

Gas transporters, independent
gas transporter, gas shippers,
gas suppliers, Xoserve and other
interested parties

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Xoserve – consultation on the legal and regulatory framework to establish new arrangements for the gas central service provider

We are interested in your views on the approach to changing the existing legal and regulatory framework under in Xoserve operates. These changes are necessary to implement our decision published in October 2013 ('our October 2013 decision').¹

Xoserve provides a range of essential services to support the GB gas industry including billing services, managing the booking of capacity, running the gas settlement systems and managing the change of supplier process.² We undertook a review of Xoserve's funding, governance and ownership arrangements. This was to ensure that they would be fit for purpose, and provide the required responsiveness and flexibility in funding, in the context of future gas industry changes.

In summary, we confirmed in our October 2013 decision that we would require changes to be made to current funding and governance arrangements to establish a co-operative model. This model means that gas transporters (GTs) and shippers will be required to jointly participate in Xoserve's governance and fund its activities. Our decision also confirmed that there would be no change to the current ownership arrangements. The GTs will remain Xoserve's owners but governance arrangements will mean that they cannot unduly influence how Xoserve is run.

We also published a report ('the CEPA report') by consultants, Cambridge Economic Policy Associates (CEPA) alongside our decision.³ It proposed a range of feasible options to change the legal and regulatory framework in order to implement our decision. On 6 December 2013 we held a workshop to take the industry through these options and to discuss the steps necessary to achieve successful implementation.⁴

We are now consulting on the options proposed in the CEPA report. We summarise the findings in the CEPA report and our initial views on these findings in this letter. We would like your views on the issues raised in this consultation. We recommend that you also read the CEPA report as it provides further analysis and discussion of the relevant issues. We ask you to please submit your response to the questions posed to Joanna Campbell (joanna.campbell@ofgem.gov.uk, 020 7901 7094) no later than 16 April 2014.

¹ Xoserve - decision in relation to new funding, governance and ownership arrangements for the gas transporters' central agent (Oct 2013):

https://www.ofgem.gov.uk/sites/default/files/docs/decisions/xoserve_decision_oct13.pdf

² See: <http://www.xoserve.com/>

³ See Appendix B of our decision - CEPA report (October 2013): <https://www.ofgem.gov.uk/ofgem-publications/84185/decisionappendixbcepareportonthelgalandregulatoryimplementation.pdf>

⁴ The slides presented and a summary of the discussion can be found as subsidiary documents to this consultation.

We also provide further information on the process we expect to be followed to implement new arrangements. This includes what we expect of the industry as implementation progresses.

1. Changing the legal and regulatory framework

1.1 Aims and objectives

We want to successfully establish the new arrangements outlined in our October 2013 decision. The CEPA report included four objectives against which they, and we, have assessed the options. These objectives are -

- to reinforce and facilitate a responsive IT and information service provider
- to ensure alignment of obligations, risk and control
- to provide a framework that can be industry led, while reserving regulatory powers that allow us to influence new arrangements in protection of the public interest
- to implement new arrangements in the most simple and practical manner, given these objectives.

1.2 What needs to be changed

The CEPA report separates the new arrangements into different elements. We provide further detail later in this document on how these elements could be included in the different legal instruments. The different elements are as follows -

- **Core requirements** – needed to establish the central service provider (CSP) as an entity (to replace the current 'Agency' requirements⁵) and to provide regulatory oversight measures.
- **Principles of governance and funding** – these will form the basis of the information that will be in the articles of association and any service agreement.
- **Shipper and GT obligations** – joint obligations on both GTs and shippers, eg to use the CSP for service delivery, to govern it economically and efficiently and to fund its operation.
- **Service requirements from the CSP** – the arrangements under which Xoserve will deliver services, including performance requirements.
- **Charging methodology** – which will outline how charges are derived and who pays for each service.
- **Service charge application** – the invoicing process and payment terms.
- **Co-operative governance arrangements** – the rules related to governance that will be included in the articles of association. The aim of these arrangements is to align obligations, risk and control.
- **Requirement to provide code and non-code services** – Xoserve will still be able to provide the services that it currently does. Not all these services are currently defined in the relevant network code.⁶ These non-code services will need to be defined in new contractual arrangements and funded by users.
- **Requirement to provide bespoke services** – existing bilateral contracts to provide these services should continue.

1.3 Legal and regulatory instruments that could be used

There are a number of legal and regulatory instruments available -

⁵ See Standard Special Condition A15 (Agency) of the gas transporter licence.

⁶ We discussed the benefits or reviewing where services are defined in our October 2013 decision (Appendix A, section A) and the CEPA report (section 4.2.2).

- **Licences** – each gas transporter (GT), independent gas transporter (IGT) and shipper has a licence to carry out its activity. The licence can be used to place obligations on these parties.
- **Uniform Network Code (UNC)⁷** – a multi-party contractual framework which supports the supply, trade and transport of gas. It has defined governance and modifications procedures allowing for changes without the consent of all parties. We have a role in approving or rejecting the majority of changes proposed.
- **Additional multi-party/bilateral contracts** – contracts such as the existing contract between Xoserve and the GTs for delivery of services (known as the Agency Service Agreement (ASA)) or bilateral contracts between Xoserve and individual users for the delivery of bespoke services.
- **Articles of association** – which together with the memorandum set out the rules for running the company. It includes rules on how decisions affecting the company are to be made and shareholders’ rights.

The central service provider will not be a licensed entity and therefore the list above includes all potential instruments to implement new arrangements.

1.4 The options

The CEPA report outlines four options whose differentiating factors are the legal instruments that are changed in order to implement each element of new arrangements (as outlined in section 1.2 above). Table 1.1 summarises this.

Table 1.1: elements of the legal framework and associated changes to instruments under each option

Element	Option 1	Option 2	Option 3	Option 4
Core requirements	GT licence	GT & shipper licence	GT licence	GT & shipper licence
Principles of governance & funding	UNC	GT & shipper licence & UNC	UNC	GT & shipper licence & UNC
Shipper & GT obligations	UNC	GT & shipper licence & UNC	UNC	GT & shipper licence & UNC
Service requirements from the CSP	Service agreement	Service agreement	UNC	UNC
Charging methodology	UNC	UNC	UNC	UNC
Service charge application	Service agreement	Service agreement	UNC	UNC
Co-operative governance arrangements	Articles of Association	Articles of Association	Articles of Association	Articles of Association
Requirement to provide code and non-code services	Service agreement	Service agreement	UNC	UNC
Requirement to provide bespoke services	Bilateral contracts	Bilateral contracts	Bilateral contracts	Bilateral contracts

Source: adapted from table 4.1 in the CEPA report

There are many common features of the four options –

- The existing GT licence condition⁸ will need to be modified to establish the CSP as an entity (placing the current requirement to have an ‘Agency’ which is the role Xoserve currently plays).
- Changes to the UNC will be required – the type and volume of change is dependent on the option progressed.
- The GTs (as owners) will be required to modify the articles of association to establish new governance arrangements.

⁷ The UNC is administered by the Joint Office of Gas Transporters: <http://www.gasgovernance.co.uk/>

⁸ See Standard Special Condition A15 (Agency) of the gas transporter licence.

- Bilateral contracts between Xoserve and users for the delivery of bespoke services could still be used.

Although each option will result in different instruments being modified the type of information that will need to be included is similar under all options.

There are two differentiating factors in these options that combine to create four options. In summary, reaching a conclusion on the most appropriate option to take forward means considering the following –

- Can the UNC efficiently require parties to jointly participate in the governance and funding arrangements or is it more appropriate to include these requirements in each party's licence?
- Are there any additional benefits in Xoserve becoming a party to the UNC, when compared to the service agreement approach?

Our assessment of the four options focuses on these two questions.

1.5 Our initial view of the options

We summarise our initial assessment of the options based on the two questions above. We have evaluated the options against the objectives outlined in section 1.1. In addition, Appendix 1 outlines the expected high-level content of GT licences, shipper licences and the UNC under each option.

In responding to this consultation we would like you to consider and respond to the two questions we pose and also provide any comments you have on the content of Appendix 1.

Can the UNC efficiently require parties to jointly participate in the governance and funding arrangements or is it more appropriate to include these requirements in each party's licence?

The new arrangements require both GTs and shippers to participate in the governance of Xoserve and to fund it. These joint requirements may extend to IGTs if, in the future, they too use Xoserve for delivery of shipper facing services. The CEPA report outlined two options that could be used to require GTs and shippers to participate: by modifying the UNC only; or through a combination of the UNC and licences.

We have considered these two options against the objectives and, in summary -

- We consider that both options could equally facilitate a responsive IT service provider.
- Both options could equally achieve an alignment of obligations, risk and control. Option 2 or 4 would result in licence requirements to jointly participate. Alternatively, option 1 or 3 would result in joint requirements being included in the UNC. The CEPA report considered that option 2 or 4 would provide a more transparent alignment. We agree that transparency is important but do not consider that one option is stronger than the other in this regard.
- Regulatory oversight can be achieved under either option. If the licence requires participation then we would have direct oversight powers and be able to take action against non-compliance. Arguably, our power to take direct action is reduced if these requirements are in the UNC. This is because the UNC would contain different sanctions against non-compliance where we would not be able to take specific enforcement action against any licensee.
- Either option would provide the industry with the tools it needs to take an active role in ongoing arrangements. However, where the licence is used it could be argued that this creates a greater role for us in relation to future developments.
- We consider that it is simpler for only the UNC to be modified as this would result in fewer changes to existing instruments.

The conclusion in the CEPA report is that using a combination of licences and the UNC to require parties to jointly participate in co-operative arrangements (option 2 or 4) is most appropriate. The main benefit noted is that this would provide a more direct approach to regulatory oversight. We agree that, in circumstances where we consider there to be a risk of consumer harm, the licence provides the most appropriate means to monitor performance and to take action against non-compliance. However, we consider that this risk is minimal in relation to the requirements on parties to participate in Xoserve's governance and funding arrangements. It is in all parties' interests to comply with these obligations – if Xoserve is not able to deliver then this will harm their businesses. We also consider that appropriate sanctions for non-compliance, eg failure to pay charges on time, can be more proportionately applied through the UNC.

Our October 2013 decision noted that we would continue to have oversight over arrangements. We consider that this can be achieved through a combination of changes to the GT licences (which under all options will need to be modified) and the UNC. In our view this would not place greater obligations or risk on the GTs as the joint requirements would still be on all parties via the UNC.

Based on this assessment we consider that the UNC is an appropriate instrument for placing requirements on parties to jointly participate in co-operative arrangements. Our preference is therefore to take option 1 or 3. We welcome comments on this and reasoned arguments for your own view. In particular, we would welcome your views on the perceived risk associated with not creating a binding requirement through licences.

Are there any additional benefits in Xoserve becoming a party to the UNC, when compared to the service agreement approach?

Xoserve is not currently a party to the UNC. It is required to deliver services on behalf of GTs through a service agreement (the Agency Service Agreement). Under new arrangements a contractual arrangement is still required, however, Xoserve will now be delivering services on behalf of, and for, shippers as well as GTs.

The CEPA report proposed two options for this contractual arrangement: continue to use a service agreement approach but extend to capture shippers; or make Xoserve a party to the UNC, with the UNC then capturing the contractual arrangement.

We have considered these two options against the objectives and, in summary –

- Using a service agreement better facilitates a responsive IT service provider as it is more akin to contractual arrangements for other IT service providers.
- Both options could equally achieve alignment of obligations, risk and control.
- It could be argued that placing all delivery requirements within the UNC creates greater regulatory oversight (given our role in relation to modifications to the UNC⁹). However, we consider that any risk here can be mitigated through the inclusion of a process in the UNC that ensures service agreements are kept in line with it.¹⁰
- If Xoserve becomes a party to the UNC it would need to be differentiated from other parties. For example, there is no desire for Xoserve to have the ability to raise modifications to the UNC. Also, not all of the services Xoserve delivers are defined in the UNC. Our decision was not intended to limit the services Xoserve can deliver. These potential limitations can be dealt with through careful drafting of UNC changes but this is likely to create additional complexity.
- On the other hand, the service agreement approach means an additional contract and necessitates the creation of a modification process with regards to it.

⁹ Unless categorised as “self-governance”, changes to the UNC come to us for approval or rejection.

¹⁰ This would mean that the service agreement is a contract that can be modified without the consent of all parties in circumstance where the changes are to reflect changes to the UNC.

The CEPA report proposed that the service agreement approach best meets the objectives. We agree with this conclusion and the arguments for it and therefore prefer option 1 or 2. We consider that Xoserve becoming party to the UNC drives no additional benefits that cannot be achieved through the service agreement approach. We welcome your comments on these conclusions and reasoned arguments for your own view.

2. The process for implementation

There are a number of steps required before implementation of new arrangements will be complete. We discussed the information below at our workshop on the 6 December. We emphasised the need for GTs, IGTs and shippers to work collaboratively to ensure successful implementation. Our view, in this respect, has not changed. We still consider that the industry is best placed to deliver implementation because:

- (i) Industry parties have the right tools to do so, primarily through using the UNC modification process;¹¹ and
- (ii) this review has, from the start, been driven by industry parties. Continued involvement and leadership will ensure the final outcome works in parties' best interests.

2.1 Implementation work streams

At the 6 December workshop there was broad agreement on the following work streams -

- **Service allocation** – drafting of the contractual framework for the delivery of code and non-code services. This will include modification of the UNC, and establishment of a service agreement (if required).
- **Annual budget process** – developing the rules in relation to the budget setting process and defining these rules in relevant instruments.
- **Cost allocation methodology and charging statement** – developing and drafting the cost allocation methodology and charging statement.
- **Invoicing arrangements** – concluding on the most appropriate invoicing arrangements and defining these in relevant instruments.
- **Board process** – defining the process, roles and responsibilities associated with election of board members and functioning of the board. Consideration should also be given to transitional arrangements.
- **Reopener related to GT price controlled revenue** – triggering of reopener and assessment of GTs' allowed revenue and output delivery in relation to Xoserve. Further modification to the GT licence to provide alternative arrangements for the pass through of Xoserve charges, if required.

We expect the industry, as a first step, to decide on how they wish to deliver each of these work streams and to provide us with information on the milestones and targeted dates for delivery.

2.2 Delivery of milestones

Section 2.1 outlines what needs to be changed to implement our October 2013 decision. In Appendix 1 of this letter we have included further detail on how that decision may impact the different legal and regulatory instruments. We deliberately left elements of new arrangements more open in our October 2013 decision. For example, the invoicing arrangements for Xoserve to charge for its services and the process for election of board members. We did this because we consider that the industry is best placed to reach the best outcome for them and do not consider any option would be detrimental to consumers.

¹¹ We do not have the power to raise UNC modifications other than through a significant code review. We do not currently consider that triggering a significant code review in these circumstances is appropriate.

Based on what is required to be done, we consider that the industry has two options with which to progress implementation -

1. Raise the necessary modifications to the UNC now. We consider that the UNC process could provide the right forum for industry debate on some of the outstanding aspects of new arrangements.
2. Establish working groups to consider the issues that still need addressed and to make a decision on what modifications are to be proposed. The output from this over-arching group would be the proposing of changes to the UNC. Our expectation would be that the UNC working groups would avoid duplicating discussions already had through the over-arching industry work group.

We recognise that the changes needed are wider than just to the UNC. However, the information in Appendix 1 shows that the licences and UNC are the main depositories of information from which the content of the additional legal instruments flow.

We are committed to continued involvement in the process of implementation. We will attend relevant industry meetings and will provide guidance and support when required. We do not expect to lead on further consultations and decisions, other than via approving or rejecting UNC modifications. We are not ruling out the need for further consultation but consider that this should not be the expected route if industry agreement cannot be reached. Rather it should be used as a last resort if issues arise which the industry considers cannot be managed through existing processes and we consider it would be in consumers' interests to consider further.

We have the option to direct one or more parties to deliver implementation through placing a requirement in licences. A delivery licence requirement would likely include specified milestones and/or deliver of new arrangements by a specified date (April 2015). Our current view is that if such requirements are needed then they should be placed on the GTs. We consider this reasonable because of the GTs unique position as owners of Xoserve. We do however recognise that the GTs cannot achieve successful implementation without the support of other industry parties. We welcome your views on whether such a delivery requirement is necessary and if so who this requirement should be placed on.

Next steps

Please submit responses to our questions no later than 16 April 2014 to Joanna Campbell (joanna.campbell@ofgem.gov.uk, 020 7901 7094). In the meantime, if you would like to discuss any aspect of this consultation please get in touch.

We will consider these responses when making our decision. The decision we make will inform the next step which will be to modify the relevant licences. We intend to start this process through informal consultation on proposed changes with the affected parties. This will be followed by the formal licence modification processes, including statutory consultation.

Yours sincerely,

Andy Burgess
Associate Partner, Transmission and Distribution Policy

Appendix 1 – Outline of licence condition content

This Appendix builds on the information in Appendix B of the CEPA report. It focuses on the content of the licences under each option. We expect limited difference between option 1 and 3, and equally between option 2 and 4 with regards to licence changes.

The '✓' indicates the document in which the requirement would be enforced. While the 'X' means that the document would not be the principle location for the requirement, it should not be read as indicating that no change would be required. For example, under option 2 or 4 the licences would be the principal document where joint requirements would be enforced. However, we expect that the UNC would contain further detail in relation to these requirements.

Xoserve will not be directly named in the UNC or licences. We therefore refer to it as the central service provider (CSP) in the tables below.

Table A1.1 - core requirements

Detail	Option 1 or 3			Option 2 or 4		
	GT Licence	Shipper Licence	UNC	GT Licence	Shipper Licence	UNC
Establish the CSP as an entity, to be owned by the GTs (removing reference to the Agency and replacing with the CSP). This will be linked to any further requirements in the UNC.	✓	X	X	✓	X	X
Obligation to modify the articles of association to bring in line with principles of governance.	✓	X	X	✓	X	X
Regulatory oversight measures - to provide for us to be notified of specified within year budget increases, allow for budget modification (in specified circumstances) and back-stop powers for GTs, as owners, to take control under our guidance in extremis.	✓	X	X	✓	✓	X
Triggering of the reopener to review GTs' revenue allowances in relation to Xoserve, and any further change to licences to establish an alternative cost pass through mechanism (if required).	✓	X	X	✓	X	X

In addition, we could place an obligation on one or more parties to ensure delivery by a specified date and to raise the necessary modifications to the UNC to do this. The necessary modifications to the UNC would include the items specified in Table A1.2 and A1.3 below.

Table A1.2 – principles of governance and funding

Detail	Option 1 or 3			Option 2 or 4		
	GT Licence	Shipper Licence	UNC	GT Licence	Shipper Licence	UNC
Statement setting out the principles of service delivery, with the detail to be included in the service agreement (separate agreement under option 1 or 2, or part of the UNC under option 3 or 4): <ul style="list-style-type: none"> - obligation on the CSP to provide the defined services and associated performance indicators - requirements associated with paying for services, and how such payments are to be made - a dispute resolution process - exit arrangements and a handover plan (if delivery role transfers from Xoserve to another company) 	X	X	✓	✓	✓	X
Statement setting out principles of funding, with the detail to be included in the charging methodology and charging statement : <ul style="list-style-type: none"> - establish and, from time to time, modify the charging methodology and resulting charges - determination of costs on an activity cost basis based on the annual budget - transparent allocation of costs - charges to be cost reflective and not unduly discriminatory 	X	X	✓	✓	✓	X
Statement setting out the principles of governance, with the detail to be included articles of association : <ul style="list-style-type: none"> - the rights and responsibilities of those that govern the CSP, including the protection of owners' subscribed share capital from equity risk arising from CSP's activities, ie alignment of risk with control - the CSP to be operated as a not-for-profit organisation - requirement to publish relevant material in relation to the budget and charges - provision for the appointment of directors and the procedure to be followed - directors' responsibilities as members of the CSP's board, including rules for decision making 	X	X	✓	✓	✓	X

Table A1.3 – shipper and GT obligations

Detail	Option 1 or 3			Option 2 or 4		
	GT Licence	Shipper Licence	UNC	GT Licence	Shipper Licence	UNC
Obligation to establish and maintain the scope of services	X	X	✓	✓	✓	X
Obligation to enter into an agreement with the CSP for the delivery of outlined services	X	X	✓	✓	✓	X
Obligation to govern jointly the CSP in accordance with the articles of association	X	X	✓	✓	✓	X
Establish, operate and develop the CSP economically and efficiently	X	X	✓	✓	✓	X
Obligation to pay for the services delivered in accordance with the charging methodology	X	X	✓	✓	✓	X
Require ongoing modification of associated documents (service agreement and articles of association) to ensure they remain in line with the UNC	X	X	✓	✓	✓	X