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Dear Jonathan

RIIO-2 SECTOR SPECIFIC METHODOLOGY

Thank you for the opportunity to respond to Ofgem's latest consultation on the RIIO-2 arrangements. Our response is concerned with the particular question of how the Gas Transporters are funded for the services that they take from Xoserve as outlined in the Uncertainty Mechanisms section of both the GD2 and GT2 Annexes.

The new Xoserve operating model introduced in April 2017 is already delivering consumer benefits. We think that there is an opportunity in setting the RIIO-2 price control to modify the arrangements for the Gas Transporters' funding of Xoserve so as to create an environment in which even greater benefits can be realised. Continued operation of the existing regulatory checks and balances in the Xoserve operating model means that this can be achieved without placing unacceptable additional cost burdens on the energy consumer. With our total costs running at less than £3 per supply point per annum, we are providing an inherently efficient service to the market, and introducing more flexible funding would carry only minimal additional risk to consumers.

We anticipate that the modified arrangements that we are advocating would apply to all Gas Transporter funded CDSP Services, with the possible exception of services to operate, support and change the Gemini IT system asset. As the application is wholly owned and fully funded by National Grid Gas Transmission, it falls outside of the additional flexibility required for funding shared services.

We also think that an alternative and more flexible funding model would better reflect the limited control that the Gas Transporters are able to exercise over key decisions about the Xoserve business and the services that it provides. We anticipate that this flexibility would equally apply to a situation in which Xoserve takes on services for Gas Transporters beyond its core role.

Our detailed response is set out in Appendix 1 for your consideration. We are happy for Ofgem to publish our consultation response in full on its website, and to meet to discuss any aspect of our response that Ofgem may wish to explore further.

Yours sincerely

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RIIO-2 SECTOR SPECIFIC METHODOLOGY

APPENDIX 1 – DETAILED CONSULTATION RESPONSE

Question GTQ38: *What do you think is the most appropriate approach for funding the Gas Transporters' expenditure for Xoserve in RIIO-2? In particular, which approach do you think is in the best interest of consumers?*

Question GDQ51: *What do you think is the most appropriate approach for funding the GTs' expenditure for Xoserve in RIIO-2 and why?*

1. Gas Transporters and Gas Shippers share control of Xoserve

Ofgem's review of Xoserve Funding, Governance and Ownership ('FGO') culminated in the implementation in April 2017 of a co-operative governance operating model and the redefinition of Xoserve's role as Central Data Services Provider ('CDSP'). The model provides for all customer constituencies (namely National Grid Gas Transmission ('NGGT'), the Gas Distribution Networks ('GDNs'), the Gas Shippers and the independent Gas Transporters ('iGTs')) to exercise collective and shared control over the Xoserve business and the services that it provides. The composition and voting arrangements of the Xoserve Board and of the Data Services Contract ('DSC') Committees ensure that no single customer constituency has undue influence, and specifically that the principal Gas Transporters (NGGT and the GDNs) do not together have a voting majority.

Xoserve consults with all of its customers on its annual Business Plan and Budget. Whilst there is a GT Licence requirement for NGGT and the GDNs to have joint ownership of the company that provides CDSP Services, this does not bestow any additional level of control or influence over and above that of the Gas Shippers or the iGTs in the setting of the Business Plan and Budget.

2. The Xoserve operating model benefits and protects energy consumers

The Xoserve operating model affords Shipper / Supplier businesses direct access to Xoserve, and to decisions about the services that Xoserve provides. The Business Plan consultation and DSC governance arrangements allow them to have a say in shaping and prioritising the delivery of services that meet energy consumers' needs.

The model prohibits the distribution of profits to shareholders, socialising the benefits of budgetary outperformance with those customer constituencies that have provided funding. A budget appeal mechanism and an obligation to notify in year budget increases provide regulatory oversight and protect energy consumers from the consequences of ineffective cost control. There is also an overarching requirement for all customers to jointly control and govern the CDSP on an economic and efficient basis. Moreover, the reputational risk to Xoserve of putting forward an unrealistic Business Plan incentivises an approach to planning and forecasting that is responsive to and reflective of the extent of customer willingness to fund.

The operation of the model over the past two years has clearly demonstrated the energy consumer benefits of effective collaboration between NGGT, the GDNs, the Gas Shippers and the iGTs:

- Project Nexus has delivered a replacement UK Link system as a platform for new gas settlement arrangements and the extension of registration and switching services to include supply points on iGT networks. The new settlement arrangements promote improved targeting of energy consumption costs at meter point level and thereby more cost-reflective end consumer billing, and the centralisation of iGT services has delivered efficiencies into Gas Shipper businesses which are passed through to the end consumer.
- Shipper funded investigation into the root causes of high levels of Unidentified Gas (UIG) is making the case for changes to demand estimation processes which will deliver greater predictability of energy costs for consumers. Specifically, our work on UIG has been called on by Ofgem in its setting of the retail price cap to protect those consumers who remain on Standard Variable Tariffs.
- Customers gave their collective backing to Xoserve's proposals to leverage its UK Link asset to provide a platform for the dual fuel Central Switching Service ('CSS'). They supported our argument that there were significant end consumer benefits to be gained from avoiding investment in a new system, and that considerable efficiencies were available both from the delivery of the CSS and CDSP consequential impacts in a single Change Programme and from the subsequent operation of an integrated market solution.

3. Gas Transporter funding arrangements limit the effectiveness of the model

Ofgem's original ambition for the Xoserve FGO Review was to establish arrangements that would provide greater responsiveness to changes in market demand and offer a more flexible approach to funding.¹ This recognised the particular nature of the Xoserve business as a data and technology services provider that has a fundamental requirement to be able to offer an agile response to the needs of its users, and that this is quite different in character from a network management business operating and investing in long life assets. A practical outworking of this ambition was a proposal to modify the price control framework to allow NGGT and the GDNs to pass through the costs that they receive from Xoserve as part of transportation charges. The subsequent decision to retain *ex ante* allowed revenues for the duration of the RIIO-1 period reflected Ofgem's concerns at the time about the delayed delivery of both Project Nexus and the FGO model.²

We think that a consequence of this decision is that NGGT and the GDNs have tended to display more risk averse behaviour than that shown by the Gas Shippers, and that this may have limited their ability and willingness to respond effectively to market demand for new services and product innovation that can deliver greater end consumer benefits. We observe that customer discussions with Xoserve about investments in centralised services, which so often offer simple industry solutions that can benefit the whole market, can become distorted by concerns about sources of funding rather than being properly focused on the case for change and the end consumer benefits that will accrue.

¹ See https://www.ofgem.gov.uk/sites/default/files/docs/2013/10/xoserve_decision_oct13_0.pdf

² See https://www.ofgem.gov.uk/system/files/docs/2016/09/xoserve_funding_decision_final.pdf

4. The changing energy market points to the need for a more flexible funding model

We see a number of changes happening in the energy market that could have significant repercussions during the RIIO-2 period for the role of Xoserve and the services that it provides. There is a risk that the continuation of an *ex ante* allowed revenue model for the RIIO-2 period, particularly one in which the ability of the Gas Transporters to earn returns may be less than in the RIIO-1 period, would limit further the capacity of NGGT and the GDNs to respond effectively to demand for new services and to product innovation.

We offer some examples of these emerging changes:

- The pace of technological change is making it increasingly difficult to predict the level and nature of demand for data services in the longer term. The work of the Energy Data Taskforce and the 'Midata in Energy' project are prime examples of harnessing the power of data and data management technologies to encourage innovation and develop new consumer products. We are first and foremost a data company that is managing large volumes of gas industry data. We're taking significant steps to make that data available and accessible to others, and this is a trend that we expect to continue to grow at pace.
- The Gas Transporters' research projects that are investigating the injection and blending of alternative sources of gas such as hydrogen and bio-methane could have a potentially significant impact on the transportation charging framework and on the register level information that Xoserve manages
- There are BEIS and Ofgem initiatives such as the Energy Codes Review and the Review of Supply Market Arrangements that are currently in their infancy, meaning that the consequent policy reform outcomes and impacts on Central Data Services are immensely difficult to predict
- The implementation of the Retail Energy Code and the CSS introduces new GDN obligations and new CDSP responsibilities; this is adding further uncertainty to future service requirements, compounded by a lack of clarity as to how these should be prioritised and balanced against competing or conflicting UNC change demands
- Looking beyond CSS implementation, we envisage further product and service innovation, driven by the wider deployment of smart-enabled technology and the emergence of a consumer-centric supply model

5. A pass through arrangement would deliver greater responsiveness but without the loss of essential consumer protections

We believe that the introduction of a pass through arrangement for the Gas Transporters' funding of Xoserve would provide all of our customers with a common view of risk in procuring services from Xoserve, and would allow discussions about responses to market demand to focus much more on the case for change and the realisation of market-wide efficiencies and energy consumer benefits, and much less on the question of individual customer constituencies' funding responsibilities.

We have discussed our thinking on the introduction of a pass through arrangement with a number of our Shipper customers. There is broad support for a change in the funding model, on the grounds that it would deliver the flexibility and agility that is needed for Xoserve and its customer community to respond to market demand, and that Xoserve's annual business planning process provides an appropriate level of control over expenditure plans and funding requirements. We noted that some Shipper customers may also be in favour of a review of the Xoserve governance model commensurate with a change to the Gas Transporters' funding model.

Gemini

We think that a possible exception to a pass through arrangement might be appropriate for the costs of operating, supporting and making changes to the Gemini application. The Gemini IT asset is wholly owned and fully funded by National Grid, and therefore does not share the same characteristics as the rest of the Xoserve shared services IT estate which requires a more flexible funding model.

Cost Control

We recognise Ofgem's concerns that a pass through arrangement would not be seen as encouraging cost control and could result in unnecessary costs being passed on to energy consumers. We think that there are sufficient controls already in place (as outlined in Section 2 above) to largely mitigate this risk, and that the Gas Transporters would continue to exercise robust budgetary control, ensuring that any exposure to cash flow timing differences is minimised. We also think that any residual post-mitigation risk would be offset by the enhanced consumer benefits of a more responsive market.

In a rapidly changing market, validating an efficient level of IT expenditure is notoriously difficult to achieve. A pass through arrangement backed up by a customer centric cost control framework would remove this challenge for Ofgem when setting the RIIO-2 price control.

Questions GTQ39 and GDQ52: *If Xoserve takes on any services beyond its core Central Data Service Provider role, how should we treat the costs and risks associated with these additional services through the price control?*

Looking ahead to a future in which, for example, the scope of the Retail Energy Code expands and the wider Code landscape takes a different shape as a result of the Energy Codes Review, there is a heightened risk that it will become increasingly difficult to define new service requirements as being within or without the scope of CDSP Services and to identify discrete customer constituency funding of those requirements.

As such, the need for funding flexibility remains paramount in order to ensure that innovation is not stifled and all market participants can play their part in delivering consumer benefits. Therefore, to the extent that services that are deemed to fall outside of the core CDSP role (as determined by Ofgem in accordance with the GT Licence provisions) and are funded by the Gas Transporters, we would propose an extension of the pass through arrangement that we are advocating for CDSP Services.

It is also possible that a major Government or Ofgem led policy review might place previously unforeseen obligations on the Gas Transporters, and that such obligations are to be discharged by way of an addition to the scope of Xoserve services. In such circumstances, the RIIO-2 price control should offer sufficient flexibility to the Gas Transporters to enable them to respond effectively, and we think that this would be best achieved by way of an extension to the pass through arrangement.