

Andrew Burgess
Associate Partner, Transmission and Distribution Policy
Ofgem
9, Millbank
London
SW1P 3GE

Seán Mc Goldrick
Gas Development Manager,
Transmission Network Service

Sean.J.McGoldrick@nationalgrid.com
Direct tel. +44 (0)1926 655 791
Direct fax +44 (0)1926 653 052

www.nationalgrid.com

24th June, 2013.

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

Dear Andrew,

Thank you for the opportunity to input into the consultation proposed in your open letter of April 29th, 2013. National Grid Gas Transmission (NGGT) has taken an active part in the development of options for improving the current arrangements for the provision of central transactional services and is committed to working with industry participants in order to implement solutions which deliver greater efficiency, transparency and customer satisfaction.

Our reply will include specific responses to the 11 questions raised in Appendix 1 of your letter, together with further expansion on our preferred implementation approach. We are happy for the contents of this letter to be shared with the industry.

Executive Summary

National Grid Gas Transmission (NGGT) has reviewed the CEPA report (February 2013) produced in response to Ofgem's request for a review of Xoserve's Funding, Governance and Ownership and is responding to the Open Letter Consultation: "Consultation on implementing new funding, governance and ownership arrangements for Xoserve, the gas transporter central agent", published by Ofgem on April 29th, 2013. Our primary comments are as follows:

- We recognise that, as Transporters' Agent, Xoserve perform an essential role in the provision of central data services to the gas industry, and have, since their inception in May 2005, been key contributors to the successful development, implementation and operation of the UK's liberalised and competitive gas market. We welcome the fact that Ofgem acknowledges the importance of the function performed by Xoserve, and is actively considering how this vital role is to be delivered in the future.

- We broadly support the proposals for a change in the arrangements for the provision of central transactional services, although we have concerns regarding the timetable proposed for their implementation and their potential for negative impact on the industry's and our own ability to effectively and efficiently deliver key domestic and international regulatory obligations.
- We welcome the fact that both the CEPA report and Ofgem's Open Letter Consultation acknowledge that, as a discrete industry sector within the overall GB Gas Industry, the Transmission sector has specific requirements in addition to, and independent of, those shared with the Distribution Network companies. We will expand upon these, and their potential requirement for additional flexibility in relation to the proposed new arrangements, later in this response.
- Whilst the evolution of the proposed arrangements from those in your consultation in 2011 has shown a positive move towards scenarios which can offer enduring benefit to our customers, we are concerned that the timing of the introduction of the proposed models may negatively impact on NGGT's ability to facilitate key domestic, international, commercial and regulatory outputs. We believe that greater thought must be given to how pre-existing and in-flight regulatory and commercial change initiatives, (e.g. implementing EU Network Codes), can be accommodated alongside the implementation of new arrangements for Xoserve. We are keen to work with all industry stakeholders, Xoserve and Ofgem to develop detailed and specific implementation scenarios which minimise the impact of introducing a step change to central service provision arrangements.
- In your consultation letter, you have grouped the options for the proposed arrangements broadly into 3 categories:
 - Delivery of services
We believe that giving industry participants greater control over those services which directly affect their businesses will drive efficiencies and improved customer satisfaction, subject to an appropriate level of redistribution of existing regulatory and contractual obligations, such that obligations and licence duties are aligned to the level of control over Xoserve and its outputs.

We acknowledge your preference for the industry to retain a single central service provider and, in principle and with today's GB Market in mind, we support this proposal.

Over the course of the next 4 years, the GB gas industry will be undergoing unprecedented levels of commercial and regulatory change as a result of the EU Third Package. We believe that, in order to safeguard our ability to meet our licence obligations, a phased approach to the change of control of system development for affected strategic platforms such as Gemini should be adopted.

- Budget setting, cost allocation and charging

We note the suggestion that historical ex-ante allowances could have acted as an inhibitor for cost transparency and agree that the proposed Pass-Through funding mechanism should provide the Shipper community with sufficient detail to be able to clearly identify their Xoserve costs. For the revision of charging mechanisms for Xoserve's services to be successful, it must be predicated upon the completion of a detailed Activity Based Cost (ABC) analysis to ensure that industry participants are required only to pay for those services they use.

- Corporate governance and ownership

We note the industry's desire to have a greater say in the day-to-day running of Xoserve, and the proposal that this can be achieved by the introduction of Shipper representative membership of Xoserve Board. We welcome customer input into the development of services provided by Xoserve and agree that changes at Xoserve's Board level have the potential to deliver greater cross-industry accountability for the efficient development and timely delivery of Xoserve's services. We believe, however, that further work is needed to describe the enduring process by which both Transmission and Distribution industry sectors' stakeholders inform the scope, scale, priority and timing of service development and change delivery.

We would also like to explore the options for including the role of the Joint Office in the scope of this review. Introducing new system change governance arrangements will enable a more transparent and inclusive element to regime change but we are concerned that, by excluding the Joint Office function from this process, there may be a significant disconnect in the overall industry decision making process. Although not a decision making body, the Joint Office has a significant role in facilitating regime change and so is a logical link in the overall process. We believe that incorporating the Joint Office as an integral part of the revised Xoserve function will deliver change efficiencies and greater transparency to all industry participants.

We remain committed to working together with Ofgem and our customers to develop effective and inclusive processes within which the cooperative business model can operate efficiently and deliver the considerable changes which the GB commercial and regulatory regime faces over the coming years.

If you would like to discuss the content of this letter at any time, please do not hesitate to contact me.

Yours sincerely,

Seán Mc Goldrick

Gas Development Manager,
Transmission Network Service,
National Grid.

Appendix 1 – Detailed responses to the consultation questions

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.

We agree that there are significant benefits to be had from retaining a single Central Service Provider model for UK-Link Systems and believe that this will be a key enabler for the roll-out and implementation of strategic initiatives such as Smart Metering and the establishment of the Data Communications Company (DCC).

With regards to the Gemini suite of systems, which is owned by NGGT and maintained by Xoserve, the benefit of integration with Xoserve's systems must be balanced against the growing legal and regulatory requirement to interact with European TSOs (and their systems) and meet growing international regulatory obligations.

We believe that the scale of European change to be implemented between now and 2017 is likely to result in a resource constraint, both human and technical, for market driven changes during this period. Given that this suggests that most of the Gemini system change over the first half of the RIIO Period will be regulatory in nature, we believe that applying Transmission sector-specific transitional arrangements would be appropriate.

We propose that NGGT retain control over the scheduling and planning of Gemini change up to and including 2017 as this will enable us, on behalf of the Transmission sector as a whole, to optimise the application of skilled and knowledgeable resource to regulatory and market driven change.

We intend to undertake a re-write of the Gemini suite of systems early in the second half of the RIIO period. In developing our re-write strategy, we will consider options for the separation of Shipper-centric functionality (e.g. the calculation of Balancing charges) from that needed by NGGT.

We believe that the adoption of this phased approach for the Transmission sector will:

- Deliver most of the desired outcomes of the Funding, Governance and Ownership review from Day 1 of the new arrangements.
- Facilitate a clear delineation between Distribution and Transmission sectors, allowing the Distribution sector to focus on those strategic initiatives (e.g. Smart Metering) and systems (e.g. Sites & Meters, Supply Point Administration, etc.), which are relevant to it.
- Ensure that the necessary resources can be applied to the delivery of European Regulatory change.

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.

2.1 Annual Budget

We believe that the setting of the annual budget will benefit from adopting several steps:

- a. Setting an annual system change workplan.
- b. Setting Xoserve's internal investment workplan.

- c. Ensuring sufficient resources are available to deliver both of these workplans.
- d. Calculating the cost and, where appropriate, reviewing the cost allocation methodologies to be applied.
- e. Authorising the annual budget.

In order to accurately capture the industry's requirements for system change, we recommend that an Industry Change Management Group (ICMG) be set up. We consider steps a, c and d to be within the remit of the ICMG who, working with Xoserve, will agree the annual system change proposals, estimated costs and resource requirements. This group should consist of industry representatives from all sectors of the industry, Transmission / Distribution, Shipper and Transporter.

To advise the scope of the ICMG, we suggest that two Change Management Group sub-committees be created, one focusing on Distribution sector-only change and the other on Transmission sector system development requirements. Where a joint service is the subject of proposed change (e.g. Invoicing), it is proposed that this could be addressed at the ICMG.

In addition to developing and agreeing annual change workplans, the ICMG should also be tasked with developing forward looking change plans out to Y + 5.

The Xoserve Board should be responsible for step b, identifying those investments necessary to meet its ongoing system maintenance / replacement requirements. It is anticipated that these investments will be proposed by members of Xoserve's Executive team.

As agreed at the industry workshops held by CEPA in November and December 2012, we believe that this process can only work if changes needed to satisfy legislative and regulatory requirements are given priority over market driven change in terms of budgeting, planning and resourcing.

Step e, the authorisation of the annual budget, should see these key elements of investment (including any surplus / deficit from the previous year) brought together following their individual approval by the relevant industry / xoserve group. The Xoserve Board should be empowered to approve / disapprove of the annual budget as a whole, but we consider they should not be able to change its content. The industry change workplan can only be altered with the approval of the relevant ICMG Sub-committee. In the event of an unresolved dispute over annual workplans, we believe that Ofgem should be given step-in powers to regulate a decision.

Given the dynamic nature of legislative, regulatory and commercial factors in domestic and international gas industries, it is likely that within-year changes will be required to the annual workplan. It is recommended, therefore, that the ICMG Sub-committees meet on a regular basis (e.g. bi-monthly) to agree and incorporate these changes into the overall workplan. Depending on the scale of variance to the annual plan's costs, a mechanism for reviewing Xoserve's charges within year may also be needed.

2.2 Treatment of under / over spend.

It has been proposed that under / over spend of the annual Xoserve budget will be kept on Xoserve's balance sheet with the appropriate recovery via the proposed Pass-Through mechanism during the following financial year. We agree with this proposal, with the following caveats:

- a. A clear financial cut-over is carried out in moving to the new arrangements.

- b. Arrangements are put in place to protect Xoserve's owners from any financial impact in the event that significant overspend is incurred.
- c. Arrangements are put in place to protect Xoserve's owners from any financial impact in the event that the new arrangements are cancelled / significantly changed.

2.3 Not-for-Profit

It has been proposed that Xoserve could become a "Not-for-Profit" organisation. We support this proposal as we feel that profit generation would be counter-productive for a cooperative business model.

2.4 Cost allocation

In your letter, you propose the introduction of a cost-reflective charging model whereby cost allocation is based on the use of individual service lines. We support this proposal and would suggest that the following rules should apply to the cost allocation methodology:

- a. Clear delineation between individual, constituency and community services must be carried out in advance of the workplan development.
- b. A full and detailed Activity Based Costing exercise must be completed to identify, insofar as it is reasonably practicable, the cost of each service provided by Xoserve and individual organisation's share of that cost.
- c. The flexibility to adjust charge allocation methodologies in a timely fashion in response to changes to services and the variations to the number of service customers / the levels of customer service usage should be incorporated into the process.
- d. Full Pass-Through of Transporters' costs, including, for NTS, all project delivery support costs associated with agreed Gemini change (i.e. NTS' involvement with System Process development, Testing, Post-Implementation support, etc.). These may need to be invoiced to Xoserve for inclusion in its overall charges for Gemini. It is anticipated that this requirement will need to continue until such time as Transmission and User Gemini functionality can be segregated.

2.5 Invoicing arrangements

Two options for invoicing and collection of charges from service users have been presented; GTs invoice and collect charges from Shippers (status quo) / Xoserve to invoice and collect charges directly from Users. Our preference is for Xoserve to invoice and collect charges from all users of its services in a consistent manner. This ensures that each user has full transparency of the cost of its services, enabling them to make an informed input into ongoing service development and delivery.

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

3.1 Controlling the Central Service Provider

It has been proposed that an obligation be placed on those who control the Central Service Provider to do so in an efficient and economic manner, and that this could be achieved by applying the obligation to either UNC or Users' licences. We support this proposal as long as the obligation is laid equally on all industry participants. We would propose that this obligation is applied to Users' licences as it is likely to be enduring in nature.

3.2 Ofgem intervention in Xoserve's budget

The consultation discusses options for putting in place a provision for the Authority to direct budget changes under specific circumstances, (e.g. where the agreed budget is insufficient to enable the Central Service Provider to deliver its obligations). We support this proposal as it is essential that the Authority retains a range of Step-In powers in the event that the proposed new arrangements falter. We would add a condition that the Authority also be able to direct budget changes in the event that a Shipper's or Transporter's ability to deliver on their licence obligations is put at risk or in the event of an unresolved dispute over annual change workplans.

3.3 Notifying Ofgem of overspends

The consultation document discusses the need to notify Ofgem in the event that overspends trigger a need for further funding. We support this option, with the refinement that:

- a. The term "overspend" should only refer to un-budgeted costs. Agreed within-year additions to the budget should be treated as budgeted costs.
- b. A realistic level of flexibility in the budget should be allowed (for example +/-10%) within which range no specific notification is needed.
- c. Xoserve should be able to adjust its charging mechanism within the budget year to enable it to recoup any overspend.
- d. Transporters should be able to adjust their transportation charges to allow pass-through of budget increases within the budget year.

3.4 Ofgem authorisation of budget increases

One of the options relating to regulatory oversight of the new arrangements suggests putting in place a provision which requires Ofgem authorisation for annual budget increases above an agreed percentage before being applied. We do not support this option. We believe that having to gain the Authority's consent to every increase in spend over a certain limit will cause high levels of unnecessary change and negatively impact on Users' ability to meet their obligations.

3.5 Restricting the scope of passed through costs

The consultation discusses putting in place a provision to restrict what costs could and could not be passed through in charges paid by customers. We do not support this option. We believe that a level playing field will be necessary if the new funding arrangements are to succeed. Ofgem is currently unable to restrict the pass-through of costs by Shippers, and so placing a restriction on Transporters would be unfair and restrictive.

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?

One of the key drivers for the review of Xoserve's Funding, Governance and Ownership arrangements has been the Shipper community's desire for greater transparency. Failure to apply a robust cost reflective charging methodology will mean that cost transparency will not be achieved.

To this end, we believe that a detailed Activity Based Costing analysis must be carried out prior to the implementation of the new arrangements, and annually thereafter, in order to identify the costs to be attributed for individual services. Further work is needed prior to the implementation of the new arrangements to refine the service allocation model such that attributable service costs can be correctly assigned to industry participants.

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?

With the exception of a small number of User Pays charges, Xoserve's costs have, historically, been smeared across the Shipper Community via Transportation Charges. Price Control allowances have been incorporated into Transportation charges, resulting in limited visibility as to the scale or timing of Xoserve costs.

Moving to a scenario where Xoserve directly invoices users for the services they receive will mean that every user will be able to clearly see how much Xoserve's services are costing them. At present Xoserve's costs are invoiced via a monthly Agency Services Agreement (ASA) invoice to each Transporter. The introduction of direct billing for all users will see an increase in the number of invoices to be prepared, issued, tracked and reconciled. We believe that the benefits derived by industry participants in achieving the desired levels of transparency and accountability, far outweigh the anticipated additional cost.

In line with the allocation of costs for other services, we would expect the cost of this additional invoicing service to be charged to each participant based on their use of the service.

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.

We understand the Shipper community's desire to have a greater say in the future direction of the Central Service Provider, and have seen Xoserve take significant steps to increase their engagement with the industry as a whole over the last two years. Xoserve have undertaken to provide representation at key industry forums, have held senior level strategic engagement events, and has provided a positive input to the FGO review process. Shipper satisfaction levels, measured via a twice yearly survey carried out by Xoserve, have shown continuous improvement. Detailed project requirements definition for key programmes such as the UK-Link Replacement Programme (formerly Project Nexus) has clearly demonstrated that Xoserve not only actively seeks out Shipper views, but is willing to adjust its plans in order to facilitate meeting Shipper expectations.

The key elements which are missing from the current arrangements, when compared to the proposed Full Cooperative model, are full transparency of Xoserve's costs and a re-distribution of powers to direct Xoserve's workload. We support the initiative to increase transparency and engagement in the definition and management of Xoserve's outputs and their associated costs, but feel that having the Xoserve Board as the final arbiters of what can / cannot be spent introduces a level of inflexibility at a time when unprecedented levels regulatory, legislative and commercial

change are expected as a result of strategic industry programmes such as Smart Metering, the UK-Link Replacement Programme and the implementation of the European Third package and the anticipated increase in management information provision resulting from the introduction of the RIIO model. To this end, we suggest that a broader catchment, working-level, Industry Change Management Group (ICMG) be established, empowered to take a view on change in the round with the aim of acting as the architects of industry change plans in the short and medium terms.

In terms of Xoserve ownership, we agree that changing ownership arrangements would likely introduce the risk of delay to the implementation of any new arrangements. Changing the ownership of Xoserve would introduce a cost of ownership to other industry stakeholders and we have struggled to identify anything in the way of recompense for this cost.

The proposed cooperative model would see a shift in control away from Xoserve's owners. It is essential that any dilution in Transporter control over Xoserve is accompanied by an appropriate reduction in risk.

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?

The proposed board membership incorporates equal numbers of both Transporter and Shipper representatives. CEPA have also proposed that one of the Transporter "seats" on the revised Board should be ring-fenced for a National Grid Gas Transmission appointee. We concur with this requirement as it is essential that the Transmission Sector, currently undergoing an unprecedented level of change, is directly represented.

The proposed structure also suggests the introduction of Xoserve's CEO as a board member and the appointment of an independent chairman. We broadly support these proposals. The direct burden to deliver on its service outputs will increase as a result of the realignment of service control to the various proposed constituencies, and so it is reasonable for Xoserve's CEO to have a say on Xoserve's Board. A skilled, knowledgeable and experienced independent chair will be essential to facilitate the cultural shift needed to make a broad-catchment board a success.

The final element of the proposed board composition would see other members of Xoserve's executive team being appointed to the board. In this instance, we do not support this proposal and believe that Xoserve's executive team should continue to be responsible to the Board. We feel that having Xoserve's Executive team sit on its Board could inhibit its ability to influence the quality and cost effectiveness of Xoserve's deliverables.

We are concerned that the Board may not convene with sufficient regularity to deliver the flexibility needed by the industry. Currently Xoserve's Board meets on a quarterly basis, focussing on corporate governance topics such as Health & Safety, Operational and Financial performance, Customer satisfaction, etc. The additional burden of requiring an in-depth challenge and review of ongoing progress with industry investment in systems development and the associated changes to annual business plans is likely to result in a significantly increased burden to the proposed scope of the Xoserve Board. We believe that a working level industry forum is needed, allowing input from all affected stakeholders, meeting on a regular basis to challenge, review, and update progress with

Xoserve's deliverables. The output from this forum, where appropriate, can then be fed through to Xoserve's Board for ratification.

In order to ensure that future Xoserve Board members have sufficient skill and experience to contribute effectively to the corporate governance of Xoserve, we believe that role descriptions should be defined and published as a guideline to those industry stakeholders seeking to appoint a Board member.

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.

We consider that, in its role of approving the central service workload and spend on behalf of the industry, the definition of the cooperative model Board's affairs should be defined by current Board and Xoserve's executive team. These should be presented to the industry prior to the introduction of the new arrangements for agreement and ratification. Assuming this is carried out satisfactorily, we see no need to introduce transporter obligations to this effect.

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?

Provide that sufficient assurance can be provided by Ofgem that Transporters will not incur increased financial / regulatory risk from the introduction of the new arrangements and, subject to satisfactory mitigation of the concerns raised by NGGT throughout this review, we do not envisage the need for specific licence obligations being needed to ensure its implementation.

We do, however, propose that Ofgem seek an assurance from Xoserve that they will facilitate the transition from old to new arrangements.

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.

Whilst the general principles of the new arrangements have now been developed, we believe that there is a great deal of work yet to be carried out in terms of:

- a. Fine tuning the various options for the new arrangements.
- b. Carrying out the necessary ABC analysis.
- c. Developing the appropriate licence and UNC changes.
- d. Revising the necessary contractual arrangements.
- e. Developing a detailed implementation plan, incorporating all necessary transitional activities.
- f. Implementing a clear cut-over from old to new arrangements.

We note that there is some uncertainty as to the length of time needed to robustly implement the new arrangements.

Considering that many of the necessary activities involve the development and agreement of legal frameworks and contracts, we are unable to speculate as to whether or not the proposed target of £2m for implementation is realistic or not. That said, we do not believe that a detailed cost impact analysis is appropriate for the implementation phase, as it will incur additional cost and delay in the move to the new arrangements.

We believe that internal management costs associated with facilitating the implementation should be borne by all parties. We agree that the cost recovery model, applied to Phase 1 of the review, is an appropriate mechanism for incremental cost recovery.

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

Whilst we support this initiative in as much as it aims to increase customer engagement, provide cost transparency and facilitate the implementation of key Distribution sector strategic initiatives, we remain concerned that the unique nature of Gemini system ownership and support, coupled with unprecedented levels of legislative, commercial and regulatory-driven system change currently emanating from Europe, are put at risk by the introduction of these arrangements.

We consider the application of a phased approach to the full introduction of cooperative arrangements for Gemini related services would enable us to meet our legislative and regulatory obligations, allow the Distribution sector to focus on facilitating the roll-out of Smart Metering, and still deliver significant benefits to our customers. We would welcome the opportunity to discuss options relating to this issue.

We note, in the consultation letter, Ofgem have stated an aspiration for the implementation of the new arrangements by April 2014, albeit with an acknowledgement that this may not be fully achievable. We would suggest that, given the volume of licence, UNC, and contractual reform, coupled with the need to develop and agree new industry governance arrangements, April 2015 would be a more appropriate target.

We believe that the scope of the review should be expanded to include the Joint Office (JO) function within the Central Service Provider model. We consider that the JO performs an essential role within the overall industry change regime and, so are a logical extension of the Central Service Provider function. Linking the JO with Xoserve will provide the Central Service Provider with greater, up-front, visibility and involvement with regulatory and commercial change programmes, thus improving their ability to efficiently and effectively plan resources, budgets and outputs.