

All interested stakeholders

Date: 10 June 2016

Dear Stakeholder,

Consultation on our minded-to position on the review of gas transporter agency (Xoserve) costs in RIIO GD1 and T1.

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.

We undertook a review of Xoserve's funding, governance and ownership arrangements to ensure that it would be fit for purpose, and provide the required responsiveness and flexibility in the context of future industry changes. In October 2013¹, after consulting on various options, we decided that a full co-operative governance model should be established for Xoserve. The gas transporters (GTs) will remain its owners, and changes to the way that it is funded will be required to fully introduce co-operative arrangements and make all users accountable for the Xoserve. An uncertainty mechanism to allow Ofgem to review GT's Xoserve cost to determine relevant adjustments to the level of allowed expenditure was included in RIIO GD1² and T1³ under special condition 3F (gas distribution) and special condition 6D (gas transmission) of the Gas Transporter (GT) licence⁴.

This letter outlines our minded-to decision on the adjustment to GT's allowed expenditure in relation to their Xoserve costs from 1 April 2017 till 31 March 2021. It discusses whether such costs for GTs should be treated as pass-through or included as part of the total expenditure allowed to the GTs in RIIO GD1 and T1. It also explains what this decision means for the Independent Gas Transporters (iGTs).

Annex 1 to this letter sets out the details of our minded to decision. Subject to consideration of the consultation responses, we are minded to:

1. Revise the total allowed expenditure for GTs for Xoserve costs for the RIIO GD1/T1 period from £600 million to £485 million (in 2014/15 price terms). The methodology we have used to arrive at these numbers is included in Annex 2, which also explains how we have allocated the expenditure between GTs.

¹ [Xoserve - decision in relation to new funding, governance and ownership arrangements for the gas transporters' central agent](#)

² The RIIO-GD1 price control sets out the outputs that the eight Gas Distribution Networks (GDNs) need to deliver for their consumers and the associated revenues they are allowed to collect for the eight-year period from 1 April 2013 until 31 March 2021. The final proposal can be found [here](#).

³ The RIIO-T1 price control set out the outputs for the gas and electricity network companies from 1 April 2013 to 31 March 2021. The final proposal can be found [here](#).

⁴ In the event of a change to Standard Special Condition A15, these allow us to conduct a review to establish the efficient level of costs.

2. Continue to include Xoserve related costs for GTs as an allowance in the base revenues for remainder of RIIO GD1 and T1.

We have also set out the impact of our decision (as per point 1 and 2) on the Independent Gas Transporters as they operate under relative price control arrangements.

Question: Do you agree with our minded to decision on items 1 to 2 above?

We will consider all responses to this consultation and publish our final decision by September 2016. Please send your responses to this consultation by 7 July 2016 to:

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Unless clearly marked as confidential, all responses will be published by placing them in Ofgem's library and on its website (www.ofgem.gov.uk). Respondents may request that their response, or part of response is kept confidential and those who wish to do so should clearly mark their documents to that effect and include reasons for confidentiality. Ofgem shall respect this request, subject to disclose requirements, for example, under the freedom of Information Act 2000 or the Environment Information Regulations 2004. It would be helpful if responses could be submitted electronically and/or in writing.

Please contact Rupika Madhura if you have any questions with regards to this consultation.

Yours sincerely,



Kersti Berge
Partner, RIIO Networks

Annex 1: Minded to decision.

Background

Concerns were raised regarding whether Xoserve's funding, governance and ownership (FGO) arrangements were fit for purpose and provided the required responsiveness and flexibility in the context of future gas industry changes. In July 2010, as part of the RIIO GD1 and T1 preparatory work, we announced that we would review Xoserve's performance and consider other options for FGO arrangements⁵.

In October 2013⁶, after consulting on various options, we published our decision to implement a co-operative model. This model requires GTs and shippers to jointly participate in Xoserve's governance. Our decision confirmed that there would be no change to the current ownership arrangements. However, while the GTs will remain Xoserve's owners, the new governance arrangements will mean that Xoserve will have to respond to the needs of all its users.

We set out our view that the industry should lead on implementing our decision on establishing a co-operative governance model for Xoserve. Since we issued our decision in October 2013, the industry has been working on the detailed implementation of the new arrangements for Xoserve. This work has faced extensive delays. The industry agreed a two phase project plan in September 2015, with the aim to establish the new arrangements for Xoserve by 1 April 2017. We have been engaging with the industry through a programme overview board (POB), which industry participants have established in order to oversee the detailed implementation work.

The timing of this minded to decision on funding has allowed us to take into account developments under the industry process, in particular the information from the cost allocation and charging methodology working group created by the industry to establish future costs for Xoserve and how they would be allocated to the users under the new governance arrangements from 1 April 2017.

Proposed Adjustment to Allowed Expenditure

The co-operative model will require GTs and shippers to jointly fund Xoserve's activities. Currently, almost all of Xoserve's activities are funded through the RIIO GD1 and T1 price controls. Under the new co-operative model these activities will be funded according to the "user pays" principle i.e. all users of services will pay for the services they receive from Xoserve. Accordingly, we made a provision for an uncertainty mechanism in RIIO GD1 and T1 to allow us to adjust the relevant allowed expenditure for GTs Xoserve costs through Special Conditions 3F (gas distribution) and 6D (gas transmission) of the GT licence.

We commenced our review of the GTs' Xoserve costs in December 2015 and aim to make a final decision on the funding arrangements by September 2016. This would ensure that the new funding arrangements align with the new co-operative model from 1 April 2017. In the meantime, the current arrangements to fund Xoserve continue to apply until 31 March 2017.

In order to assist our review, we issued an information request to GTs and Xoserve on 15 December 2015 to provide information on costs and the allocation methodology for Xoserve and its users. We received a submission on 29 January 2016. We understand this submission was compiled using the information from the cost allocation and charging methodology working group, which sits under the POB. The working group comprises of representatives of from Xoserve, GTs, iGTs and shippers and we understand this submission to us has been shared with all participants of the working group. Since receiving

⁵ [Open letter consultation on Gas Distribution Price Control Review 2 \(GDPCR2\) – the way forward](#)

⁶ [Xoserve - decision in relation to new funding, governance and ownership arrangements for the gas transporters' central agent](#)

this information, we have been liaising with GTs and Xoserve further to obtain clarity on various parts of the submission.

Our analysis of the industry submission on costs

We have analysed the information submitted to us. The purpose of our analysis was to determine the adjustment to the allowed expenditure for GTs for Xoserve costs, from 2017-18 to 2020-21, to enable implementation of the user pays principle under new co-operative governance model.

Our methodological approach to the analysis is described in detail in Annex 2. In summary, we have compared the figures submitted to us on 29 January 2016 by GTs and Xoserve with the figures in Xoserve's 2014-15 Regulatory Reporting Pack (RRP), which Xoserve submits to us annually. We have used the forecast cost data from Xoserve's 2014-15 RRP as the basis for the revised allowances for 2017-18 to 2020-21 and applied the cost allocation information provided to us in the 29 January 2016 submission as per Cost Allocation and Charging Methodology Report.

We understand that the figures submitted to us on 29 January 2016 reflect forecast costs for Xoserve for the years 2016 to 2021 that have been approved by the Xoserve board but we have not received an explanation for the difference between these numbers and those in the RRP. There are small differences between the two for the first four years of RIIO GD1 and T1 but in the last four years the differences are larger, with the costs being higher in the 29 January 2016 submission. We also note that total costs for Xoserve in the last four years of RIIO GD1 and T1 submitted in the 2014- 2015 RRP are broadly the same as in the 2013-14 RRP. Accordingly, we have decided to use forecast costs from the RRP for this minded to decision.

Our minded to decision

We are minded to revise total allowances for the RIIO GD1 and T1 period from £600 million to £485 million. The £115 million reduction in allowed expenditure partly reflects the reduction in GTs share of Xoserve costs for 2017-18 to 2020-21 as per the new funding and governance arrangements and partly reflects the efficiency savings. Table 1 shows the RIIO GD1 and T1 allowances by GTs set at the start of the price control period. Table 2 shows the revised Xoserve expenditure allowances by GTs for 2017-18 to 2020-21.

Table 1 - RIIO GD1/T1 Xoserve totex allowances (£m, 2014-15 prices)

	2014	2015	2016	2017	2018	2019	2020	2021	Totals
EoE	11.1	12.4	10.6	10.3	8.1	8.6	9.6	9.7	80.4
Lon	6.2	6.9	6.0	5.8	4.6	4.8	5.4	5.4	45.0
NW	7.5	8.4	7.2	7.0	5.5	5.8	6.5	6.6	54.5
WM	5.7	6.4	5.5	5.3	4.2	4.4	5.0	5.0	41.7
NGN	7.0	7.9	6.8	6.6	5.2	5.5	6.2	6.2	51.4
SC	5.0	5.6	4.8	4.7	3.7	3.9	4.3	4.4	36.2
SO	11.1	12.4	10.7	10.4	8.2	8.6	9.7	9.7	80.8
WWU	6.9	7.8	6.7	6.5	5.1	5.4	6.1	6.1	50.5
NGT SO	16.0	14.8	21.6	28.3	25.6	19.7	16.6	16.8	159.5
Totals	76.6	82.5	79.9	84.9	70.1	66.7	69.4	69.9	600.0

Table 2- GTs' totex allowances adjusted for review of Xoserve costs, to reflect FGO arrangements (£m, 2014-15 prices)

	2014	2015 *	2016 *	2017 *	2018	2019	2020	2021	Totals
EoE	11.1	12.4	10.8	10.5	4.7	3.5	3.1	2.4	58.4
Lon	6.2	6.9	6.1	5.9	2.7	2.0	1.8	1.4	32.8
NW	7.5	8.4	7.3	7.1	3.1	2.4	2.1	1.6	39.5
WM	5.7	6.4	5.6	5.4	2.3	1.7	1.5	1.2	29.9
NGN	7.0	7.9	6.9	6.7	2.9	2.2	1.9	1.5	37.2
SC	5.0	5.6	4.9	4.7	2.1	1.6	1.4	1.1	26.3
SO	11.1	12.4	10.9	10.5	4.8	3.6	3.1	2.4	58.9
WWU	6.9	7.8	6.8	6.6	2.9	2.2	1.9	1.5	36.7
NGT SO	16.0	14.8	21.8	28.4	20.0	22.2	22.3	19.4	165.0
Totals	76.6	82.6	81.1	85.8	45.5	41.6	39.1	32.4	484.7

*2014-15 to 2016-17 figures include implementation costs of the FGO programme.

Source: Ofgem analysis

Proposed treatment of revised allowed expenditure: pass-through or allowance

The revised allowed expenditure of Xoserve to GTs can be treated in two ways: a pass-through or as an allowance within the price control.

The GT's licences allows costs for certain pass-through items to be included as part of their maximum allowed revenue, such as Ofgem licence fee⁷. These costs are usually not in companies control and therefore it is deemed appropriate to pass such costs to the consumers directly. All other costs that are in regulated companies' control are treated as part of the price control to incentivise regulated companies to keep these costs efficient.

One of the key areas of concern for shippers, which led to the review of Xoserve, was that Xoserve's current funding and governance arrangements meant that Xoserve was unable to meet the individual requirements of its various user groups. This was because given Xoserve's costs were included in GT's RIIO GD1 and T1 allowances, GTs were focussed on their own interests given RIIO incentives rather than considering what may have been best for the full range of Xoserve's customers.

To address this concern, the cooperative model intended to consider Xoserve running costs as "stand alone" costs that would be jointly controlled by the industry. Users of Xoserve under the new arrangements would jointly agree the basic services Xoserve would provide. Anything beyond these basic services would be paid for by the particular user requesting the additional service. Given these costs were jointly agreed (rather than being in GTs control), it was considered at that time that such costs for GTs could be treated as pass-through.

Our minded to decision

Notwithstanding the principles set out above which we continue to think is the right long-term trajectory, we are now minded to treat Xoserve costs to GTs (for 2017-18 till 2020-21) as an allowance in base revenue for RIIO GD1 and T1, rather than treating them as a pass-through.

Our minded to decision has been influenced by events that have developed since we concluded on our review of FGO in October 2013, principally, the delays in the industry led

⁷ [RIIO-GD1 Handbook](#), total expenditure 63,

project to establish cooperative governance model for Xoserve as per our FGO review and delays in delivery of project Nexus⁸.

This has reduced our confidence in the industry being able to adapt swiftly to joint-working and shared responsibility to govern Xoserve costs. We are concerned that treating Xoserve's costs as "stand alone" and as such pass-through would not provide the proper checks and balances that need to be in place to protect consumers from inefficient, uncontrolled costs being incurred.

We note that during the implementation period of our FGO review conclusions of October 2013 to establish new governance arrangements for Xoserve, it has been necessary to delay the implementation of Project Nexus to 1 October 2016. In early 2016 Ofgem also had to step in to take overall sponsorship of the Programme⁹. We are currently considering whether a further delay would be in consumers' interests. Given the costs involved in this Nexus delivery programme, it is important that there continues to be appropriate oversight of the central costs of programme for consumers, both during implementation and the intensive support or "hypercare" period that will be necessary after the new systems go-live¹⁰.

Given this, we consider that it is in the interest of gas consumers that the costs of Xoserve in relation to GTs are not pass-through and continue as an allowance for the remainder of RIIO GD1 and T1.

As part of our work on RIIO 2, we will reconsider our position on these allowances based on the performance of the industry in creating an effective cooperative governance model in practice from 1 April 2017 onwards. We will also need to consider any implications from the implementation of the proposed remedy by the Competition and Markets Authority to reform the governance of code administration and central system delivery.

Impact on consumers for the remainder of RIIO GD1 and T1

The impact of this review is to reduce GTs' expenditure allowances by £115million (the difference between the totals presented in Tables 1 and 2) for RIIO GD1 and T1. The reduction in expenditure allowances is due to several factors, which can be explained as follows, along with the impact of these on the consumers:

1. We have a set a lower level of costs for Xoserve, reflecting that the actual costs of Xoserve to date have been lower than the allowances provided for in RIIO GD1 and T1. Across the final four years of RIIO GD1 and T1 this accounts for a total of £53 million of reduction in costs. We expect consumers to benefit from this through reduction in the charges to the users of for the services provided by Xoserve from 1 April 2017.
2. Based on the user pays principle of FGO, GTs share of Xoserve costs will reduce from 1 April 2017. Across the final four years of RIIO GD1 and T1 this accounts for £64 million of the reduction in GTs costs of Xoserve. To the extent that this is not a reduction in Xoserve cost, instead a reduction in proportion of Xoserve related costs that would be paid by GTs, this will not directly reduce overall charges for Xoserve paid for by customers and therefore the consumers.
3. Finally, allowances are £2 million higher in 2014-15 – 2016-17, as we have allowed efficiently incurred expenditure for implementing the new arrangements for Xoserve.

⁸ The UK Link system, operated by Xoserve for energy settlements, supply point administration and other functions for the GB gas market, is scheduled to be replaced. Project Nexus is the industry programming aiming to ensure that the replacement systems meet the current and anticipated requirements of market participants <http://www.gasgovernance.co.uk/sites/default/files/Ofgem%20Open%20Letter%20on%20Project%20Nexus%20and%20Ofgem%20sponsorship.pdf>

¹⁰ However, it is likely that the vast majority (and possibly all) of remaining Project Nexus related costs will fall in 2016/17

Impact on Independent Gas Transporters (iGTs)

Once Project Nexus is delivered, iGTs will also receive services from Xoserve under the user pay principle and will also have a seat on the board of Xoserve as per the new co-operative governance arrangements.

iGTs operate under a "relative price control" mechanism. This means they cannot charge consumers above the revenue set by us for the GT in their area. This means that if during the RIIO, the allowed revenues is increased for GTs, iGTs are able to earn greater revenues; if GTs' allowed revenues decrease they are able to recover lower revenue.

We recognise that in this instance our decision to reduce the price control revenue for GTs would result in a reduction in the revenue iGTs can recover from their consumers but on balance, we believe the effect of this re-opener on iGTs costs is manageable given that in other instances iGTs have gained from the increase in the revenues GTs can recover (for example on recent decision on the enhanced physical site security uncertainty mechanism¹¹).

¹¹ https://www.ofgem.gov.uk/sites/default/files/docs/2015/09/physical_security_decision_letter_-_september_2015_0.pdf

Annex 2: Overview of methodology to calculate revised allowances for Gas Transporters (GTs) Xoserve costs for 2017-18- 2020-21.

This annex describes how we have calculated the revised allowances for total expenditure (totex) of the eight gas distribution networks (GDNs) and the gas transmission network presented in Table 2 of Annex 1.

In summary, we have used forecast costs provided in Xoserve's 2014-15 Regulatory Reporting Pack (RRP)¹² for the years 2017-18 to 2020-21 and allocated these forecasts to networks using information provided by Xoserve and GTs in the Cost Assessment Template (CAT) submitted on 29 January 2016 us as per our information request of December 2015 for this review of GTs costs.

The revised allowances also include the efficiently incurred implementation costs of funding and governance review of Xoserve (for 2014/15 to 2016/17), which we said in our October 2013 decision letter we would be minded to include. These are the costs which have been incurred by the GTs to implement the revised arrangements by 1 April 2017.

Forecast costs for Xoserve

We have two main sources of information on Xoserve's costs: (1) the RRP, most recently submitted to Ofgem in July 2015; and (2) the CAT, submitted to Ofgem in January 2016. We have compared Xoserve's costs from these two sources. There are small differences between the two for the first four years of RIIO GD1 and T1 but in the last four years the differences are larger, with the costs being higher in CAT submission. We have not received an explanation of the differences. We also note that the total costs for Xoserve in the last four years of RIIO GD1 and T1 submitted in the July 2015 RRP are broadly the same as the previous years. Accordingly, we have decided to use forecast costs from the RRP for this minded to decision.

In the RRP, we request Xoserve to provide actual and forecast costs by year in several categories including: operational expenditure (opex) core service costs; opex user pays' costs; capital expenditure (capex); and IS expenditure. For the purposes of calculating revised allowances for the GTs we have excluded user pay costs (as these are not paid by the GTs) and also exclude capex (as this is included in IS expenditure) The resulting costs (opex core service costs plus IS expenditure) are shown in Table 3.

Table 3: Xoserve forecast expenditure (excluding user pays costs) 2017-18 to 2020-21 (£m, 2014-15 prices)

<i>(£m, 2014-15 prices)</i>	2017-18	2018-19	2019-20	2020-21	4-yr Total
Xoserve expenditure, excluding user pays' costs	62.0	54.9	50.9	44.5	212.2

Allocation of forecast costs of Xoserve to user groups from 1 April 2017

We have allocated the costs in Table 3 to the eight GDNs (in aggregate) and to the gas transmission network using information provided by Xoserve in the CAT and in response to our subsequent clarification requests.

For the purposes of allocating forecast costs, we calculated the proportion of opex core service costs and IS costs to be paid by the GDNs (in aggregate) and the gas transmission network. Costs in the CAT were split into: opex (by core services, core service projects and user pays), capex and IS costs (including opex and capex). We were provided with

¹² Xoserve are required to submit a reporting pack on their costs to us each year.

percentage allocations by user group for these categories except core service projects. We excluded user pay costs. The allocations we determined are shown in Table 4.

Table 4: gas distribution and gas transmission share of Xoserve forecast expenditure (excluding user pays costs) 2017-18 to 2020-21

	2017-18	2018-19	2019-20	2020-21
Gas distribution share	41%	35%	33%	29%
Gas transmission share	33%	40%	44%	43%

The resulting forecast expenditures allocated to gas distribution and gas transmission (from applying the allocations in Table 4 to the forecast expenditures in Table 3) are presented in Table 5 below.

Table 5: gas distribution and gas transmission share of Xoserve forecast expenditure (excluding user pays costs) 2017-18 to 2020-21

<i>(£m, 2014-15 prices)</i>	2017-18	2018-19	2019-20	2020-21
Gas distribution share	25.4	19.46	16.8	13.0
Gas transmission share	20.1	22.1	22.3	19.2

Allocation of cost to GDN

We have allocated the forecast costs of the GDNs to individual GDNs using the share of the GDNs' supply points in the total number of supply points, as presented in Table 6.

Table 6: GDNs' shares of all supply points (as at 31 March 2015)

GDN	% share of supply points
NGG East of England (EoE)	18.3%
NGG London (Lon)	10.4%
NGG North West (NW)	12.3%
NGG West Midlands (WM)	9.0%
Northern Gas Networks (NGN)	11.6%
SGN Scotland (SC)	8.3%
SGN SO (Southern)	18.7%
Wales and West Utilities (WWU)	11.4%

Implementation costs

In our October 2013 decision letter on page 12, we stated that: "We are minded to include ... provision for the recovery of additional costs that Xoserve incurs in implementing new arrangements. We would expect the efficiency of any costs incurred to be evidenced." Xoserve submitted details of these implementation costs (by network, except for National

Grid Gas Distribution, for which an aggregate value was presented) as part of the CAT and, in May 2016, updated costs were provided (not disaggregated by network) by POB through its Chair .

Table 7 shows the implementation costs we propose to allow. For 2014-15 these are based on the CAT, for the following two years they are based on the updated values from May 2016 (and allocated to networks based on the breakdown for 2014-15).

Table 7: Implementation costs by network (£000s, 2014-15 prices)

<i>(£000s, 2014-15 prices)</i>	2014/15	2015/16	2016/17
NGG EOE	25.3	197.1	150.4
NGG Lon	14.4	112.3	85.6
NGG NW	17.0	132.4	101.0
NGG WM	12.4	96.6	73.7
NGN	16.0	124.8	95.2
SGN SC	11.0	85.8	65.5
SGN SO	26.0	202.8	154.7
WWU	16.0	124.8	95.2
NGGT	17.0	132.6	101.2