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Dear Rupika,

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

Thank you for the opportunity to provide views on the proposed modifications to the funding arrangements for Xoserve from April 2017. This letter is written on behalf of both National Grid Gas Distribution and National Grid Gas Transmission and may be published by Ofgem.

We have actively supported the development of the Funding, Governance and Ownership (FGO) programme, successfully delivering the Phase 1 implementation in April 2016 which has seen the legacy agency model opened up to offer the ability for representatives from the Shipper community to engage directly with Xoserve at corporate and industry governance levels. We believe that significant progress has been made over the course of the last 18 months and that Gas Transporters (GTs) have demonstrated noteworthy leadership in the success of development activities to date.

We remain committed to the implementation of the fully cooperative Central Data Service Provider (CDSP) business model and look forward to taking this next step with our stakeholders and customers in the evolution of data service provision for the Gas industry.

The foundations of this new business model are based on:

- full and open engagement by Xoserve with all of it customers
- the development of improved and inclusive governance arrangements

- the introduction of simplified and equitable funding arrangements aimed at facilitating proportionate allocation of costs to all industry parties.

It is with this in mind that we would like to raise our concerns in relation to certain aspects of the proposed funding arrangements in your consultation document. Specifically, we would like to provide our views on:

- the minded-to position in relation to ex-ante allowances for the remainder of RIIO1
- the proposed reduction to the Gas Transporters' portion of allowances
- alignment with CMA remedies
- Transmission-specific considerations
- change uncertainty
- FGO implementation costs.

Ex-ante allowances versus cost Pass-through

We see the key benefit of the Pass-through mechanism lying with the industry as a whole as it removes barriers to achieving strategic consensus across all licenced parties.

We are concerned that Ofgem's minded-to proposal to retain an ex-ante allowance mechanism for the funding of Xoserve's costs will undermine Ofgem's primary intent of embedding co-operation between CDSP users to the benefit of consumers. The pace of change and uncertainty within the energy industry is, if anything, increasing due to European developments (including the impact of the recent referendum on European Union (EU) membership), Smart Metering, DCC, Faster Switching and the necessary implementation of the CMA market review remedies. In our opinion, these factors reinforce the need for the development and implementation of the FGO model as originally conceived.

We understand Ofgem's concerns that until the co-operative model is seen to be working effectively, removal of price controls may lead to increasing CDSP service costs to customers. However, retaining price controls fundamentally alters the balance of control and risk envisaged by the FGO model, exposing Gas Transporters to the financial and regulatory consequences of the decisions of others through loss of control of the CDSP. Currently the Xoserve Board and Business Planning and Budget management are all controlled by Gas Transporters, but FGO will completely change this framework. RIIO price controlled Gas Transporters will have a minority (three of eight) Directors on the new Board and a corresponding minority in the Business Planning and Budgeting process.

The Ofgem minded-to proposal will therefore expose Gas Transporters to both financial and delivery risk for regulatory or legislative obligations (such as those outlined previously) without the means to manage or control them. A price control in that sense may not deliver the outcome that Ofgem is intending as CDSP control will rest elsewhere. By contrast, Pass-through arrangements would encourage the co-operation and flexibility Ofgem originally envisaged to deliver the growing industry change agenda for gas customers.

In addition, Ofgem's original proposal to introduce pass-through funding has also been identified as a key facilitator for the accession of the iGTs to the provisions of the Uniform Network Code (UNC). The extension of ex-ante funding principles could be perceived as being a barrier to entry for these smaller organisations which are being asked to enter into a minority stakeholding in an arrangement which has no safety net for the impacts of underperformance caused by other parties.

Should Ofgem wish to confirm its minded-to proposal we suggest that it will need review the balance of risk and control to ensure Gas Transporters are able to deliver legislative and regulatory change on behalf of the industry and have a degree of financial protection in doing so. The cost allocation and charging methodology envisaged as part of FGO will not of itself provide financial safeguards as significant industry change is more likely to involve cost and risk sharing across sectors. There may therefore be a need for reserve powers for Gas Transporters either within the GT Licence or elsewhere to re-calibrate the balance of the FGO model.

Proposals to reduce GTs' ex-ante allowances

We are concerned that Ofgem has proposed significant and material reductions to the funding to be made available for change programmes over the remainder of the RIIO period. We believe that, given the continually evolving industry change horizon, the forecasts described in the January 2016 RFI and supplementary questions responses are appropriate and conservative in nature.

We note Ofgem believes it did not receive satisfactory answers to its questions following the RFI, although we are unaware of any correspondence beyond its supplementary questions as responded to by Xoserve. The rationale for utilising the 2014/15 RRP over the January 2016 submission is therefore perplexing particularly as the January 2016 submission is based on a later and more comprehensive view of anticipated change.

We would appreciate the opportunity to discuss Ofgem's rationale for treatment of forecast costs and provide any further information that would assist in clarifying cost movements between the 14/15 RRP and January submission.

National Grid Gas Transmission (NGGT) concerns

NGGT has an exemplary track record of successful system change delivery both on behalf of the GB Market and abroad in our interactions with Europe. We do not feel that Ofgem's consultation and its assessment of value added by GTs adequately takes these successes into account. The RIIO period so far has seen the successful delivery of a multi-phased programme of change which has met the requirements for the implementation of the EU's 3rd Energy package. It has also seen the successful development and deployment of the "Settlement Reform" element of Project Nexus which was ported onto the Gemini system in September 2015.

In the course of the delivery of industry change programmes to date, a certain amount of rephasing has been necessary. This is a normal planning function and is aimed at delivering efficient and effective value from the available technical and SME resources. The net result of this is that we are not anticipating a material downturn in the volume or cost of change proposed in the RFI response in January. Clearly, the proposed reduction to allowances will put the delivery of this change at risk.

We have been unable to clearly follow the cost allocation methodology applied by Ofgem in the reallocation of allowances. This has inhibited our ability to fully assess the impacts of the proposed reductions. We also feel that it is important to acknowledge that, as an industry, we have yet to agree the year 1 sharing factors and that the allocation methodology applied in the January RFI has always been considered as being subject to change as further analysis us carried out and greater clarity achieved. We are working with Xoserve and industry stakeholders to refine the analysis into cost drivers, cost constituencies and the changes needed to reflect amendments to the UK Link service model brought about by Project Nexus. We anticipate having a more reflective cost allocation methodology developed later this summer.

We are also keen to gain assurance that Ofgem has, in its proposals, accounted for a significant change to the way Gemini RTB costs are to be allocated. Historically split on the basis of NGGT 36:64 DNs, work on identifying future accountability and control of services has seen NGGT being asked by Shipper and DN stakeholders to assume 100% of costs (and allowances) associated with the operation of these essential commercial services. This will require applying an increase of £11.3m to our allowances and an equal decrease in allowances to be shared amongst the DNs. Given the operational nature of these costs, we view that there is limited opportunity for financial outperformance. Any shortfall in funding of such operational costs could result in a detrimental effect to our ability to continue to provide the quality of system access to which Gemini users have become accustomed. We would be grateful if Ofgem could provide the assurance that allowances for costs such as these will be protected and the revised 100% allowance allocation included in its methodology

Change Uncertainty

The industry is entering a phase of increased uncertainty brought about by market and regulatory driven change. As we approach the end of the decade, we believe that the increasing pace of Gas Retail Market evolution needed to deliver Smart Metering and Faster Switching is likely to result in even greater levels of consequential Balancing & Settlement change being needed onto the Gemini system.

The recent political shift away from continued membership of the European Union (EU) has added a significant new risk to the management of gas industry commercial systems and is almost certain to result in additional work being needed on Gemini and other UK Link systems. We believe that there is now a potential for widespread redaction of EU-originating Code requiring material unpicking of EU-driven system changes. No allowance has been made for these in the RFI submission. Given the nature of the services offered by Gemini and related functions being undertaken by NGGT in its dealings with EU Transmission System Operators (TSOs) on behalf of the British market, we are concerned that not only is additional funding likely to be necessary but also that NGGT will be disproportionately impacted by nature of its role as intermediary between domestic and international markets. We would welcome proposals from Ofgem as to how uncontrolled costs of this nature should be defrayed.

Ofgem have identified that the Competition and Markets Authority (CMA) have suggested that system service providers should be licenced and that the proposed funding mechanism for FGO supports a step towards this eventuality. It is our opinion that, in order to facilitate the seamless switch to an independently regulated service provision function, increased, not reduced, flexibility in the delivery of its services will be essential. Placing a financial cap on a subset of its customers inhibits the development of a model which would see Shippers and Transporters focus on the definition of “what” needs to change in the industry and a licenced system service provider be accountable for the efficient selection and implementation of the “how” element.

FGO Implementation costs

We note that Ofgem has included an allowance for incremental costs associated with implementation costs incurred by Networks of £2.3m. While this accords with the estimate that GTs are funding directly through programme manager and legal costs, it does not include those costs borne by Xoserve of c. £900k. These costs arise directly through implementation of FGO and include Data Services Contract development, corporate governance changes and executive recruitment fees for Shipper Directors. All such information was detailed in the January 2016 submission and therefore should be included as recoverable through the price control.

National Grid trusts that this response is helpful, but should Ofgem wish to discuss any of the points raised please contact Seán McGoldrick Sean.J.McGoldrick@nationalgrid.com in the first instance.

Yours sincerely,

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