



# **FUTURE ARRANGEMENTS FOR THE GAS TRANSPORTER CENTRAL AGENT**

**OFFICE OF GAS AND ELECTRICITY MARKETS**

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October 2013

**Legal and regulatory implementation report**



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## EXECUTIVE SUMMARY

Ofgem has published its consultation paper for Phase 1 of its project to implement new funding and governance arrangements for Xoserve.<sup>1</sup>

Whilst the consultation was open to responses, Ofgem asked the CEPA consortium<sup>2</sup> to continue the development work on the options for the regulatory and contractual framework to implement the proposed new arrangements.

This report sets out the steps that we have followed to take forward the options which were set out in our Phase 1 report,<sup>3</sup> the relative advantages and disadvantages of different approaches and our views on a preferred approach. Whilst Ofgem has not yet made a final decision on new cooperative funding and governance arrangements of Xoserve, we have been asked to solely consider options for the regulatory and contractual framework that would implement the minded to position which Ofgem proposed in its April 2013 consultation: this is the Full-Cooperative funding and governance model with retained Gas Transporter (GT) ownership.

This would involve Xoserve acting as a Central Service Provider (CSP) to Great Britain's (GB) gas industry delivering services directly to customers rather than as an agent delivering licence and code obligations on the GTs behalf.<sup>4</sup> Under this model, GTs and Shippers would share corporate control of the CSP and would jointly fund its activities.

### 1 Objectives for the supporting legal and regulatory framework

We have sought to develop options for the supporting legal and regulatory framework that would implement the Full-Cooperative with retained GT ownership model in order to meet with a series of high-level objectives. These include that:

- the arrangements should reinforce and facilitate a responsive IT and information service provider given the gas industry's requirements;
- the legal framework and its supporting documents should ensure alignment of obligations with control under the CSP regime;
- while implementation of the CSP regime should be industry led, there must be certain reserved regulatory powers for the Gas and Electricity Markets Authority (the "Authority") to influence the new arrangements in protection of the public interest; and
- to the extent feasible given the objectives above, the legal framework should be as simple and practical to implement given current arrangements.

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<sup>1</sup> Ofgem (2013): 'Consultation on implementing new funding, governance and ownership arrangements for Xoserve, the gas transporter central agent', [available here](#).

<sup>2</sup> For Phase 2 this has included TPA Solutions.

<sup>3</sup> These were provided in Annex E which considered initial principles for a supporting regulatory framework.

<sup>4</sup> Which is the focus of its current commercial activities.

Based on these objectives, we have sought to distinguish the different approaches or “options” for the legal framework which could in theory support the Full Cooperative with retained GT ownership model and to identify our preferred approach.

## 2 Instruments available to support implementation

There are a variety of legal instruments which could be used to implement the proposed cooperative arrangements. These include<sup>5</sup>:

- *GT licences* – which are licences to provide gas transportation services. Each GT has a separate transportation licence.
- *Shipper licences* – which are licences to transport gas through a transportation system operated by a GT. Again, each Shipper has a separate Shipper licence.
- *Uniform Network Code (UNC)* – an *existing* multiparty contractual framework which supports the supply, trading and transport of gas in GB with defined regulatory oversight and governance.
- *Multiparty contracts* – for example, the current Agency Service Agreement (ASA) which is a multi-party contract between Xoserve and the GTs.
- *Bilateral contracts* – Xoserve already has bilateral contracts in place with Shippers for certain bespoke services. Other bilateral contracts could be developed to support legal implementation.
- *Articles of Association* – which together with the memorandum of association, form the company’s constitution.

Some of these instruments are regulatory instruments, whereas other instruments, such as Xoserve’s Articles of Association and the contracts to which it is a party, are governed by normal corporate laws.

We have assumed that legal implementation must be achieved by means of *existing* gas regulatory instruments, including GT licences, Shipper licences and the UNC, as there is no intention to enforce the new arrangements through the creation of a new CSP licence (which whatever its merits as an approach, we have not been asked to consider).

In developing legal options for the CSP regime, we have also been cognisant of the fact that each of these instruments has its key distinguishing characteristics (in terms of the delivery of a new regulatory framework to implement the cooperative model). For example:

- the UNC (as a multi-party agreement between the GTs and users of the gas transportation system) is suited for the establishment of regime principles between the parties that would control the CSP under a cooperative framework (i.e. GTs and Shippers);

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<sup>5</sup> This list contains the most realistic options rather than being exhaustive. Use of legislation defining a new licensable activity is another. Gas Act changes would also be primary legislation.

- the Articles of Association which define the objectives of the company and other aspects of its corporate governance are, almost by definition, the appropriate instrument for enforcing the corporate governance arrangements of the CSP; and
- multi-party contracts (which the UNC is a particular example of already applying within the gas industry) as a means for specifying requirements between contract parties, appear suited to specifying the levels of services and outputs from the CSP and the associated payment terms of the contract parties.

These distinguishing features of each of the instruments available to support implementation, together with the high-level objectives for the supporting legal framework set out above, have influenced our option design and evaluation process.

### **3 Identifying approaches for legal implementation**

Given the above, in seeking to identify different approaches which might then be considered for legal implementation, a first issue is whether the arrangements require, and indeed would benefit from, changes to Shipper licences in addition to GT licences, rather than relying on the UNC to bind Shippers into the new funding and governance arrangements.

A more complex issue is whether the new regime is best contractually structured relying solely on the UNC (an existing multi-party agreement with the gas sector), in which the CSP becomes a party to the UNC (potentially on a different basis to existing Shippers and GTs) or whether there should as now, be a combination of obligations, principles and mechanisms set out in the UNC, with additional service agreements (along the lines of the existing ASA between Xoserve and the GTs).

These two factors give rise to four broad options, based on different combinations of approach, as we have illustrated in Figure 1 below.

Figure 1: Different approaches for implementing the Full Cooperative model with retained GT ownership

	Amend only GT licences	Amend GT and Shipper licences
<b>CSP not a party to the UNC</b>	<p><b>Option 1:</b></p> <p>GT licences set out the requirements of the CSP regime to be reflected in the UNC. The UNC then binds both GTs and Shippers to the new joint arrangements and establishes the detailed principles of the new regime. The UNC would, as a result, set out all obligations and rights of Shippers and GTs in relation to the CSP. A multiparty Service Agreement contract or possibility numerous separate contracts (involving the CSP, Shippers and GTs) would be used to set out the service requirements of the industry from the CSP.</p>	<p><b>Option 2:</b></p> <p>Amendments to both GT and Shipper licences bind GTs and Shippers to the new joint arrangements as new licence conditions place certain obligations on GTs and Shippers in relation to the CSP. The licence conditions also set out what is required as regards the details of the CSP regime to be reflected in the UNC. As the CSP is not a party to the UNC, this approach (as with Option 1) again involves a multiparty Service Agreement contract ( or contracts) between the CSP, Shippers and the GTs to set out service requirements from the CSP.</p>
<b>CSP party to the UNC</b>	<p><b>Option 3:</b></p> <p>As with Option 1, GT licences set out the requirements of the CSP regime to be reflected in the UNC. The UNC would bind Shippers and GTs to the new joint arrangements. Under this approach, however, the CSP would be a party to the UNC. The content of multi party Service Agreement contract (s) under Option 1 would be “rolled into” the UNC. As a result, the UNC acts as the main depository for all requirements in relation to the CSP, including charging methodologies, service level agreements, Shipper and GT rights and obligations.</p>	<p><b>Option 4:</b></p> <p>As with Option 2, amendments to both GT and Shipper licences bind the GTs and Shippers to the new joint arrangements as new licence conditions place certain obligations on GTs and Shippers in relation to the CSP. Like Option 3, under this approach, the CSP would be a party to the UNC and the UNC would act as the main depository for all requirements in relation to the CSP, including charging methodologies, service level agreements and Shipper and GT rights and obligations in relation to the CSP.</p>

Source: CEPA and TPA

In Table 1 below we have mapped how the key elements of the legal framework are expected to apply within the different legal instruments that are available under each of these options. In each case, we show where the following regime elements would be expected to fit:

- *core requirements of the joint industry CSP regime* – by which we mean aspects of the Full Cooperative CSP regime over which the Authority wish to retain regulatory control, direct or indirect;
- *Shipper and GT obligations and rights in relation to the CSP* – for example, in relation to corporate governance and funding of the CSP;
- *principles of the governance and funding regime* – to be reflected in the CSP’s charging and corporate governance arrangements;
- *industry service requirements from the CSP* – given the obligation on the CSP to provide certain services, the legal instrument under which those services are provided;

- *the CSP’s charging methodology and service charges* – the charging methodology forming the basis for the calculation of the CSP service charges;
- *the joint corporate governance arrangements of the CSP* – including CSP membership, limitation of liability on behalf of the CSP’s owners (i.e. the GTs) and the CSP Board arrangements; and
- *code and non-code services* – how industry requirements outside of the core code services currently offered by Xoserve would be facilitated under each option.

*Table 1: Mapping aspects of the legal framework to legal instruments*

<b>Element</b>	<b>Option 1</b>	<b>Option 2</b>	<b>Option 3</b>	<b>Option 4</b>
Core requirements of the joint industry CSP regime	GT licences	GT & Shipper licences	GT licences	GT & Shipper licences
Shipper and GT obligations and rights in relation to the CSP	UNC	GT & Shipper licences & UNC	UNC	GT & Shipper licences & UNC
Principles of the governance and funding regime	UNC	GT & Shipper licences & UNC	UNC	GT & Shipper licences & UNC
Industry service requirements from the CSP	Service Agreement contract <sup>1</sup>	Service Agreement contract <sup>1</sup>	UNC <sup>1</sup>	UNC <sup>1</sup>
Charging methodology	UNC	UNC	UNC	UNC
Service charge application	Service Agreement contract <sup>1</sup>	Service Agreement contract <sup>1</sup>	UNC <sup>1</sup>	UNC <sup>1</sup>
Joint corporate governance arrangements	Articles of Association	Articles of Association	Articles of Association	Articles of Association
Requirement for CSP to provide code and non-code services	Service Agreement contract <sup>1</sup>	Service Agreement contract <sup>1</sup>	UNC <sup>1</sup>	UNC <sup>1</sup>

*Source: CEPA and TPA*

*Note 1: Together with other bilateral contracts as required*

The different approaches outlined are not, at least in our view, mutually exclusive. Different blends of approach can in theory be envisaged, depending on what is considered required in terms of regulatory oversight and control under the new arrangements and the best contractual framework for CSP services within the GB gas industry.

This, in particular, applies to the location of GT and Shipper rights and obligations in relation to the CSP (licences or the UNC) and whether industry service level requirements would best sit within the UNC or additional multi-party service agreements. As a result, each of the options might be considered



as relative extremes of the different approaches which might be envisaged by Ofgem and industry parties to support legal implementation of the CSP regime.

As Table 1 also shows, the approach adopted, particularly in terms of the content of GT and/or Shipper licence conditions, is not always a constant across each of the options. For example:

- Under Option 1 and 3 the licence obligations that apply to the GTs would be solely focused on the implementation and establishment of the CSP regime, in particular covering the requirements of the regime that would need to be set out in the UNC. As a result, the joint obligations and rights of both the GTs and Shippers in relation to the new joint CSP regime would be UNC rather than licence rights and obligations.<sup>6</sup>
- In contrast, with Option 2 and 4, the expectation is certain aspects of GT and Shipper rights and obligations in relation to the CSP would be contained in licence conditions. For example, a key regime obligation for GTs and Shippers<sup>7</sup> is to ensure CSP services are established, operated and developed on an economic and efficient basis. This would be a licence obligation for both Shippers and GTs under Options 2 and 4.

The joint licence obligations that apply under Options 2 and 4 would be expected to extend at a minimum to the regulatory oversight and control measures put in place to protect the public interest<sup>8</sup>, but could potentially be more extensive.

The Authority would, as a result, have a more direct relationship with both GTs and Shippers in relation to those obligations under Options 2 and 4 (as compared to Options 1 and 3) as they would apply under the respective licences.

#### **4 Evaluation of the options and our preferred approach**

We have evaluated each of these four options against the high-level objectives for the supporting CSP legal framework set out above.

As regards the contracting arrangements, given the high-level objectives for the legal implementation of the CSP regime, we believe that the Service Agreement led approach (i.e. Option 1 and 2) has significant advantages over the sole UNC approach.

It is important to remember that a core principle of the proposed approach is that the CSP is about delivery of industry IT and data requirements set by the industry through the UNC, not making Xoserve part of that decision-making / governance process. Indeed, the more arms-length the relationship the greater the likelihood of a more disciplined and dispassionate delivery from Xoserve, than perhaps would be the case if Xoserve was closer to the decision making process.

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<sup>6</sup> Effectively the GT licence conditions set out a number of *requirements* in relation to the CSP that need to be set out in the UNC as opposed to *obligations* under their licences.

<sup>7</sup> Via their corporate governance role in the new CSP regime.

<sup>8</sup> As set out above, this includes the obligation to ensure CSP services are established, operated and developed on an economic and efficient basis, but also extends to various regulatory controls over the budgeting process.

The sole UNC approach would consolidate the CSP regime and service delivery requirements within the code, meaning that this single contracting vehicle is used to implement the new arrangements. Although the UNC is a multi-party contract, and so in theory would be legally workable as a framework for CSP services (provided the CSP is made a party to the UNC), it would not be dedicated to CSP services and the contract requirements of those services.

There would also be the legal complexities of making the CSP a party to the code under this approach, combined with the risk, in our view a material one, that the CSP becomes more of a “creature of the code” and all that entails (including a degree of ‘*stasis*’). The objective is to create a contractual vehicle for the CSP’s commercial delivery of IT services, not to blur industry governance of the trading and transportation of gas with the enforcement of the CSP’s service delivery.

In contrast, a Service Agreement approach would allow the UNC to act as the multi-party agreement between Shippers and GTs (with the Authority’s approval) to collectively agree the principles and objectives of the CSP regime, while the Service Agreement (s) between the CSP, GTs and Shippers would provide the means for each party to the agreement (s) to individually enforce it. This dedicated contractual arrangement seems more suited to an IT and information service provider, although it would need to be carefully structured to ensure that it operates effectively within the context of the UNC and industry change processes.

As a consequence, we believe the key choice for the supporting legal and regulatory framework for the CSP regime should be focused solely on Options 1 and 2.

Simplicity would suggest that it may be better to rely on GT licences to implement changes required for the initial set up. However, an arrangement that relies on both Shipper and GT licences to impose certain obligations on those parties that would control the CSP is likely to promote the most *direct* and, therefore, arguably most effective regulatory oversight and control of the new arrangements and, therefore, protection of the GB public interest, if there was an ultimate need for the regulator to step in. A joint Shipper/GT licence approach – if only from a transparency and clarity perspective – may also achieve the most powerful joint alignment of obligations and control under the new arrangements.

Therefore, on balance we would tend to prefer Option 2 recognising that considerable legal work would still be required to implement it.

## 1. INTRODUCTION

Ofgem has published its consultation paper for Phase 1 of its project to implement new funding and governance arrangements for Xoserve.<sup>9</sup>

Whilst the consultation was open to responses, Ofgem asked the CEPA consortium<sup>10</sup> to continue the development work on the options for the regulatory and contractual framework to implement the proposed new arrangements.

This report sets out the steps that we have followed to take forward the options which were set out in our Phase 1 report,<sup>11</sup> the relative advantages and disadvantages of different approaches and our views on a preferred approach. Whilst Ofgem has not yet made a final decision on new cooperative funding and governance arrangements of Xoserve, we have been asked to solely consider options for the regulatory and contractual framework that would implement the minded to position which Ofgem proposed in its April 2013 consultation: this is the Full-Cooperative funding and governance model with retained Gas Transporter (GT) ownership).

### 1.1. Approach

We have adopted a four stage option development and evaluation methodology for our assignment. The initial step has involved a review of the legal instruments (e.g. licences, codes, (other<sup>12</sup>) contracts and company constitutional documents) potentially available to support legal and regulatory implementation, and the legal and other characteristics of each instrument.

As a second step, we have then defined the proposed Full Cooperative model (as set out in Ofgem's consultation paper and our final Phase 1 reports) and the expected changes relative to the current arrangements (that is, the existing GT Agent model). This helps us to define the key elements of required regulatory and legal change process (for example, parties' rights and obligations).

Having completed this initial upfront analysis, we have then turned to more detailed option development. This involves an assessment of the precise balance between what needs to happen as regards Xoserve's relationship with the UNC and how it delivers its services, as currently specified there and in the Agency Services Agreement (ASA), and the rights and obligations that are defined within GT and Shipper licences, the UNC, contracts and company documents – that is, *how* legal implementation could be achieved.

As a concluding step we then provide an initial, high-level, evaluation of the short-listed options against a set of design principles and criteria before providing our views on a preferred approach for Ofgem and industry consideration.

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<sup>9</sup> Ofgem (2013): 'Consultation on implementing new funding, governance and ownership arrangements for Xoserve, the gas transporter central agent', [available here](#).

<sup>10</sup> For Phase 2 this has included TPA Solutions.

<sup>11</sup> These were provided in Annex E which considered initial principles for a supporting regulatory framework.

<sup>12</sup> Codes have contractual force, as well as having a particular status under the Gas Act licensing regime.

## 1.2. Document structure

The rest of the document follows the four stage methodology that is outlined above:

- Section 2 considers the legal instruments available for implementation.
- Section 3 outlines the proposed cooperative model, expected changes relative to existing arrangements and the types of rights and obligations that the legal framework will need to implement.
- Section 4 develops a set of options for regulatory/legal implementation based on our proposed option design principles.
- Section 5 provides our initial high-level evaluation of the short-listed options based on a set of proposed evaluation criteria.
- Section 6 provides our conclusions.

Appendix A provides more detailed descriptions of each of the options, including the proposed contracting structure under each approach.

Appendix B provides illustrative 'heads of terms' for the licence conditions under two of the short-listed options.

## 2. INSTRUMENTS AVAILABLE TO SUPPORT IMPLEMENTATION

This section considers the vehicles which are available for implementing the proposed cooperative model and their characteristics (as legal/regulatory instruments). This forms a basis for the option design and then evaluation in Sections 4 and 5.

### 2.1. What instruments are available to support implementation?

There are a variety of legal instruments which could be used to implement the proposed cooperative arrangements. These include<sup>13</sup>:

- *GT licences* – which are licences to provide gas transportation services. Each GT has a separate transportation licence.
- *Shipper licences* – which are licences to transport gas through a transportation system operated by a GT. Again, each Shipper has a separate Shipper licence.
- *UNC* – an *existing* multiparty contractual framework which supports the supply, trading and transport of gas in GB with defined regulatory oversight and governance.
- *Multiparty contracts* – for example, the current ASA which is a multi-party contract between Xoserve and the GTs.
- *Bilateral contracts* – Xoserve already has bilateral contracts in place for certain bespoke services. Other bilateral contracts could be developed to support legal implementation.
- *Articles of Association* – which together with the memorandum of association, form the company's constitution. This defines the objectives of the company and other aspects of its corporate governance.

Some of these instruments are regulatory instruments (that is licences and, to a different degree, industry code) which in this context are granted by a statutory authority which confer particular rights and responsibilities to the licensee (that is the entity awarded the licence), whereas other instruments, such as Xoserve's Articles of Association and the contracts to which it is a party, are governed by normal corporate laws. The subsections which follow consider the purpose and form of each instrument and their key distinguishing characteristics (in terms of the delivery of a new regulatory framework to implement the proposed cooperative model). The analysis is intentionally high-level, highlighting the basic features of each instrument.

#### 2.1.1. Licences – GT and Shippers

In this context, a licence may be granted by Ofgem to another party (the “licensee”). This is in essence a right to allow / authorise a designated party to undertake an activity which would otherwise be

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<sup>13</sup> This list contains the most realistic options rather than being exhaustive. Use of legislation defining a new licensable activity is another. Gas Act changes would also be primary legislation.

prohibited (under the Gas Act 1986) and is normally accompanied by a series of obligations. Unlike a contract, in which the parties are essentially entering into an *agreement* in which all have their respective rights and obligations, a licence is much more of a one way arrangement in which the licensor *grants* particular rights to the licensee, which can only be amended by the licensor and which can be unilaterally rescinded if the accompanying obligations are not fulfilled. Likewise, the procedures for altering the content of each instrument type differ significantly.

So, in the gas industry, the Gas Act 1986 (as amended) prohibits certain activities unless the person carrying on that activity is licensed, exempt from the requirement for a licence, or eligible for an exception to the prohibition on unlicensed activities.

Licensable activities under the Gas Act include (but are not limited to):

- A *GT licence*, which allows the licensee to convey gas through pipes to premises, or to another system of pipelines operated by another GT.
- A *Shipper licence*, which allows the licensee to arrange with a GT for gas to be introduced into, conveyed through, or taken out of a pipeline system operated by that GT.

The Gas and Electricity Markets Authority (GEMA<sup>14</sup>) is responsible for granting GT and Shipper licences. It has the ability to amend those licences (subject to certain appeal mechanisms to the Competition Commission (CC), soon to become the Competition and Markets Authority (CMA)).

For the purposes of this report and project, licences provide a means for Ofgem to *directly* place obligations on both GTs and Shippers to effect the implementation and delivery of the proposed cooperative model. In fulfilling their obligations, GTs and Shippers are responsible to Ofgem to ensure they are discharged effectively.

### 2.1.2. UNC

The UNC is a contractual framework which supports a multi-transporter environment. It replaced the previous Network Code following Gas Distribution Network (GDN) sales in 2005.

The UNC is essentially an “umbrella” contractual arrangement comprising a set of commercial terms for gas transportation services applying in respect of the National Transmission System (NTS) and all GDNs.<sup>15</sup> It comprises transportation rules (transportation arrangements between GTs and Shippers, and transportation arrangements between individual GTs), off-take arrangements and modification rules (amongst other issues).

A key distinguishing feature of the UNC is that although it is a multi-party contract between the GTs and users of the gas transportation system, it is a modifiable contract for which all parties to the contract *do not* need to agree to modifications – equally, Ofgem has a defined role in approving (or

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<sup>14</sup> The executive arm of which is ‘Ofgem’ and these terms are generally used interchangeably.

<sup>15</sup> Herbert Smith (2005): ‘Energy Briefing’

not) changes under the UNC Modification Rules. This contrasts with a more usual contractual arrangement in which all parties will typically need to agree to any changes.

Recommendations on Code modifications are made by the UNC Panel, which may be finally approved by GEMA (although GEMA is not a party to the agreement, it has a statutory role; likewise the requirement to be a party to the relevant code is contained in the licences). There are mechanisms whereby Ofgem decisions relating to the UNC may be appealed to the CC (to become in due course the CMA).

### **2.1.3. Bilateral contracts**

A bilateral contract is a reciprocal arrangement between two parties where each promises to perform an act in exchange for the other party's act (normally the provision of a service for a financial consideration). Typically bilateral contracts are used to specify levels of service and outputs and associated payment terms between the two contracting parties.

For the purposes of this project, a key distinguishing feature of a bilateral contract is that once that contract has been entered into, both parties to the contract must agree to any alterations from the original basis on which the agreement was made. It is possible to provide for arbitration in particular circumstances, but this is generally a burdensome process only suitable to contract disputes rather than amendment.

A bilateral contract (entered into between two parties) typically does not involve regulatory oversight and control over the contract terms or modifications of that agreement (unless specific regulatory oversight/arbitration is made a part of the agreement<sup>16</sup>) – although there may be a role for a third party arbiter, to assist in resolving any disputes. This means they may be better suited for specifying requirements (e.g. service levels) between contract parties, rather than as an instrument of imposing regulatory control.

### **2.1.4. Multi-party contracts**

Not every transaction or contract is executed by two counter-parties. Often there may be one contract but more than two parties (“multi-party”). The existing ASA between Xoserve and the GTs is an example of a multi-party contract.

Similar to a bilateral contract, a key distinguishing feature (from the perspective of this project), is that once a multi-party contract is entered into, normally all parties must agree to any alterations from the original agreement. Again, in general, regulators (such as Ofgem) do not have oversight/control of multiparty contracts, although the UNC is an example of an agreement which there is a designated role for the regulator.

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<sup>16</sup> For example, the PPP Arbiter was recognised as the arbitration party on contractual issues in the London Underground PPP Agreements.

Like bilateral contracts, multi-party contracts can provide a means to specify levels of service and outputs and the associated payment terms of the contract parties.

### **2.1.5. Articles of Association**

A company's Articles of Association are the rules for running the company that shareholders and 'officers' (directors and company secretary) have to adhere to. These include rules on how decisions that affect the company must be made and any specific rights or roles that shareholders might have in making those decisions.

Most companies use standard ('model') articles but these can be amended or a company can choose to write its own. The Articles of a typical company will cover issues such as interpretation and limitation of liability, directors responsibilities and decision-making powers, shares and distributions, decision-making by shareholders (for example, organisation of general meetings and voting at general meetings) and administrative arrangements.

From the perspective of this report and project, the Articles of Association provide a legal instrument to implement the *corporate* governance arrangements that form part of the proposed cooperative model.



### 3. PROPOSED COOPERATIVE MODEL AND ITS IMPLEMENTATION

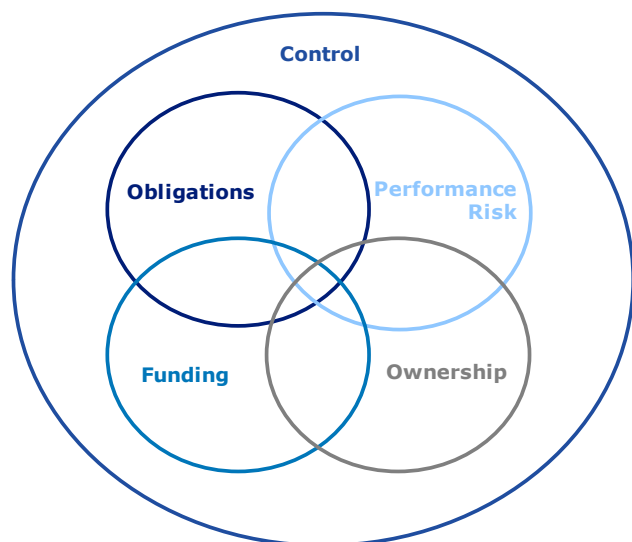
Having reviewed the instruments that are available to aid regulatory and legal implementation, in this section we outline the cooperative model proposed by Ofgem in its April 2013 consultation paper and our Phase 1 report. We use this initially to identify expected changes to the current arrangements and then the obligations, rights and regime design principles that may need to be defined within a new regulatory and legal framework for Xoserve.

#### 3.1. Proposed co-operative model

Our Phase 1 report concluded that what we had defined as a Light cooperative model was inconsistent with the Ofgem decision to implement Option C (a cooperative model) and also contained a number of potential inconsistencies and a lack of alignment of our key principles of obligations, funding, services and control.

There were, however, 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. We therefore recommended to Ofgem that attention in the short term should focus on the Full Cooperative model with retained GT ownership, separated from control. Figure 3.1 below shows a high level assessment of this model against our cooperative alignment principles.

Figure 3.1: Alignment under the Full Cooperative model with GT ownership



- **Funding** is provided by all parties, with primary control at the annual meeting that approves the 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** sit with all parties, which require them to enter into a contract with Xoserve for their delivery and to participate in efficient management of Xoserve.
- **Performance risk** sits with all parties, with all participant control providing the means to manage performance risk.
- **Ownership** retained by GTs, but Articles and other documents limit rights and risks.

Source: CEPA and TPA

From a governance perspective, a key design principle was divorcing ownership from control as the most practicable means by which to give effect to the new cooperative model. Governance arrangements (including new Board arrangements) would then 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, thus aligning risk and control.

From a funding and charging perspective, the new cooperative model will introduce collective industry responsibility for funding the central service provider and more flexible funding arrangements with the removal of Xoserve's costs from price controlled allowances. There will also be mechanisms for exerting cost control. This will be achieved through active participation by all users (Shippers and GTs) in an annual budget process, industry processes for managing variations against budgets and through new charging arrangements.

Ofgem's Phase 1 consultation paper proposes to adopt the Full Cooperative model with retained GT ownership in full (that is, both governance and charging and funding proposals).

Their 'minded to' recommendation is also that direct charging arrangements should be introduced for all parties (i.e. GTs and Shippers) to promote the more direct customer relationship between Xoserve and Shippers going forward.

Our Phase 1 report also discussed and proposed the concept of a paradigm shift in the industry from the implementation of the new cooperative model. The role that Xoserve currently plays in the industry and the range of services that it offers suggests that it should be seen as a Central Service Provider (CSP) delivering services directly to customers rather than an agent delivering licence and code obligations on behalf of the GTs. This potentially has quite important implications for what might need to change within the existing legal and regulatory framework, particularly as regards defining stakeholder obligations under licences and the UNC.

Our final Phase 1 report noted that the ASA is currently a contract between an Agency 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). 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 or on behalf of 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 CSP, to the industry as a whole, in its own right.

We suggested, therefore, that to maintain consistency with the proposed change of paradigm, it may need to be the CSP (or GTs and Shippers collectively) that is ultimately identified as the party which is responsible for delivering the services that it provides, so as to align obligations with control. How this might be implemented however, was not set out definitively.

### 3.2. Identifying the changes to the current arrangements

Having set out the main elements of the proposed cooperative arrangements, in this sub-section we identify the areas where the governance and funding arrangements of Xoserve are expected to change from the existing arrangements. Consistent with our reporting framework for Phase 1, we have considered where there are likely to be changes, and where there are unlikely to be changes, according to: services; funding and charging; and corporate governance and ownership.

In each case, we have considered: the current arrangements; the proposed new (cooperative) arrangements; and what might therefore need to change to facilitate implementation of the new arrangements. Based on this analysis, we can identify the rights, obligations and regulatory aspects that will need to be established through changes and development of the legal and regulatory framework.

In summary, there would seem to be the following key areas to consider:

- **Who has the legal obligation for the delivery of services under regulatory instruments such as the UNC and licences?** This could be Xoserve, all parties (i.e. Shippers and GTs) or one party (that is, the GTs). Given the paradigm shift for the cooperative model, Xoserve is a CSP to the gas industry and in this case it would seem most logical that the obligation for the delivery of services should at some level sit with it (although as explored in Section 4 there are other options). However, ultimate responsibility flows back to the industry which has corporate control of Xoserve as the CSP.
- **Where are the scope of services defined (and amended)?** Currently this takes place in a combination of GT licences, the UNC and contracts (primarily the ASA). This may or may not change depending on the approach taken to legal implementation. In particular, Ofgem may see the need to retain some degree of oversight (as it clearly does with licences, and by a 'lighter touch' any UNC obligations) of certain obligations but not of all functions that may be carried out by Xoserve.
- **What provisions are made for Gemini services?**<sup>17</sup> Our Phase 1 report suggested that a contract could exist between National Grid Gas Transmission (NGGT) and Xoserve to enable NGGT to direct Gemini change (with Xoserve remaining its service provider as currently).<sup>18</sup>
- **What forms of regulatory control are required over the funding arrangements?** Ofgem requires oversight of the budget and legal means to direct budget changes (albeit *in extremis*); however, GT funding of the body will be removed from price controls going forward (and replaced by a pass-through under their allowed revenue restriction). While the objective of the cooperative model is to implement joint *industry governance* of CSP arrangements, given the criticality of the services provided, Ofgem (again *in extremis*) is also likely to require at least

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<sup>17</sup> The provision of Gemini services involve a number of additional issues compared to Xoserve's other business areas given the IS assets are owned by NGGT.

<sup>18</sup> This has the benefit of retaining a common service provider model, whilst providing the flexibility for NGGT to be able to direct changes that might arise outside of the UNC modification process. There are however, other options for how NGGT flexibility to direct Gemini change could be created (see Section 4).

the capacity to direct changes in the arrangements should there be material concerns with the industry's governance/running of the CSP.

- **The approach to budgeting of costs, including how the budget is determined and how budget variations are managed.** To replace the current price control process, the approach to budgeting will need to be defined in a legal document with obligations placed on those that control the CSP to fund material variations against the budgets. The budget must also be published and subject to an approval process.
- **Cost allocation, charging and invoicing.** Based on Ofgem's proposals there will need to be a direct contractual relationship between Xoserve and Shippers and Xoserve and the GTs to facilitate direct invoicing for services. To support the calculation of charges:
  - as currently, Xoserve will need to maintain an activity costing methodology (which may or may not need to be reviewed); and
  - there will need to be a new charging methodology document to replace the current Agency Charging Statement.<sup>19</sup>
- **Definition of the principles of the company.** While Xoserve will endure as a limited company owned by the GTs, the following design principles will need to be enshrined within the company's legal framework:
  - The company is run on behalf of and controlled by its constituencies in the gas industry ("members") rather than its shareholders.
  - The company will no longer distribute any profit to the company's shareholders.
  - Shippers as well as GTs should have the right to participate in the corporate control of the company, thereby exercising control.
  - Therefore, protections need to be introduced to ensure that the owners (i.e. GTs) do not face risks that they cannot control.
  - Similarly the owners should also be constrained from exercising control as the company's shareholders (as they now exercise control as members).
- **Defining the company's Board structure and Board arrangements.** Through the company's Board, industry corporate control will be exercised over Xoserve (with the addition of a General Meeting). The right to elect Board members will need to be defined and any regulatory oversight Ofgem may have over the Board election process.
- **Commitment<sup>20</sup>, risk allocation and financing arrangements.** All industry parties will face obligations to fund and support the financing of Xoserve. This will support the alignment of

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<sup>19</sup> There is an additional issue whether Ofgem should have regulatory governance over the principles, approach and amendment of that charging methodology.

<sup>20</sup> Commitment is defined in a relatively broad sense, ranging from obligations to participate in the company's governance, to funding specified services and more narrowly the contractual commitments that are made.

performance risk with the parties that control Xoserve. These rules and obligations will need to be defined through the legal framework which supports the new arrangements, potentially through a combination of licences, the UNC, new contracts and company documents, such as the company's Articles of Association.

### 3.3. Conclusions

This section has reviewed the proposed cooperative model as defined in Ofgem's April 2013 consultation paper and our Phase 1 reports.

As well as identifying what needs to be defined within the new arrangements, this analysis (when compared to the existing legal and regulatory framework) helps to highlight a number of important issues for consideration as part of the option development exercise taken forward in Section 4.

First, **Xoserve currently has no regulatory personality.** Many of the proposed rights and obligations for both Shippers and GTs under the CSP regime are in reference to a CSP company (Xoserve) which is not currently defined in the existing regulatory framework. GT licences and the UNC refer to an Agency, but not Xoserve. This may create certain challenges in envisaging how the rights and obligations in relation to a CSP (as opposed to the GTs appointed Agent) can be created without applying changes to the existing regulatory framework.

Second, linked to the previous point made above, there may need to be a **CSP role defined in existing regulatory instruments (that is, licences and the UNC).** The new arrangements might create the need to define a CSP role that Xoserve will perform, as it is in reference to that CSP role that both Shippers and the GTs will have certain obligations and rights; any 'default' may be captured by a breach of licences or the UNC, even where a task is in practice entrusted to Xoserve. Following this, to support implementation, certain obligations might then need to be placed on Xoserve as the CSP which can be enforced by the GTs and Shippers either as members of its Board or else potentially through the UNC.

Having reviewed the components of the proposed Full Cooperative model, we now turn to the high-level objectives, principles and description of the options for legal implementation of these arrangements. This is the focus of Section 4.

## 4. OPTIONS DEVELOPMENT

In this section we develop options for the regulatory and contractual framework which could lead to the legal implementation of the new co-operative arrangements.

First we set out the design principles and objectives that we have used to develop four short-listed options (this builds on the analysis in Annex E of our Phase 1 report). We then provide a short description of each option and how they would meet our imposed design principles.

An example of the detailed design of each short-listed option (for instance, including the types of legal requirements and provisions that *could* be defined within GT and Shippers licences, the UNC, contracts and other legal documents) is then provided in Appendix A. Again, we note that these might best be seen as ‘straw men’ – examples (and perhaps extreme examples) of the range of a broad spectrum of options, which are very likely to be subject to change following further discussion and consideration by Ofgem and the industry.

### 4.1. Design principles and objectives

In this section we set out the high-level objectives that the supporting legal and regulatory framework will need to achieve, followed by the design principles we have used in developing each of the options.

#### 4.1.1. Objectives for the supporting legal and regulatory framework

To recap on Section 3, the regulatory and contractual framework for the new cooperative arrangements should (as far as possible) seek to define CSP as client facing provider of IT and data services to the gas industry and should provide for the alignment of obligations, risks and control.

While there is a role for Ofgem in the new arrangements (that is, regulatory oversight and ability to influence the new arrangements in the protection of the public interest) in general the objective is for implementation (and the on-going operation of the new joint governance and funding framework) to be industry rather than Ofgem led.

As service provider to the whole (or at least the major part of) the gas industry, the CSP will need a legal and contractual framework which provides legal clarity on its service definitions (“what is required”), charging and invoicing processes (“how costs are to be recovered”) and its liabilities. The new legal and governance arrangements for the CSP should also facilitate rather than hinder the effective delivery of services, and the changes to those services, rather than, for example, frustrating the delivery of UNC modifications.

Finally, to the extent feasible given the objectives above, the legal framework should also be as simple and practical to implement as possible given current arrangements.<sup>21</sup>

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<sup>21</sup> Simplicity and practicality are not in themselves requirements of the Full Cooperative CSP regime. They are, however, objectives for legal implementation.

We can as a result identify the following four high-level objectives for the supporting legal and regulatory framework to implement the Full Cooperative CSP regime:

- the arrangements should reinforce and facilitate a responsive IT and information service provider given the gas industry’s requirements;
- the legal framework and its supporting documents should ensure alignment of obligations with control under the CSP regime;
- while implementation of the CSP regime should be industry led, there must be certain reserved regulatory powers for the Gas and Electricity Markets Authority (the “Authority”) to influence the new arrangements in protection of the public interest; and
- to the extent feasible given the objectives above, the legal framework should be as simple and practical to implement given current arrangements.

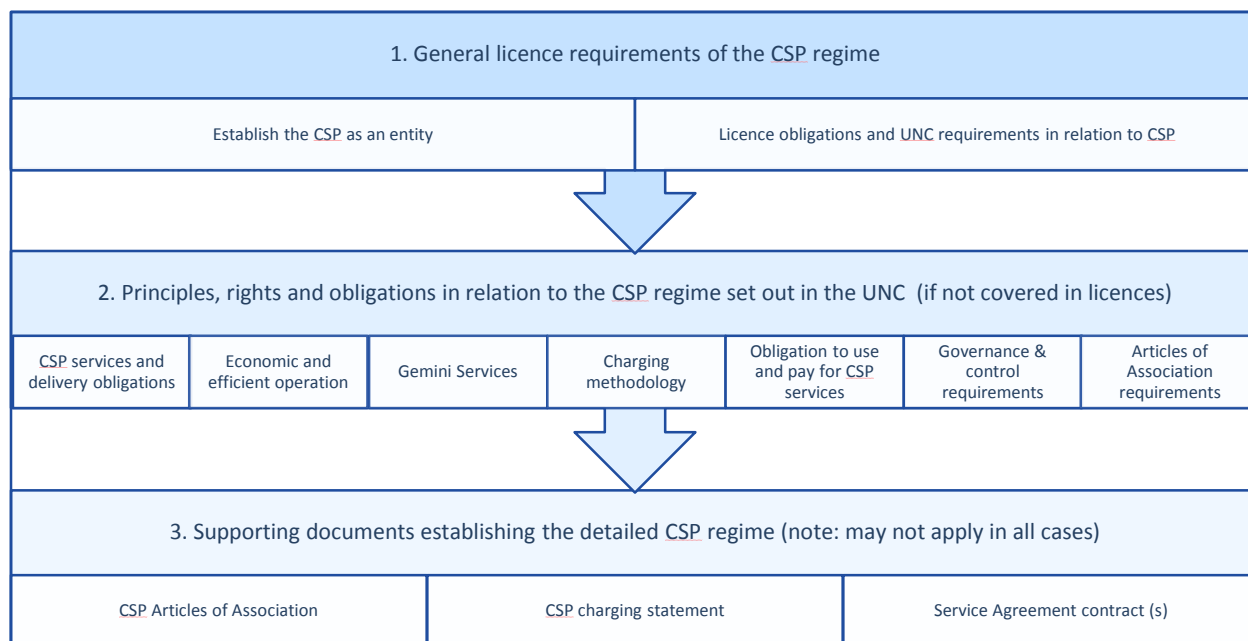
#### **4.1.2. Principles for the supporting legal and regulatory framework**

Following Section 2, legal implementation must also be by means of *existing* gas regulatory instruments, including GT licences, Shipper licences and the UNC, as there is no intention to enforce the new arrangements through the creation of a new CSP licence (which whatever its merits as an approach, we have not been asked to consider).

This means that our options have been developed on the basis that *existing* Shipper and/or GT licences would act as the primary document for regulatory implementation. Rights and obligations in relation to the new CSP regime would then “cascade” from this primary document, into the UNC and other documents (such as supporting contracts).

As a result, the aspects and more detailed requirements that are covered in the legal framework to establish the CSP have a distinct hierarchy. This is illustrated in Figure 4.1.

Figure 4.1: Cascade process from Shipper and/or GT licences to the UNC and other legal documents



Source: CEPA and TPA

At the highest level, there are general aspects which we expect to be covered in GT and/or Shipper licences as the primary legal/regulatory document. These cover:

- the arrangements and requirements for *establishing* the CSP as an entity that would replace the existing GT Agency role;
- the high-level principles/requirements in relation to the Full Cooperative with retained GT ownership model; and
- leading from the above, enduring joint obligations and UNC requirements in relation to the CSP (including potential obligations on licensees to raise UNC modification(s) which would set out the detailed requirements of the new CSP regime).

Depending on the preferred approach to legal implementation (see options below) different balances of obligations and regime principles can be envisaged to be set out in Shipper and/or GT licences or alternatively the UNC.

There is a third, additional, aspect for GT licences, which will need to specify the regulatory treatment of the GT funding of CSP activities through their pricing restrictions (that is, pass-through arrangements for GT CSP service charges).

Certain detailed requirements in relation to the CSP could be set out within licences (as the primary legal implementation document) or through required modifications of the UNC. These requirements (based on the analysis in Section 3) will need to cover:

- CSP services and service delivery obligations;



- obligation to establish, operate and develop CSP services on an economic and efficient basis;
- delivery and rights in relation to Gemini services;
- cost allocation and charging methodology;
- Shipper and GT obligations to use and pay for CSP services; and
- requirements of CSP’s corporate governance (including aspects of the company’s Articles of Association).

Note, for the avoidance of doubt, at least the high-level principles that relate to these requirements would be expected under any approach adopted to be set out in licences. This will provide clarity on the objectives of the new CSP regime, but also a degree of regulatory oversight of the new arrangements and flexibility for their amendment (see discussion below).

Once these *regulatory* requirements and principles are set out in licences and/or the UNC, they are however expected to “cascade” into the supporting documents of the CSP, including the company’s actual Articles of Association, Service Agreement contracts (if such contracts are in force) and cost allocation and charging methodologies.

## 4.2. Options

Our proposed options for the supporting legal framework are then differentiated by how to implement this hierarchy and achieve the core objectives for the regime.

In seeking to identify approaches which might then be considered for implementation, a first issue is whether the arrangements require, and indeed would benefit from, changes to Shipper licences in addition to GT licences, rather than relying on the UNC to bind both Shippers and GTs into the new funding and governance arrangements. This issue may differ between each specific aspect of the proposals.

A more complex issue is whether the new regime is best contractually structured relying solely on the UNC (an existing multi-party agreement with the gas sector), in which the CSP becomes a party to the UNC (potentially on a different basis to existing Shippers and GTs) or whether there should, as now, be a combination of obligations, principles and mechanisms set out in the UNC, with additional service agreements (along the lines of the existing ASA between Xoserve and the GTs).

These two factors give rise to four broad options, based on different combinations of approach to these two key design choices:

- **Option 1** would involve using only the *GT licences* as the primary regulatory instrument to establish the CSP regime. GT licences would be used to set out the requirements of the CSP regime to be reflected in the UNC. The UNC would then bind both GTs and Shippers to the new joint arrangements and would establish the detailed principles of the new regime. The UNC would, as a result, set out all obligations and rights of Shippers and GTs in relation to the CSP. A multiparty Service Agreement contract or possibly numerous separate contracts

(involving the CSP, Shippers and GTs<sup>22</sup>) would then support the UNC in establishing the service requirements of the industry from the CSP. Likewise, the CSP Articles of Association would establish the CSP corporate governance arrangements.

- In contrast **Option 2** involves amendments to GT *and* Shipper licences. In this case, both licences are used to bind the GTs and Shippers to certain aspects of the joint arrangements and act as the basis for the “cascade” that requires details of the CSP regime to be set out in the UNC and supporting documents. As with Option 1, Option 2 involves a multiparty Service Agreement contract (s) between the CSP, Shippers and GTs but unlike Option 1 new licence conditions would place certain obligations directly on Shippers and GTs in relation to the CSP.
- **Option 3** is similar to Option 1 in that GT licences would address all high-level CSP requirements (acting as the trigger for other regulatory and contractual changes). However, under this approach, the content of the multiparty Service Agreement contract would be “rolled into” the UNC and the CSP made a party to the UNC. As a result, the UNC acts as the main depository for all requirements in relation to the CSP, including charging methodologies, service level agreements, Shipper and GT rights and obligations, and the multiparty agreement for service delivery between the CSP, Shippers and GTs
- **Option 4** adopts a similar approach as Option 3 (in terms of the content of the multi-party Service Agreement contract being rolled into the UNC); however, consistent with Option 2, it involves changes to *both* GT and Shipper licences to directly bind both the GTs and Shippers to certain aspects of the new joint arrangements. Like Option 2, both GTs and Shippers would as a result face licence obligations in relation to the CSP.

In the case of Options 1 and 3, the UNC can be thought of as the bridge that binds GTs and Shippers to the new regime requirements in the absence of amendments to Shipper licences to create the new obligations. In contrast, Options 2 and 4 do not require the UNC to be the bridge by which GTs and Shippers are bound to the service agreement and other regime requirements, since certain licence obligations on both GTs and Shippers can achieve this more directly. All four options would create a direct contractual relationship between the CSP and Shippers and the CSP and the GTs and would thereby allow the CSP to invoice each party for its charges directly.

In Table 4.1 below we have mapped how the key elements of the legal framework are expected to apply within different legal instruments that are available under each of these options. In each case, we show where the following regime elements would be expected to fit:

- *core requirements of the joint industry CSP regime* – by which we mean aspects of the Full Cooperative CSP regime over which the Authority wish to retain regulatory control, direct or indirect;
- *Shipper and GT obligations and rights in relation to the CSP* – for example, in relation to corporate governance and funding of the CSP;

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<sup>22</sup> Other parties could potentially be included in this Service Agreement.

- *principles of the governance and funding regime* – to be reflected in the CSP’s charging and corporate governance arrangements;
- *industry service requirements from the CSP* – given the obligation on the CSP to provide certain services, the legal instrument under which those services are provided;
- *the CSP’s charging methodology and service charges* – the charging methodology forming the basis for the calculation of the CSP service charges;
- *the joint corporate governance arrangements of the CSP* – including CSP membership, limitation of liability on behalf of the CSP’s owners (i.e. the GTs) and the CSP Board arrangements; and
- *code and non-code services* – how industry requirements outside of the core code services currently offered by Xoserve would be facilitated under each option.

Table 4.1: Mapping aspects of the legal framework to legal instruments

Element	Option 1	Option 2	Option 3	Option 4
Core requirements of the joint industry CSP regime	GT licences	GT & Shipper licences	GT licences	GT & Shipper licences
Shipper and GT obligations and rights in relation to the CSP	UNC	GT & Shipper licences & UNC	UNC	GT & Shipper licences & UNC
Principles of the governance and funding regime	UNC	GT & Shipper licences & UNC	UNC	GT & Shipper licences & UNC
Industry service requirements from the CSP	Service Agreement contract <sup>1</sup>	Service Agreement contract <sup>1</sup>	UNC <sup>1</sup>	UNC <sup>1</sup>
Charging methodology	UNC	UNC	UNC	UNC
Service charges application	Service Agreement contract <sup>1</sup>	Service Agreement contract <sup>1</sup>	UNC <sup>1</sup>	UNC <sup>1</sup>
Joint corporate governance arrangements	Articles of Association	Articles of Association	Articles of Association	Articles of Association
Requirement for CSP to provide code and non-code services	Service Agreement contract <sup>1</sup>	Service Agreement contract <sup>1</sup>	UNC <sup>1</sup>	UNC <sup>1</sup>

Source: CEPA and TPA

Note 1: Together with other bilateral contracts as required

The different approaches and options outlined are not, at least in our view, mutually exclusive. Different blends of approach can in theory be envisaged, depending on what is considered required in terms of regulatory oversight and control under the new arrangements and the contractual framework for CSP services within the GB gas industry.

This, in particular, applies to the location of GT and Shipper rights and obligations in relation to the CSP (licences or the UNC) and whether industry service level requirements should sit within the UNC or additional multi-party service agreements. As a result, each of the options might be considered as relative extremes of the different approaches which might be envisaged by Ofgem and industry parties to support legal implementation of the CSP regime.

As Table 4.1 also shows, the approach adopted, particularly in terms of the content of GT and/or Shipper licence conditions, is not always a constant across each of the options. For example:

- Under Option 1 and 3 the licence obligations that apply to the GTs would be solely focused on the implementation and establishment of the CSP regime, in particular covering the requirements of the regime that would need to be set out in the UNC. As a result, the joint obligations and rights of both the GTs and Shippers in relation to the new joint CSP regime would be UNC rather than licence rights and obligations.<sup>23</sup>
- In contrast, with Option 2 and 4, the expectation is certain aspects of GT and Shipper rights and obligations in relation to the CSP would be contained in licence conditions. For example, a key regime obligation for GTs and Shippers<sup>24</sup> is to ensure CSP services are established, operated and developed on an economic and efficient basis. This would be a licence obligation for both Shippers and GTs under Options 2 and 4.

The joint licence obligations that apply under Options 2 and 4 would be expected to extend at a minimum to the regulatory oversight and control measures put in place to protect the public interest<sup>25</sup>, but could potentially be more extensive.

The Authority would, as a result, have a more direct relationship with GTs and Shippers in relation to those obligations under Options 2 and 4 (as compared to Options 1 and 3) as they would apply under the respective licences (see discussion below).

In the subsections which now follow, we consider in more detail key aspects of the regulatory and contractual framework under these four options, including:

- how in each case, regulatory oversight is achieved and would provide Ofgem with the right to direct changes in the CSP arrangements, in protection of the public interest;

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<sup>23</sup> Effectively the GT licence conditions set out a number of *requirements* in relation to the CSP that need to be set out in the UNC as opposed to *obligations* under their licences.

<sup>24</sup> Via their corporate governance role in the new CSP regime.

<sup>25</sup> A set out above, this includes the obligation to ensure CSP services are established, operated and developed on an economic and efficient basis, but also extends to various regulatory controls over the budgeting process.

- Xoserve’s capacity to continue to offer non-code services, as is the case with the current arrangements;
- how the modification process of the contractual, governance and funding documents would be expected to be managed under each option;
- the treatment of Gemini services under the options (and the relative pros and cons of different approaches); and
- the location of key CSP regime design principles, such as the charging methodology under the joint cooperative model.

#### 4.2.1. Regulatory oversight and protection

We have developed all four of the legal implementation options to include, in some form or another, the three regulatory oversight measures that are proposed by Ofgem in its April 2013 consultation document. These include:

- Placing an obligation on those who control the CSP (i.e. Shippers and GTs) to ensure the services are established, operated and developed on an economic and efficient manner.
- A provision for Ofgem to direct budget changes under specific circumstances such as the budget being set too low to enable the CSP to carry out its obligations.
- Ensuring that overspends of budget, which trigger a need for further funding from users, are notified to Ofgem.<sup>26</sup>

Under each option, the licence condition(s) that would support the cascade process for the CSP regulatory framework, would set out the high-level principles and requirements of the new CSP regime, including the proposed regulatory control measures. Where the options begin to differ, is how each regulatory oversight measure could be *enforced*.

Under options 2 and 4 each of these regulatory control measures would be expected to be made a part of the licence obligations of *both* GTs and Shippers. The principles of step-in rights related to budget changes and notification of overspends would be set out in both licences and expressed as obligations rather than simply requirements for the UNC. Similarly, as regards the key economic and efficient obligation, this would apply as a licence obligation and if there was considered to be a breach of this requirement, Ofgem would *in extremis* have its usual powers to address such a breach under licences.

In contrast, under Options 1 and 3, while GT licences would reflect the principles of what is required in terms of the CSP regime, the obligations that support the regulatory oversight measures, would be UNC obligations, so as to jointly apply to Shippers and GTs. As a consequence, regulatory remedies *might* an issue with Options 1 and 3, a point we return to as part of our evaluation in Section 5.

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<sup>26</sup> See Ofgem (2013): ‘Consultation on implementing new for Xoserve, the gas transporter central agent’, p. 6

In addition to the regulatory oversight measures discussed above, we also envisage under all options a GT licence step-in right for Ofgem to require that governance of CSP reverts to GTs. This would ensure that in extreme circumstances the pre-existing regime could be readily re-established, again where necessary to protect the public interest.

#### **4.2.2. Code and non-code services**

As well as core code services, Xoserve also currently offer a number of non-code services, some of which relate to GT licence conditions, others are bespoke services requested by individual users as part of the User Pays arrangements.

The new regulatory and contractual framework that supports the CSP should not prevent Xoserve from continuing to offer these services that are required and valued by the industry.

One way to address this issue (under all four options) would be to make a distinction between the (mandatory) CSP Services required under the UNC and other (non-mandatory) CSP Services. This could, for example, work as follows:

- Code services would be defined as mandatory services from the outset and set out clearly in the UNC and/or Service Agreement(s).
- Non-code services would be those that the CSP could elect to provide, and would need to be acknowledged (for cost allocation purposes) but not defined in detail.

An alternative approach could be to include all the services that Xoserve currently provides as mandatory services initially – this would give the industry comfort that the starting point for the new CSP would be “business as usual”.

Our suggested approach leans towards the second approach; that is mandated provision (at least initially) of all current code and non-code Xoserve services.

Under Option 1 and 2, we would propose that the differentiation between CSP code services and non-code (e.g. GT licence obligation based) services would be maintained. All code and non-code services would be maintained and delivered under the new Service Agreement(s).

The process under Option 3 and 4 would be more complicated. Delivery of all CSP code and non-code based services may need to become an obligation of the CSP under the UNC, as this would be the multiparty agreement under which its services are delivered (the CSP a party to that agreement). This would, as a result, require changes to the current distinction between code and non-code services given the intention to wrap the arrangements fully within the UNC.

We would also expect that under each option, Xoserve would continue to operate bilateral contracts with individual customers for very specific bespoke services/requirements, as is the case currently. Together with the core multi-party Service Agreement contract or the UNC, this should provide flexibility for the CSP to provide additional services as required by industry stakeholders.

### 4.2.3. Modification process

In this section we set out how the modification process of the CSP legal framework would work under each of the options. This includes the modification of CSP service requirements and the future development of the cooperative CSP regime.

As regards amendments to CSP service requirements:

- The process under Options 3 and 4 would be identical to the UNC modification process as the current content of the ASA (plus any new contract requirements) would be rolled into the UNC. This would mean that any modifications to CSP service requirements would need to be agreed through the UNC Panel and Authority veto/non-veto arrangements that apply to the UNC as a multi-party agreement.
- In contrast, Options 1 and 2 would, at least in the case of code services, rely on cross-referencing between the CSP Service Agreement and the UNC (this is the case currently with the ASA). Should a change in the UNC impact on CSP services, all of the parties to the new CSP Service Agreement would need to agree to changes in the contract, unless a more mechanical process was adopted whereby changes at the UNC level were required to be picked up in the new CSP service agreements.

As regards amendments to CSP funding and governance arrangements, under all of the options the principles of the cooperative regime would be reflected in licence requirements and the UNC. As a result, should the industry wish to amend these arrangements, it would in all cases need to seek amendments to the UNC.

Given that under all options Shippers and GTs would need (either under their licences or the UNC - see above discussion on regulatory enforcement) to comply with the principles of corporate governance and CSP funding set out in the UNC, there would, as a result, be certain restrictions on the extent to which the regime can evolve without regulatory approval.

As a general rule we envisage that regime evolution would be subject to a degree of industry consultation and transparency, even were changes to documents outside the UNC are involved – for example, the Service Agreement and Articles of Association.

### 4.2.4. Gemini

The four options have been developed on the basis of no change to current Gemini arrangements (i.e. the CSP will fulfil exactly the same role for Gemini as Xoserve currently does) and ownership of the systems assets will remain unchanged.

However, given its ownership of the Gemini systems, our Phase 1 report recognised the special interests of NGGT in relation to the CSP and its provision of services. We suggest that these special interests could be achieved in a number of ways:

- in a separate contract between the CSP and NGGT in relation to specific Gemini services (as proposed in our Phase 1 report); or

- possibly a right for NGGT to direct Gemini changes under the UNC/Service Agreement framework that would apply under the different options.

The more detailed option design in Appendix A assumes the second option, as this would help to ensure that either a new Service Agreement (or Agreements) or the UNC would act as the main contractual vehicle under the new CSP arrangements, reducing contractual complexity.

This however, is an issue that may need to be considered further as part of the implementation process of the new arrangements, given that it will require discussion and agreement between the parties involved, with particular input for NGGT.

#### **4.2.5. Location of key documents**

Under all the options, it is expected that the corporate governance arrangements of the CSP would be set out in the Articles of Association of the company. These would need to reflect the governance principles set out within GT and/or Shipper licences and the UNC.

Again, across all of the options the CSP charging methodology would be set out in the UNC as this would reflect the funding principles (following regulatory approval) agreed by Shippers and GTs for the CSP that they would control. As a commercial agreement between these two parties, and a legal instrument over which the Authority has regulatory oversight, it seems appropriate that key regime funding principles are located here.

The CSP would then be expected to calculate and invoice charges either under its Service Agreement with the GTs and Shippers (Options 1 and 2) or the UNC (acting as the service delivery vehicle - Options 3 and 4) in accordance with this methodology. Hence, service charges determined using the charging methodology are applied in the Service Agreement under Options 1 and 2 but the UNC under Options 3 and 4.

#### **4.3. Summary**

In this section we have set out four proposed options for the regulatory and contractual framework that would underpin the new proposed CSP regime.

We have illustrated the key design principles of each option and how they derive from a distinct hierarchy of the proposed rights and obligations in relation to the new CSP regime that “cascade” from GT and potentially Shipper licences, into the UNC and other legal documents (such as supporting Service Agreement contracts).

We now turn to an evaluation of each of the options which informs our conclusions of which option is likely to be preferable.



## 5. OPTIONS EVALUATION

Having set out options, in this section we evaluate those options against the high-level objectives for the supporting CSP legal framework which we set out in Section 4.

In considering the simplicity and the practicality of each option, we have also considered their legal efficiency and effectiveness and the extent to which we believe that they provide operational alignment and clarity.

### 5.1. Evaluation

#### 5.1.1. Regulatory oversight and control to protect the public interest

All four options would offer some form of *regulatory oversight and control* for the Authority in protecting the public interest as the high-level requirements of the new arrangements would be defined within regulatory instruments (either new licence conditions or the UNC).

The Shippers and GTs jointly – either under licence conditions or the UNC – would need to ensure that certain condition(s) and reserved powers for the Authority are reflected in the supporting governance documents and contractual framework which would support the new arrangements. These reserved/step-in powers, combined with the GTs retained ownership of the CSP, should provide Ofgem with the capacity (*in extremis*) to direct changes in the arrangements should there be material concerns with the industry’s governance of the CSP.<sup>27</sup>

From an enforcement perspective, however, that is the ability for the Authority to seek remedies were the parties that control the CSP not to fulfil their obligations, we consider Options 2 and 4 would provide the more effective form of regulatory oversight and control (while still operating within the industry led principles of the CSP regime) as key Shipper and GT *obligations* in relation to the CSP would be reflected in the new licence conditions for the CSP regime.

For example, the principle of step-in rights related to budget changes and notification of overspends against the budget would be set out in both Shipper and GT licences (then reflected in UNC and then the CSP corporate arrangements). As highlighted in Section 4, as regards the obligation to ensure CSP services are established, operated and developed on an economic and efficient basis, was there considered an industry breach of this key requirement, under Options 2 and 4, the Authority would have its usual powers to address such a breach under licences.

In contrast, the extent of regulatory control under Options 1 and 3 is less clear cut. In this case, while GT licences would reflect the requirements of the CSP regime, the obligations that support the regulatory oversight measures which Ofgem has proposed, would be UNC obligations. They would be joint commercial obligations between the GTs and Shippers under their multi-party agreement, rather than *direct* obligations with the regulator. As a consequence, regulatory remedies *might* be considered an issue with Options 1 and 3.

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<sup>27</sup> Effectively equivalent to ship wreck clauses contained within energy network company licences.

### 5.1.2. Alignment of obligations and control

Options 1 and 3 would achieve alignment of obligations and control by the fact that all obligations in relation to the new CSP and provision of services are reflected as joint obligations of both GTs and Shippers within the UNC. While GTs would have certain licence obligations in relation to establishing and implementing the CSP<sup>28</sup> (unlike Shippers) these would in the majority form requirements of amendments to the UNC as opposed to CSP licence *obligations*.

In contrast, Options 2 and 4 would achieve alignment by both parties that control Xoserve having certain licence as well as UNC obligations in relation to the CSP.

From a cross-industry perspective, we believe that Options 2 and 4 – if only from a transparency and clarity perspective – would achieve the most powerful joint alignment of obligations and control, as both industry parties that control the CSP would face licence obligations and requirements. This arrangement would impose the most *direct* alignment of obligations and control with regulatory oversight.

### 5.1.3. Simplicity and practicality

In our view, whilst all of the options are possible legally, there is a question of what might be optimal from a *legal efficiency and effectiveness perspective*, especially taking into account what is already in place. In terms of the contractual frameworks involved:

- Options 1 and 2 involve a combination of the UNC and service agreements tailored specifically to the purposes of the CSP and the services it delivers to the major constituencies of the gas industry (which is similar to the existing arrangements).
- In contrast, Options 3 and 4 would require the UNC to be “adapted” from a multi-party Shipper-GT agreement, to a new GT-Shipper-CSP agreement with multi-party requirements, in which all of the service requirements would be incorporated into the UNC.

Although both approaches are likely to be legally workable, from a first principles perspective, Options 1 and 2 would seem to offer a less involved structure for delivering the services required by the industry, especially in terms of not having to make the CSP a party to the UNC.

Whilst under Options 1 and 2 the Service Agreement (as with the ASA currently) would need to cross-refer to the UNC<sup>29</sup>, this contractual framework would allow for a much clearer differentiation under the CSP arrangements between:

- the UNC as a GT/Shipper multi-party agreement which, amongst many other issues, would set out the principles of the CSP regime and Shipper/GT obligations that would ultimately drive their cooperative engagement in the CSP; and

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<sup>28</sup> Related to their enduring nominal ownership of Xoserve.

<sup>29</sup> A feature, we note, that is not uncommon to commercial contracts.

- a Service Agreement (s) as the new joint arrangement between the CSP, GTs and Shippers focused solely on CSP service delivery and how industry service and performance level requirements of the CSP are specified at a service level.

Options 1 and 2 share the most common features with the existing ASA arrangements, which again is likely to appeal from an implementation perspective.

In contrast, under Options 3 and 4, although the UNC is a multi-party contract, and so in theory would be legally workable as a framework for CSP services (provided the CSP is made a party to the UNC), it would not be dedicated to CSP services (the focus is the commercial transportation of gas). The UNC would need to fulfil a range of objectives in relation to the CSP.

From the perspective of licence changes, simplicity would suggest that it may be better to rely on GT licences to implement changes required for the initial set up. However, there is trade-off here with regards other objectives, such as the direct alignment of obligations and control and Ofgem's capacity to seek regulatory enforcement under the new arrangements (see discussion below).

#### **5.1.4. Reinforce and facilitate an IT and information service provider role**

Over and above the legal workability of the different approaches is the extent to which they would *underpin the desired operational model*.

It is important to remember that a core principle of the proposed approach is that the CSP is about delivery of industry IT and data requirements set by the industry through the UNC, not making Xoserve part of that decision-making / governance process. Indeed, the more arms-length the relationship the greater the likelihood of a more disciplined and dispassionate delivery from Xoserve, than perhaps would be the case if Xoserve was closer to the decision making process.

In this respect:

- Options 1 and 2 have the benefit of Service Agreement contract(s) that can be clear on what is required of the CSP (from a delivery perspective) which would then reinforce the desired client facing orientation.
- In contrast, with Options 3 and 4, CSP service delivery requirements are inevitably linked with other (GT-Shipper) commercial aspects in the UNC, which could have the effect of blurring the requirements of Xoserve's service delivery.

Options 1 and 2 would, as a result, allow the UNC to act as the multi-party agreement between Shippers and GTs to collectively agree the principles and common objectives of the CSP, while the Service Agreement between the CSP, GTs and Shippers would provide the means for each party to the agreement to individually enforce their CSP service requirements.

This dedicated contractual arrangement seems better suited to an IT and information service provider, although it would need to be carefully structured to so as ensure that it operates effectively within the context of the UNC and industry change processes.

Options 3 and 4 have the potential to change the dynamic of an agreement between GTs and Shippers (the UNC) by introducing a new (and important) party with obligations for delivering certain services, although this risk could be at least partially mitigated by limiting the powers of Xoserve, for instance prohibiting its ability to raise mods. Options 3 and 4 also risk the CSP becoming more of a “creature of the code” and all that entails (including a degree of ‘*stasis*’).

## 5.2. Conclusions

Given our evaluation, and the core objectives for the legal implementation of the CSP regime, as regards the contracting arrangements, we believe that the Service Agreement led approach (i.e. Options 1 and 2) has significant advantages over the sole UNC approach.

As a consequence, we believe the choice for the supporting legal and regulatory framework for the CSP regime should be focused solely on Options 1 and 2. Outline illustrations of the licence conditions that could support each of these options is, therefore, provided in Appendix B.

Simplicity would suggest that it may be better to rely on GT licences to implement changes required for the initial set up. However, an arrangement that relies on both Shipper and GT licences to impose certain obligations on those parties that would control the CSP is likely to promote the most *direct* and, therefore, arguably most effective regulatory oversight and control of the new arrangements and, therefore, protection of the GB public interest, if there was an ultimate need for the regulator to step in. A joint Shipper/GT licence approach – if only from a transparency and clarity perspective – may also achieve the most powerful joint alignment of obligations and control under the new arrangements.

Therefore, on balance we would tend to prefer Option 2 recognising that considerable legal work would still be required to implement it.

As highlighted through the option development process (see Section 4), the approach we have outlined, should be considered as a relative extreme of an Option 2 led approach. The outlines of the illustrative licence conditions in Appendix B assume (for illustrative purposes) that common obligations which would be imposed directly through GT and Shipper licences would be fairly extensive, covering all the key requirements of the regime.

However, different variants of Option 2, particularly as regards the balance of GT and Shipper obligations in relation to the CSP that sit within licences and the UNC, can be envisaged. For example, the number of licence obligations could be kept to a minimum (e.g. to cover only regulatory oversight measures) and instead the obligations enforced through the UNC (as with Option 1). Certain aspects of the regime requirements could also be solely set out in the UNC, as opposed to both licences and the UNC. This is an area that might helpfully be explored further through consultation and working groups between Ofgem and relevant industry parties.

## 6. CONCLUSIONS

This report has sought to set out options for the regulatory and contractual framework to implement the proposed CSP cooperative arrangements. We have then provided an initial evaluation of those options against a set of design criteria.

The first conclusion we take from this paper, confirming our Phase 1 findings, 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.

A first key issue is whether the arrangements require changes to Shipper licences in addition to GT licences, rather than relying on the UNC to bind shippers into the new arrangements.

A more complex issue is whether the new regime is best contractually structured relying solely on the UNC, in which the CSP becomes a party to the UNC (potentially on a different basis to existing Shippers and GTs) or whether there should as now, be a combination of obligations, principles and mechanisms set out in the UNC, with additional service agreements (along the lines of the existing ASA). These two factors give rise to four options, based on the different combinations of approach.

On balance we would tend to prefer Option 2 (a joint GT and Shipper licence based approach involving dedicated Service Agreements(s) for CSP services) recognising that considerable legal work would still be required to implement it.

## **APPENDIX A: DETAILED DESIGN OF OPTIONS**

### **A.1. Introduction**

In this appendix we provide more detail on each of the four legal implementation options outlined in the main report. For each option we provide:

- an illustration of the regulatory framework;
- an overview of the design principles that support each option; and
- a more detailed description of how each option would work from a legal and commercial perspective.

Table A1: Overview of Option 1 design

Overview of regulatory and contractual framework:	Design principles:
<p><i>Figure: illustration of regulatory framework</i></p> <p><i>Articles of Association (AoA)</i></p> <p>GT Licence is used as the basis for developing the cascade process that requires the detail of CSP arrangements to be set out in the UNC and other legal documents</p> <p>GT licence obligation to amend Xoserve's AoA to comply with principles set out in the UNC</p> <p>GT Licence</p> <p>Service Agreement Contract</p> <p>UNC</p> <p>Contract defines the scope of services being provided, any modification processes, costing/charging arrangements and the requirement that Shippers and GTs pay the CSP</p> <p>UNC obligations for Shippers and GTs to: enter into a Service Agreement with a CSP; assume a role in the CSP's governance; ensure CSP Services are established, operated and developed on an economic and efficient basis. UNC specifies the principles of the CSP corporate governance arrangements and CSP charging methodology.</p>	<p><b>Design principles:</b></p> <ul style="list-style-type: none"> <li>▪ The GTs' transporter licences are used as the primary basis for developing the cascade process which implements the CSP arrangements. There are <i>no amendments</i> to Shipper licences.</li> <li>▪ The GT licences establish what is <i>required</i> from the CSP regime to be reflected in the UNC, as opposed to enshrining GT obligations and rights in relation to the CSP.</li> <li>▪ The intention is that the UNC should collectively bind <i>both</i> GTs and Shippers to the new joint arrangements.</li> <li>▪ The principles for the CSP joint corporate governance arrangements would be specified within the UNC and reflected in Xoserve's Articles of Association.</li> <li>▪ The principles of the CSP joint funding arrangements would be specified in a charging methodology included in the UNC.</li> <li>▪ UNC obligations to procure certain services from the CSP would sit jointly with the GTs and Shippers, with the CSP providing services to each group under one or more Service Agreements.</li> <li>▪ The new Service Agreement (s) would require the CSP to provide certain services and GTs and Shippers as the service users to pay the CSP for delivering them.</li> </ul>
<p><b>Description:</b></p>	
<p>Option 1 would obligate changes to Xoserve's Articles of Association to enshrine the new joint corporate governance arrangements. The company's Articles of Association would need to comply with principles for the joint CSP corporate governance arrangements as specified in the UNC. The UNC would be amended (with the requirement to amend the UNC set out in the GTs licences) so that parties to the UNC must enter into a contract with an appointed CSP for the delivery of services. The scope of services (what is required to be delivered) would be set out in the UNC with the detailed service definitions set out in the Service Agreement. The terms and conditions of that contract would conform with principles and objectives as set out in the UNC. UNC parties would have various obligations and rights in relation to the CSP from entering into the Service Agreement contract and the UNC.</p>	

Table A.2: Overview of Option 2 design

Overview of regulatory and contractual framework:	Design principles:
<p><i>Figure: illustration of regulatory framework</i></p> <p>The diagram illustrates the regulatory and contractual framework for Option 2. It shows the following components and relationships:</p> <ul style="list-style-type: none"> <li><b>Articles of Association (AoA):</b> Represented by a document icon at the top left.</li> <li><b>Shareholders:</b> A box below AoA, with a dashed arrow pointing to AoA.</li> <li><b>Xoserve Board:</b> A box below Shareholders, with a solid arrow pointing to CSP.</li> <li><b>CSP (Common Service Provider):</b> A box below Xoserve Board, with a solid arrow pointing to GTs and Shippers.</li> <li><b>GTs (General Traders):</b> A box to the right of CSP, with a solid arrow pointing to Shippers.</li> <li><b>Shippers:</b> A box below GTs, with a solid arrow pointing to UNC.</li> <li><b>UNC (UNCertainty):</b> A document icon to the right of Shippers, with a solid arrow pointing to UNC.</li> <li><b>GT Licence:</b> A document icon above GTs, with a solid arrow pointing to GTs.</li> <li><b>Shipper Licence:</b> A document icon below Shippers, with a solid arrow pointing to Shippers.</li> <li><b>Service Agreement Contract:</b> A document icon between CSP and GTs, with a solid arrow pointing to GTs.</li> <li><b>Annotations:</b> <ul style="list-style-type: none"> <li>"As per Option 1" (pink) points to the UNC icon.</li> <li>"As per Option 1" (pink) points to the Shipper Licence icon.</li> <li>"GT licence obligation to amend Xoserve's AoA to comply principles set out in the UNC" (pink) points to the GT Licence icon.</li> <li>"Licences would also set out certain GT and Shipper obligations in relation to the CSP." (pink) points to the UNC icon.</li> </ul> </li> </ul>	<p><b>Design principles:</b></p> <ul style="list-style-type: none"> <li>Amendments to <i>both</i> Shipper and GT licences are used to develop the regulatory and contractual framework.</li> <li>As with Option 1, this involves licences being used as the basis for the cascade process that requires the detail of the CSP arrangements to be set out in the UNC and other legal documents.</li> <li>In this case, however, the GT and Shipper licences would be used as the vehicles for enshrining certain Shipper and GT obligations and rights in relation to the CSP.</li> <li>The principles of the CSP joint corporate governance arrangements would be specified within licences and/or the UNC and then reflected in Xoserve company documents.</li> <li>The principles of the CSP joint funding arrangements would be specified in a charging methodology included in the UNC.</li> <li>UNC obligations to procure certain services from the CSP would sit jointly with the GTs and Shippers, with the CSP providing services to each group under one or more Service Agreements.</li> <li>The new Service Agreement contract(s) would require Xoserve to provide certain services and GTs and Shippers as the service users to pay the CSP for delivering them.</li> </ul>
<p><b>Description:</b></p>	
<p>Option 2 involves similar designs principles and therefore legal framework as Option 1. However, in this case <i>both</i> the GTs (under their GT licences) <i>and</i> Shippers (under their Shipper licences) have CSP related licence obligations with the requirements of the CSP set out in a combination of licences and the UNC. Licences and /or UNC would be amended (depending on the balance of obligations that sit within licences or the UNC) so that GTs and Shippers must enter into a contract with an appointed CSP for the delivery of services. The scope of services (what the CSP is required to be delivered) would be set out in UNC and the detailed service definitions set out in the Service Agreement. The terms and conditions of that contract would conform with principles and objectives as set out in the UNC. UNC parties would have various obligations and rights in relation to the CSP from entering into the Service Agreement contract and the UNC.</p>	



Table A.3: Overview of Option 3 design

Overview of regulatory and contractual framework:	Design principles:
<p><i>Figure: illustration of regulatory framework</i></p> <p>GT licence is used as the basis for developing the cascade process that requires the detail of CSP arrangements to be set out in the UNC and other legal documents.</p> <p>GT licence obligation to amend Xoserve's AoA to comply with principles set out in the UNC</p> <p>UNC defines principles of the CSP regime, including the rights and obligations of the CSP, Shippers and GTs. UNC acts as the repository for the CSP's budgeting, costing and charging methodologies and the definition of CSP service and performance requirements.</p> <p>UNC is used as the main regulatory and contractual vehicle for the implementation of the new joint governance and funding arrangements</p>	<p><b>Design principles:</b></p> <ul style="list-style-type: none"> <li>As with Option 1, GT licences are used as the basis for developing the cascade process which requires the detail of CSP arrangements to be set out in the UNC and other documents.</li> <li>High-level requirements and principles of the CSP regime are set out in the GT licences.</li> <li>In this case the CSP is made a party to the UNC and recovers its service charges under the UNC (so there is no need in principle for a separate Service Agreement contract).</li> <li>With the CSP a party to the UNC, it is also the CSP which is obliged under the code to deliver specified services (as compared to Options 1 and 2 where UNC obligations are jointly made the responsibility of Shippers and GTs).</li> <li>Contractual enforcement of service provision to individual parties and the consequences of CSP non-performance (such as compensation) would also be addressed in the UNC.</li> <li>The UNC therefore acts as the repository of all regulatory design principles and objectives (implementing the new joint governance and funding arrangements) <i>and</i> is the main contractual vehicle governing service delivery requirements.</li> </ul>
<p><b>Description:</b></p>	
<p>As with Option 1, GT licences address all high-level CSP requirements (acting as the trigger for other regulatory and contractual changes). Option 3 would then involve rolling all or part of the content of the current ASA into the UNC. The CSP is made a party to the UNC and the delivery of data, information and IT services (as set out within the UNC) are therefore made the <i>direct</i> obligation of the CSP. Shipper and GT rights and obligations in relation to the CSP are also defined in the UNC. As with Option 1, this option would also obligate changes to Xoserve's Articles of Association to enshrine the new joint corporate governance arrangements in accordance with the principles for joint governance set out in the UNC. As with Option 1, the UNC is expected to bind both Shippers and GTs to the new joint arrangements rather than licences.</p>	

Table A.4: Overview of Option 4 design

Overview of regulatory and contractual framework:	Design principles:
<p><i>Figure: illustration of regulatory framework</i></p> <p>The diagram illustrates the regulatory framework for Option 4. It shows a flow from Shareholders to Xoserve Board to CSP. The CSP is linked to a UNC (United Network Code) which in turn links to GTs and Shippers. Licences (GT Licence and Shipper Licence) are shown as key components. Annotations include: 'Articles of Association (AoA)', 'GT and Shipper Licences are used as the basis for developing the cascade process that requires the detail of CSP arrangements to be set out in the UNC and other legal documents. Licences would also set out certain GT and Shipper obligations in relation to the CSP.', 'GT licence obligation to amend Xoserve's AoA to comply with principles set out in the UNC', and 'As per Option 3'.</p>	<p><b>Design principles:</b></p> <ul style="list-style-type: none"> <li>Amendments to <i>both</i> Shipper and GT licences are used to develop the regulatory and contractual framework.</li> <li>As with Option 1, this involves licences being used as the basis for the cascade process that requires the detail of the CSP arrangements to be set out in the UNC and other legal documents.</li> <li>In this case, however, like Option 2, the GT and Shipper licences would be used as the vehicles for enshrining certain Shipper and GT obligations and rights in relation to the CSP.</li> <li>The main difference from Option 2 is that the CSP is made a party to the UNC and recovers its service charges under the UNC (so there is no need in principle for a separate Service Agreement).</li> <li>With the CSP a party to the UNC, it is also the CSP who is obliged under the code to deliver specified services.</li> <li>Contractual enforcement of service provision to individual parties and the consequences of CSP non-performance (such as compensation) would also be addressed in the UNC.</li> <li>The UNC therefore acts as the repository of all regulatory design principles and objectives (implementing the new joint governance and funding arrangements) <i>and</i> is the main contractual vehicle governing service delivery requirements.</li> </ul>
<p><b>Description:</b></p>	
<p>As with Option 2, GT and Shipper licences address all high-level CSP requirements (acting as the trigger for other regulatory and contractual changes). Option 4 would then involve rolling all or part of the content of the current ASA into the UNC. The CSP is made a party to the UNC and the delivery of data, information and IT services (as set out within the UNC) are therefore made the <i>direct</i> obligation of the CSP. Changes to Xoserve’s Articles of Association would be obligated to enshrine the new joint corporate governance arrangements in accordance with the principles set out in the UNC. Like Option 2, Shipper and GT rights and obligations in relation to the CSP are defined through a combination of licences and the UNC.</p>	

## **APPENDIX B: OUTLINE OF ILLUSTRATIVE LICENCE CONDITIONS**

### **B.1. Introduction**

In this appendix we provide an outline of illustrative licence conditions that could be used to give effect to the Option 1 and Option 2 legal and regulatory frameworks.

The CSP is not a party to the UNC under either option, so CSP services are provided via a Service Agreement in both cases. The key difference is that under Option 1 only the GT Licences are amended (with the Shipper Licences remaining unchanged) whilst under Option 2 both the GT and Shipper Licences are amended.

### **B.2. Outlines of illustrative licence conditions**

As shown in Table B1 below we have categorised the various requirements giving effect to the CSP arrangements as GT obligations, common (GT and Shipper) obligations and supporting requirements – the latter relate to the three key documents required to underpin the common obligations, the Service Agreement, the Charging Methodology and the Articles of Association.

The columns to the right show the vehicles used to impose the obligations and other requirements under the two options. GT-specific obligations can obviously be imposed directly using the GT licences. Under Option 1 it is necessary to use the UNC to bind GTs and Shippers to the common obligations, so the GT licences specify the common obligations to be imposed by the UNC.

Under Option 2 common obligations can be imposed directly through the GT and Shipper licences. We have assumed for (illustrative purposes) that common obligations that would be imposed directly through licences under Option 2 would be fairly extensive. However, as discussed in the main report, the number of licence obligations could instead be kept to a minimum and enforced through the UNC (as per the approach under Option 1).

Table B1: Licence condition overview

Nature of requirement	Ref.	Requirement	Option 1	Option 2
GT obligations	GT 1	GT obligations to establish the CSP as an entity	GT licences impose GT-specific obligations	
	GT 2	GT obligations to re-assume governance role if Ofgem step-in right exercised		
	GT 3	Price control arrangements		
	GT4	GT obligations to make UNC modifications facilitating the CSP arrangements (Option 1)	GT licences	N/A
Common GT and Shipper obligations	CO 1	Common obligations to implement the CSP Arrangements	GT licences specify common obligations to be imposed via UNC	
	CO2	Common obligations to establish and maintain the scope of CSP Services		
	CO3	Common obligations regarding entering into an use of Service Agreement		
	CO4	Common obligations regarding governance of CSP in accordance with Articles of Association		
	CO5	Common obligations regarding economic and efficient CSP Service provision and other Ofgem regulatory oversight measures		
	CO6	Common obligations regarding CSP Charges and CSP Charging Methodology		
	CO 7	Common obligations establish, maintain and make transparent the terms of the Service Agreement, Charging Methodology and Articles of Association		
Supporting requirements for common obligations	SR 1	Service Agreement requirements	GT licences specify supporting requirements to be included in UNC	
	SR 2	CSP Charging Methodology requirements		
	SR 3	Articles of Association requirements		
			GT licences specify supporting requirements to be included in UNC	GT and Shipper licences directly specify supporting requirements

Source: CEPA and TPA