it essentially results in no change. Further consideration may need to be given to transitional issues if it is decided that changes are needed to the provision of the Gemini system.

Question 1: Do you agree that there are benefits in retaining the central service provider as one delivery body for all systems and services, including Gemini systems? Do you consider there to be an alternative structure with greater benefits? Please provide evidence of these additional benefits.

B. What a co-operative model means for - budget setting, cost allocation and charging (p.14-21, 29-34 and Annex C)

Current arrangements

Xoserve's primary source of funding is from the GTs who set gas transportation charges to shippers which include the costs associated with Xoserve. Shippers in turn may pass these charges on to consumers. The GTs' price control arrangements mean that Xoserve's expected costs for core services are capped for the period of a price control. This means that any over/under spend of the revenue cap is funded/given back to the GTs. Xoserve invoices shippers for gas transportation charges on behalf of the GTs but the GTs themselves are responsible for collecting the charges from shippers.

The remaining sources of funding are for services known as "user pays" and for additional services provided under bilateral contracts. The costs of which are recovered from users, either directly by Xoserve or by GTs.

The main concerns with this approach are the perception of a lack of transparency in how costs are derived and the inflexibility it can create. Including costs associated with the central service provider within gas transportation charges means that shippers cannot easily identify these costs separately from the costs of others services the GTs provide.

Options for change

In order to achieve the objectives set out above we consider options within four key areas -

- setting the budget
- how to treat deviations from budget
- how costs are allocated between users
- how costs are recovered.

We discuss each in turn below.

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Setting the budget

CEPA proposes that flexibility is introduced through establishing arrangements which allow for all users to participate in the process of establishing the annual budget. This would necessitate the removal of current funding arrangements whereby the expected costs of Xoserve are set ex-ante for the period of the price control and recovered through gas transportation charges. The majority of Xoserve's costs are likely to be relatively fixed and stable but this may not be the case for all costs, particularly those driven by change (including new requirements from UNC modifications). Flexibility in funding arrangements will ensure industry driven developments can be progressed in a timely manner.

Under this approach the Board would be responsible for proposing the annual budget in conjunction with Xoserve's management. CEPA proposes that the budget should be split between three categories: business run costs; change management costs; and demand/development costs for major projects. The budget proposal would include a report explaining the reasons for any year on year change in the budget. For example, changes may be due to a new IT development project or to factor in over/under spend of a previous year's budget. This proposal would then be voted on by all users by way of a general meeting. In effect a rejection of the budget at this meeting would be a vote of no confidence in the Board. One option in this situation is for us to have step in powers to examine the budget. We envisage that these would be limited to occasions where a party appealed the final budget to us and we agreed that the budget would not allow the central service provider to deliver its obligations.

The alternative approach is a continuation of current arrangements whereby funding would continue to be provided through transportation charges set by the GTs. The charges would continue to be capped based on regulated revenues set ex-ante, with any over/under spend of this cap funded/kept by the GTs.

How to treat deviations from budget

It is unlikely that actual costs will regularly exceed the budget, particularly given the frequency of the proposed budget process. However, there may be situations where within year cost overruns do occur. The proposal is for small over/under spends to be kept on the balance sheet of Xoserve. For larger over spends additional funding would have to be sought from those who control the central service provider. For under spends we consider that these should be factored into the budget for future years rather than triggering a reduction in charges within year (given that consumers may not see the benefit of reduced charges instantaneously due to fixed energy contracts).

This approach means the central service provider is operated as a not-for-profit organisation. The alternative option, as we noted above, is for current processes to be retained. This would mean that any over spends of the capped funding would need to be funded by GTs, but they would not be able to pass this on to shippers through transportation charges.

How costs are allocated between users

There are two options for how the central service provider's budget could be recovered -

- Maintain the current method of allocating costs for core services. Cost would be allocated to shippers based on the transportation charging methodology set by the GTs.
- Apply a new cost reflective charging model where by cost allocation is based on the use of individual service lines.

As discussed above the services and systems which Xoserve provide are closely linked, but this does not preclude the establishment of a suitable cost allocation methodology to allow for service line charges to be produced. This does not mean that an invoice would be produced for each service line, but would make the information available at this level for those requiring it. The aim of a new cost reflective charging model would be to

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appropriately target costs on users who drive these costs. This approach would allow for different types of cost to be allocated to users using different approaches, eg a day to day running cost could be allocated in a different way to the costs associated with a system development project.

The advantage of cost reflective charging is the clearer link achieved between those that impose cost/ benefit from services and the related charge. The intention of this would be to ensure that shippers' management have more visibility of the charges and increased incentive to play an active role in managing such charges. The benefit of retaining the current process of cost allocation is that it would reduce the time required to implement.

How costs are recovered

There are two options available for invoicing and collecting charges from users -

- The GTs invoice and collect charges from shippers.[6]
- The central service provider invoices and collects charges from users directly.

The benefit of the second option would be to further enforce the direct link between the central service provider and its users. However, we recognise that there may be barriers to adopting such an approach and therefore there may be merit in retaining the current process. Shippers have indicated that the proposed approach could create additional costs due to necessary system changes. There may also be added cost imposed on the central service provider if it is placed in a position where it would take on the liability of missed payments from users.

Preliminary recommendation

Stakeholders' concerns around the transparency of Xoserve's costs and the inflexibility of funding arrangements were key factors driving the review of current arrangements. We therefore consider that it is crucial that the outcome of this review resolves these two issues. Our recommended approach, to achieve the flexibility and transparency desired, is for the annual budget process to be more inclusive. The process would be led by the Board (see section C for a discussion on Board arrangements) in conjunction with the central service provider's management as set out above.

We consider that this approach necessitates a change to how costs are recovered by the GTs. Currently the GTs recover costs through transportation charges and this is capped. This mechanism therefore does not allow for annual changes in the amount to be recovered through charges, ie the cap is fixed ex-ante for the period of a price control. Retaining this cost recovery mechanism under proposed new arrangements could leave the GTs facing a level of risk disproportionate to the level of control they have over the costs of the central service provider. It is proposed that a pass through mechanism would be provided in the GTs' regulatory arrangements. This would allow for annual changes to the costs to be recoverable through charges. We consider that this mechanism would be an appropriate way of protecting GTs from risk which they can not fully control.

This proposed approach means that regulatory scrutiny of costs would likely reduce as costs will no longer be assessed by us as part of each price control review. We consider it unfeasible for us to assess the efficiency of proposed costs on an annual basis as this would extend the length of the budget setting process. One risk of reducing regulatory scrutiny is that costs may escalate unnecessarily. We consider that a range of other factors in our recommended approach will mitigate this risk. For example -

- Shippers would be able to exercise control over costs through both the Board and wider industry participation in the budget process. They have an incentive to both limit the costs imposed on them and to ensure that costs are predictable. We note that through engagement as part of the recent price control reviews shippers have

[6] This does not preclude Xoserve from issuing invoices on behalf of the GTs as currently happens.

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made it clear that they value predictability and we would expect them to consider the central service provider's costs no differently.
- The proposed approach increases transparency for all participants and creates an environment where costs can be more easily challenged.
- Some competitive pressure on the central service provider's costs already exists through contracting out service delivery to third parties. We would expect this to continue under new arrangements.

We are also considering a range of possible regulatory measures to ensure regulatory oversight is maintained. The measures we are considering are -

- Placing an obligation on those who control the central service provider to do so in an efficient and economic manner. We need to consider further whether the obligation would be best applied through the UNC or in users' licences.
- Putting in place provision for us to direct budget changes under specific circumstances. The only circumstance we consider appropriate, at this time, is where we conclude that the budget is not appropriate to allow the central service provider to deliver its obligations.
- Ensuring that overspends of budget, which trigger a need for further funding from users, are notified to us. Given the incentive GTs and shippers have to ensure such situations do not occur we would expect this to be rarely used.[7]
- Putting in place provision for annual budget increases above an agreed percentage to come to us for approval before being applied.
- Putting in place provision to restrict what costs could and could not be passed through in charges paid by consumers.

Our initial view is that there is merit in putting in place the first three measures but not the final two. Our concern with the fourth measure is that it would lengthen the budget setting process which, as noted above, is a situation we wish to avoid. We struggle to see how the fifth measure could work in practice given that we do not regulate the prices shippers charge consumers. It would seem unfair to place a restriction on the GTs ability to pass through additional costs when we are unable to place the same restriction on shippers. We welcome feedback on these measures and our initial view.

Our preliminary recommendation is for a new cost reflective charging methodology to be adopted. We recognise that this approach will add time, and potentially cost, when compared to keeping existing charging arrangements. We consider that the drawbacks of change are mitigated by the benefits of ensuring that shippers can clearly identify the charges which they incur for using the central service provider. This ensures that shippers see the charge as a direct impact on the costs which they face rather than simply part of transportation charges where they could dismiss them as being outside of their control.

The cost allocation methodology developed would need to take into account the objectives of causality and transparency while ensuing this was achieved without undue complexity. It is important to take a proportional approach given the scale of the costs imposed on consumers by the operation of the central service provider.[8]

We also consider there to be benefits from the central service provider invoicing directly. This would ensure the transparency sought by users by creating a clear division between transportation charges (invoiced by GTs) and central service provider charges (invoiced by Xoserve). We recognise that there may be other issues with this approach. We will need to seek further advice on the ability of Xoserve to take on this role and will take into consideration any further comments through this consultation process. Stakeholders have also indicated that there would be a cost to them of adopting new charging and invoicing

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[7] The GTs are restricted on when they can change their charges and shippers may also be restricted due to the fixed nature of some energy contracts and the cost involved in changing consumers' charges.
[8] Costs of operating Xoserve account for less than 1.5 per cent of GTs' base revenues over the price control period.

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arrangements. We would welcome further evidence of these costs in response to this consultation.

Transition and implementation

We recognise that there would be a period of transition before new arrangements were fully in place. We do not consider that the introduction of new arrangements would effect the delivery of services through this transitional phase. One specific transitional issue would be ensuring that Xoserve can recover agreed costs, in particular the cost of large projects currently in development. We have committed to funding Xoserve's costs through GTs' regulatory revenues until an appropriate point in time when changes would need to be made to the financial models and licence conditions of the GTs. We discuss implementation timescales in section D of this consultation.

We recognise that the industry would also need time to develop and put in place cost allocation methodologies and agree the details of the budget setting process. We also note that while changing charging arrangements should not in itself cause costs to increase in aggregate, it may be the case that some parties are affected more than others. We would expect these distributional impacts to be investigated in the development of a cost allocation methodology and for all affected parties to be given adequate time to adapt.

Question 2: Do you agree with our preliminary recommendation for how future budgeting, charge setting and invoicing arrangements should work? Do you consider there to be greater benefits in establishing other arrangements? Please state your reasons why.

Question 3: What are your views on the measures we have identified to ensure regulatory oversight is maintained?

Question 4: Do you consider there to be further barriers to adopting a new cost reflective charging methodology which we have not considered? What would be the cost to you of establishing a new cost reflective charging methodology?

Question 5: Do you consider there to be further barriers of the central service provider directly invoicing users? What would be the cost to you of the central service provider directly invoicing users?

C. What a co-operative model means for - corporate governance and ownership
(p.22-27, 34-39 and Annex D)

Current arrangements

Xoserve is a Company Limited by Shares with each GT owning a proportion of total shares. The Board of Xoserve is comprised of directors nominated by each of the shareholders and a non-executive Chairman.

Xoserve's current governance arrangements do not allow for all users of its services to exercise control over its affairs. This seems to have lead to a perception by some users of a lack of transparency.

Options for change

Options for governance and ownership are discussed below on the basis of retaining a single central service provider. The principles could equally be applied if the decision is to split it into separate entities for delivering GT and shipper facing services.

CEPA's development of the options took a bottom–up approach. It first considered the building blocks of corporate governance then from these building blocks they derived alternative models which could be adopted. We do not discuss the building blocks in depth in this paper but refer the reader to CEPA's report for more information (Annex D, chapter 2). We focus on the principles that new governance arrangements should deliver. We consider the key principles to be that -

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- governance should allow for collective engagement and accountability by all users of the central service provider
- control should be aligned with those who bear performance risk rather than those who own the central service provider
- arrangements should be transparent in both the way they are established and on an ongoing basis.

The options developed are intended to fit with the principles we outline above. They are termed the light co-operative model, the full co-operative model and the contracted services alternative. Appendix 3 outlines the characteristics of each option and we discuss these briefly below.

The *light co-operative model* represents the least change option whereby the GTs would retain ownership and control of the central service provider. Shippers would have more power to influence decision making through the establishment of a Shipper Advisory Board with the option for the Board to appoint a non-executive shipper member.

The *full co-operative model* has two variants with the common feature being that control and the allocation of performance risk would be aligned with the central service provider's users. This would be achieved through control of the company being exercised at a high level by the Board of the company, comprised of members elected by both GTs and shippers.

In the full co-operative model with all participant ownership those who own the central service provider also control and bear its performance risk. In the alternative option, which separates ownership from control, the GTs could retain nominal ownership with clear rules set down to ensure that they do not bear all of the performance risk, given they would not have full control over the affairs of the central service provider.

A further variant to these models has been termed the *contracted services alternative.* This approach would require the creation of a new entity whose role is to contract out service delivery to third parties. The relationship between the procurement arm and the delivery bodies would result in performance risk being placed on the delivery bodies.

Preliminary recommendation

We note CEPA's recommendation for full co-operative governance arrangements to be adopted. We our minded to agree with this recommendation as we consider that it would provide the benefits sought, by allowing all users to exercise control. This would be achieved through the establishment of new Board arrangements.

We have concerns that the light co-operative model does not deliver the benefits sought. Our view is that it would not adequately meet the principles of a co-operative model described in our decision of January 2012. The only benefit we can identify is that it represents the least change option therefore limiting any time and cost of implementation. While it would give shippers more say in issues that affect them (through the establishment of a Shipper Advisory Board), control would still rest with the GTs and therefore the ability to influence decision making would be limited relative to the full co-operative model. Given our recommendation for changes to funding arrangements, this limitation may be detrimental to ensuring that appropriate oversight and safeguards are in place to protect consumers.

We consider that the contracted services alternative has some additional merits when compared to other models, primarily the alignment of risk on the party best able to manage it. However, the cost in terms of time and resource required to implement make it less favourable than our preferred approach. Issues with the adoption of this model, which do not exist under the other models, include TUPE (transfer of undertakings (protection of employment)) and the crystallisation of pension liabilities.

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If Xoserve is reformed based on the full co-operative model there is then the question of ownership. CEPA's analysis, including reference to models in action at similar bodies (see Annex A), demonstrates that ownership and control can be separated. Our preliminary recommendation is therefore for GTs to retain ownership. The main benefit would be the avoidance of additional time and cost involved in implementation were ownership arrangements to be changed.

Transition and implementation

There are a number of important steps that would need to be taken to establish new governance arrangements. Our initial view, based on CEPA's analysis, is that there are no insurmountable issues that would prevent the industry from implementing any of the models discussed in this consultation. The changes and time required to make such changes will vary depending on the model adopted. We consider the focus of transition and implementation should be on -

- establishing an appropriate Board structure
- achieving a structure which divorces ownership from risk and control.

We discuss each of these in turn below. Our discussion focuses on establishing arrangements for the full co-operative model or contracted services alternative. As we discuss above, there would be limited changes needed to implement the light co-operative model and therefore we do not examine these further.

Board structure

In order to implement a new model for co-operative governance there would need to be changes to the structure of the central service provider's Board. We consider that new governance arrangements should result in a Board structure which allows for -

- all users of the central service provider to have a right to elect, and to remove, Board members while ensuring that no party can dominate
- all users to bear the performance risk of the central service provider
- the election of Board members who have relevant skills and expertise for overseeing a company such as Xoserve
- the GTs to retain ownership but for the right of non-ownership groups to sit on the Board to be defined, to ensure non-owners are not excluded from exerting control
- Board members to provide overall direction and stewardship, including providing them with the opportunity to challenge the central service provider's senior management
- the appointment of an independent Chairman and potentially the Chief Executive and additional relevant senior management.
- flexibility in arrangements, eg to allow for the inclusion of iGTs in the future

CEPA's recommended approach to achieving these aims is for Board members to be elected via constituency groups - one for GTs and one for shippers.[9] Each constituency would be able to vote a designated number of members on to the Board. We consider that the benefit of establishing constituencies is that differences between industry groups would be represented giving all users the ability to collectively share corporate control of the central service provider. Our main concern with this approach however is that it may limit the pool of individuals for election and thus limit the ability to have a Board with relevant skills. We expect that this concern can be mitigated through careful selection of candidates and through allowing the Board to use expert advisors where necessary.

We also consider that there would be benefit in the Board ensuring that an incentive scheme, which rewards the central service provider's management for meeting financial

[9] The CEPA report discusses how NGGT could require a seat on the Board given the special circumstances of the Gemini system. It also discusses how iGTs may be included if they use the central service provider in the future.

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and performance targets, exists. However, we do not currently consider that there is benefit in us requiring such a scheme; rather it should be up to the new Board if and how they wish to run such a scheme.

We are not setting out in detail in this consultation our view of how the process of election to the Board should work or the remuneration that each Board member should receive. We consider that the industry is best placed to establish Board arrangements through the implementation phase following our decision on new arrangements. We would welcome views from stakeholders on whether they consider that such requirements should be stipulated in the GT and/or shipper licence.

Divorcing ownership from risk and control

Our preferred approach requires a separation of ownership and control, ie the GTs would retain ownership but performance risk would be shared by all users who are able to exert control. CEPA considers that one possible route to achieve this would be to specify Board composition in the Articles of Association with restrictions placed on an individual party's ability to amend them. Legal documentation may also need to define that the owners are not the party who will bear performance risk, rather all users would bear this risk.

We consider that this can be achieved and note similar arrangements are in place for Elexon.[10] Elexon is owned by National Grid Electricity Transmission but all users of Elexon's services exert control and bear performance risk. The Elexon model achieves this separation through the obligation on all signatories to the Balancing and Settlement Code (BSC) to fund and bear Elexon's performance risk.

The risks in relation to the central service provider are likely to range from cost exceeding the budget to more serious failures of either the systems which it operates or its users. Under the full co-operative model the parties which control the central service provider would bear the risk of such failures. However, given the proposed funding arrangements, ultimately consumers will be the party affected by any failure. As discussed in section B we are proposing a number of measures to ensure consumer protection remains.

Question 6: Do you agree with our preliminary recommendation to apply the full co-operative model with retained GT ownership? Do you consider there to be greater benefits in establishing alternative arrangements? Please state your reasons why.

Question 7: Do you agree or disagree with the principles of the Board structure we outline? Do you consider that these principles can be achieved through the arrangements outlined?

Question 8: Do you agree or disagree with our initial view that the details of the establishment and ongoing affairs of the Board are best left for the industry to develop? If you disagree please state what areas you consider that we should require through licence obligations.

D. Further transition and implementation issues

CEPA notes that the length of time required to implement reform will vary depending on the final arrangements taken forward. We expect the industry to play a key role in ensuring that implementation is progressed under reasonable timescales. We encourage the industry to consider now, while the consultation is open, what will be required to ensure timely implementation. However, we recognise that it may be premature for the industry to establish formal arrangements prior to the outcome of this consultation.

As part of our consideration of licence modifications which may be required to implement our decision, we will be considering whether a licence requirement should be placed on one

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[10] Elexon is the administrator and delivery body for the Balancing and Settlement Code (BSC) for the electricity sector. It is also know as the BSCCo.

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of more parties to ensure implementation is progressed. We would welcome views on the need for such requirements.

We recognise that there will be a direct cost to the industry from implementing reform, eg progressing changes to contractual arrangements. CEPA's report provides a preliminary assessment of the costs of transition to new arrangements. These estimates vary depending on which model is progressed with the cost of our preliminary recommendation expected not to exceed £2m. We welcome feedback on this cost assessment.

Question 9: Do you consider that a licence requirement should be placed on one or more parties to ensure that implementation is progressed? If so, what do you consider a reasonable timescale in which full implementation can be complete?

Question 10: Do you have any views on CEPA's estimated cost of implementation? Please provide evidence of any additional costs you consider should be accounted for.

Related industry developments

As we highlighted above, we do not consider that this review will have an effect on service delivery and in particular the delivery of large development projects already in progress, eg changes to the UK Link system. Funding for delivery of services has been provided as part of the RIIO-T1 and GD1 settlement and will continue until an appropriate time when implementation of new arrangements is complete. Going forward we consider that new arrangements would better facilitate ongoing industry changes, for example those linked with the Smart Metering Implementation Programme (SMIP).

We are aware of ongoing discussions related to iGTs making use of the central service provider in the future.[11] We consider that the proposed new arrangements will not hinder this industry led development and that new arrangements put in place should be flexible enough to allow for this possible future development. We have suggested under our discussion on Board structure that, were iGTs to use the central service provider, they should be able to exert control like all other users through inclusion on the Board.

Next steps

We have included a set of questions for stakeholders in this letter which are summarised in appendix 1. We request that you send responses to joanna.campbell@ofgem.gov.uk by 26 June 2013. Please note that, unless clearly marked confidential, your response will be placed on our website.

Following this consultation process we will publish our decision on arrangements that we expect the industry to establish. We will also issue a statutory consultation on any necessary licence modifications and consequential changes to the Price Control Financial Models and Price Control Financial Handbooks.

Yours sincerely

Andy Burgess
Associate Partner, Transmission and Distribution Policy

[11] Currently iGTs do not use the services delivered by Xoserve nor are iGTs party to the UNC. They are party to their own network code, the iGT UNC.

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Appendix 1 – Questions for consultation

Service delivery

1. Do you agree that there are benefits in retaining the central service provider as one delivery body for all systems and services, including Gemini systems? Do you consider there to be an alternative structure with greater benefits? Please provide evidence of these additional benefits.

Budget setting, cost allocation and charging

2. Do you agree with our preliminary recommendation for how future budgeting, charge setting and invoicing arrangements should work? Do you consider there to be greater benefits in establishing other arrangements? Please state your reasons why.
3. What are your views on the measures we have identified to ensure regulatory oversight is maintained?
4. Do you consider there to be further barriers to adopting a new cost reflective charging methodology which we have not considered? What would be the cost to you of establishing a new cost reflective charging methodology?
5. Do you consider there to be further barriers of the central service provider directly invoicing users? What would be the cost to you of the central service provider directly invoicing users?

Corporate governance

6. Do you agree with our preliminary recommendation to apply the full co-operative model with retained GT ownership? Do you consider there to be greater benefits in establishing alternative arrangements? Please state your reasons why.
7. Do you agree or disagree with the principles of the Board structure we outline? Do you consider that these principles can be achieved through the arrangements outlined?
8. Do you agree or disagree with our initial view that the details of the establishment and ongoing affairs of the Board are best left for the industry to develop? If you disagree please state what areas you consider that we should require through licence obligations.

Transition and implementation

9. Do you consider that a licence requirement should be placed on one or more parties to ensure that implementation is progressed? If so, what do you consider a reasonable timescale in which full implementation can be complete?
10. Do you have any views on CEPA's estimated cost of implementation? Please provide evidence of any additional costs you consider should be accounted for.

General

11. Do you have any other comments on any aspect of the CEPA report or this consultation letter?

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Appendix 2 – Background to Xoserve and this consultation

The GTs established Xoserve in 2005 to act as the central agent (the "GT Agent") providing a common system and service interface between GTs and the wider industry.[12] It is owned and governed by the GTs and underpinned by licence and Uniform Network Code (UNC)[13] obligations. Xoserve is therefore not the party which decides what services to deliver, rather it is there to deliver obligations, and any changes to them, in the UNC.

Delivery of the agency services it provides are predominantly (c. 90%) funded by the GTs through their regulated revenues, which in turn are recovered from shippers through transportation charges. The regulated revenues are set ex-ante for the length of a price control (previously five and now eight years). This means that the charges to shippers, in relation to Xoserve, are capped for this period. The remainder of funding is for agency services that are deemed appropriate to be funded by the user(s) requesting the service (known as 'user pays' services). Xoserve also provides services outside its GT Agent role on bilateral commercial terms.

We asked stakeholders, as part of the recent price control reviews for the gas distribution and gas transmission sectors (RIIO-GD1 and T1)[14], whether changes to arrangements introduced as part of the previous price control had driven improvements in the quality of service and the perception of value for money.[15] Some responses indicated that there had not been marked improvements and some considered that current governance and funding arrangements were restricting Xoserve's ability to deliver what they wanted.[16] Therefore, in parallel with the RIIO-GD1 and T1 reviews, we commenced a more in depth review of arrangements for the central service provider.

Following consultation, in January 2012 we concluded that reform of the funding, governance, and ownership arrangements on the basis of a co-operative model was needed to ensure that they are fit for purpose to deliver value for money services in a time of industry change.[17] Industry participants had proposed a number of different options that could potentially fit within the scope of the proposed co-operative model.

With this in mind we chose to develop these options through an implementation project to allow further industry discussion. CEPA was commissioned to develop proposals compatible with the principles of a co-operative model, drawing on proposals put forward by industry in their responses to the September 2011 consultation.[18]

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[12] The GT licence (See Standard Special Condition A15 (Agency)) obliges the GTs to have a joint agreement in place for the provision of common systems and services and sets out the principles by which a common service provider should be established.
[13] The UNC is the network code for the gas industry. It sets out common rules and processes, such as balancing of the gas system, which must be followed by parties to the code. GTs and shippers are obliged to be party to the UNC.
[14] These reviews were commenced in July 2010 and concluded in December 2012 with the publication of Final Proposals which set the price control framework, applying from April 2013 to March 2021, for the GTs.
[15] For an explanation of the changes introduced in 2008 see Gas Distribution Price Control Review – Final Proposals (Dec 2007), Chapter 8: http://www.ofgem.gov.uk/Networks/GasDistr/GDPCR7-13/Documents1/final%20proposals.pdf
[16] See for example a summary of responses to our stakeholder engagement, para. 5.8 of: http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/GD1decisionoutput.pdf
[17] Upcoming industry change includes the Smart Meter Implementation Programme (SMIP) and gas settlement reform (Project Nexus).
[18] Open letter consultation: Review of Xoserve (Sept 2011): http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=324&refer=Networks/GasDistr/RIIO-GD1/ConRes

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Appendix 3 – Options for co-operative governance

Element	Current arrangements	Light cooperative model	Full cooperative model	
			GT ownership	All participants ownership
Structure	One company			
Ownership	GTs			All participants
Control	GTs		All participants	
Type of organisation	Limited company			Limited company or Company Limited by Guarantee
Financing	GTs		All participants	
Annual meeting	No budget oversight (Board responsibility)		All participants	
Board composition	GTs only	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	
Performance risk allocation[1]	GTs	GTs (but depends on cost pass through)	All participants	
Market risk allocation[2]	Mainly GTs, some service users	Service users		
Profit / not for profit	Profit	Not for profit, but with ability to earn surpluses not for distribution[3]		
Other groups	None in terms of wider industry focus	Shipper Advisory Board	One of more User Groups	
Minority interests	Specific protections (which might vary between models)			
	Contracted Services Alternative			
Structure	One company	Two companies; Central entity contracts with (independent) service provider		

Source: CEPA report (March 2013, p.25)
Notes: (1) 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. (2) 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? (3) 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.

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