Lansdowne Gate
65 New Road
Solihull
West Midlands
B91 3DL
0121 623 2305
www.xoserve.com

Rupika Madhura
Head of Gas Distribution Policy
RIIO Gas Networks
Ofgem
9 Millbank
London
SW1P 3GE

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Dear Rupika

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

Thank you for the opportunity to respond to Ofgem's consultation on its review of Agency costs in RIIO-GD1/T1. We are responding in our prevailing capacity as the Transporter Agency and as the company that, subject to the implementation of SSC A15A of the Gas Transporter ("GT") Licence and appointment by the GTs, is expected to fulfil the role of the Central Data Service Provider ("the CDSP").

We understand that Ofgem has set out two minded-to positions, firstly to continue to include Xoserve charges to GTs as an allowance in their base revenues for the remainder of RIIO-GD1/T1, and secondly to revise the total allowed expenditure for GTs for Xoserve charges for the RIIO GD1/T1 period from £600 million to £485 million (in 2014/15 price terms).

Continuation of GT Allowances

Ofgem's minded-to position on the GT funding of CDSP Services reverses a key conclusion that was set out in its letter of 31 October 2013[1], namely that if the CDSP charging methodology resulted in the GTs funding a proportion of CDSP costs, and the totality of CDSP costs had been subject to the co-operative governance arrangements, then Ofgem would modify the price control framework to allow the GTs to pass through such costs as part of their transportation charges. This conclusion has been foundational to the subsequent design and development by the FGO Programme of a co-operative governance model that would provide a proxy for a regulatory price control, and in which risk would be socialised amongst the community of users of CDSP Services and reflected in the contractual and corporate control arrangements.

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

The review of Xoserve funding and governance commissioned by Ofgem and undertaken by Cambridge Economics Policy Associates in 2012 concluded that a pass through arrangement was considered appropriate "to ensure that both GT and Shipper constituency groups have the same flexibility to fund the common central service provider, and to avoid the tensions that exist under the current funding arrangements organised around price controlled regulatory allowances"[2]. It follows that continuation of the current arrangements (albeit with a different share across constituencies) would only cause such tensions to be perpetuated. Moreover, a CDSP funding model in which, compared to the prevailing RIIO-GD1/T1 position, a greater share of costs are Shipper funded (outside of a price control arrangement) and a lesser share of costs are GT funded (subject to a price control arrangement) would in fact be likely to further exacerbate the situation. The current User Pays funding arrangements (introduced in 2008 following a thorough review by the industry Xoserve Services Workgroup) relate to only a small subset of transactional services, where users may flex their levels of demand and where costs are capable of varying with usage. By comparison, the proposed CDSP funding model would include joint GT and Shipper funding of some core activities where costs are largely capacity driven and where, if one party has a different view, potentially driven by their different funding model, there is increased potential for disagreement, which could put at risk efficient market operation.

The minded-to position is contrary to Ofgem's previously stated FGO review objectives and to the currently envisaged FGO target model on a number of fronts:

a) It would not contribute to the realisation of Ofgem's ambitions for Xoserve to operate with increased flexibility and responsiveness in the context of the uncertainties that are expected to prevail during the remainder of the RIIO-GD1/T1 period, as the GTs would continue to be incentivised to outperform against their allowances and they may therefore be perceived as seeking to suppress or defer changes in market arrangements that Shippers consider that they should not fund;

b) It would leave the GT and Shipper constituencies facing different risk profiles, and would undermine a fundamental principle of the co-operative model that risk and reward should be shared equitably amongst the community of users, and that the associated control model, for CDSP services and budgets should be consistent with that risk and reward exposure. The recovery by the GTs of their CDSP Charges through transportation charges to Shippers would be limited to the value of allowed revenues, whereas Shippers would face no such constraint in the recovery of their CDSP Charges through charges to their customers;

c) It would necessitate a review of the proposed changes to:

    i) The CDSP corporate governance model, potentially repositioning control with Board members commensurate with the different risk profiles of their nominating constituencies; and

[2] See https://www.ofgem.gov.uk/sites/default/files/docs/2013/04/cepa_xoserveapr13.pdf

ii) The CDSP contractual governance model, where, for example, decisions about service change should sit with parties bearing the funding risk; and

d) It may also necessitate a review of the proposed changes in the status of the Networks' ownership of Xoserve, as shareholdings with reserved rights may be seen as an additional route to exercise control over exposure to risk.

In light of these challenges, we would want to see Ofgem setting out its expectations for the target arrangements for CDSP funding, governance and ownership, and clarifying for stakeholders how it would see the retention of GT allowed revenues as being compatible with the full co-operative model that was targeted following CEPA's extensive research and Ofgem's subsequent consultation and decisions. In response, it is likely that the FGO Programme would need to carry out an impact assessment on the design of the FGO target model, to define any amendments that may be required to Programme deliverables, including the CDSP contractual framework and Xoserve's corporate governance arrangements, and to review the timescales for implementation. We assume that the assessment would extend to a regulatory review of the drafting of SSC A15A of the GT Licence.

We would also welcome clarification of Ofgem's thinking on the timing of any future review of CDSP funding, governance and ownership, as the consultation letter appears to anticipate both a co-operative model coming into effect in April 2017 and a further review of arrangements as part of the development of RIIO 2.

Revision of Allowed Expenditure Values

There are two weaknesses in Ofgem's approach to its proposed revision of allowed expenditure values. Firstly, it references cost forecasts included in Xoserve's 2014/15 Regulatory Reporting Pack ("the RRP") rather than those included in the January 2016 GT cost assessment template submission ("the CAT"), and secondly, it fails to recognise that the cost allocation model and charging methodology which will determine the proportions of CDSP funding provided by each user are the subject of ongoing industry discussions under the UNC FGO Workgroup.

The CAT presents a complete view of CDSP funding requirements and is supported by a business narrative that sets out our prevailing planning assumptions, explains the basis of the financial forecasts, and provides commentary on the management controls in place to ensure that expenditure is necessarily and efficiently incurred. The subsequent lack of substantive engagement on the CAT financial forecasts and business narrative and the selection of the RRP both point to the absence of a robust process for determining the values for proposed allowances.

The CAT differs from the RRP in two important respects:

a) The CAT forecasts are aligned with our 2016 Business Plan ("BP16"), approved by the Xoserve Board in January 2016, whereas the RRP forecasts reflect our 2015 Business Plan ("BP15"). Importantly, BP16 assumes a Project Nexus Implementation Date of 1 October 2016[3], whilst BP15 assumes 1 October 2015, which has the effect of rephasing investment expenditure and deferring the realisation of operating cost efficiencies to later into the RIIO-GD1/T1 period. Other changes in the business have also taken place between the two planning cycles, including:

i) The rephasing of Gemini investment expenditure for both market and technology driven change;

ii) The selection and timing of a move to new office accommodation;

iii) Changes in company pension contribution costs and the introduction of a new job evaluation framework; and

iv) Consistent with FGO Programme outputs, the inclusion of provision for remuneration of Directors and search fees in respect of future Director selection processes; and

b) Secondly, the CAT reports the total CDSP costs, whereas the specific requirements of the RRP template exclude IS expenditure on individual projects that are each less than £0.5m in value.

We estimate that the use of the RRP rather than the CAT to determine the value of proposed allowances understates the aggregate value of the CDSP funding requirement by £28.5m and of the proposed GT allowances by £23.2m (Transmission £13.4m; Distribution Networks £9.8m) for the four year period from April 2017 to March 2021. The annex to this letter sets out further information in support of this estimate, noting that the analysis remains subject to further review.

We have also reviewed the percentage shares of Transmission and Distribution Network funding of the CDSP and their application to forecast costs as set out in Tables 4 and 5 of the consultation letter, and have compared these to the percentage shares included in the CAT. We estimate that the approach adopted by Ofgem understates by £3.9m the proposed Distribution Networks' allowances for the four year period from April 2017 to March 2021.

When submitting the CAT in January 2016, we highlighted to Ofgem that the cost allocation model and charging methodology that was applied to cost forecasts in order to derive a view of the extent to which constituencies would be required to fund the CDSP was a draft position and was expected to evolve further. The timing of the UNC Mod 565 development process is such that a decision on GT funding policy and on allowed expenditure values is expected to run ahead of the conclusion of industry discussions on changes to the UNC, on the CDSP contractual framework and on the charging methodology. This creates a risk of misalignment between the basis of allowances and the basis of CDSP charges to the GTs. The proposed continuation of GT allowances would leave the GTs facing the risk that the final contractual position directs a greater share of costs to the GTs than included in the allowances, with a consequent exposure to under-recovery because of the cap on transportation charges to Shippers. Alternatively, a lesser share of costs being directed to GTs would result in charges being levied twice on Shippers, both through transportation charges from the GTs and CDSP service charges directly from Xoserve.

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[3] We note that this has been superseded following Ofgem's June 2016 consultation on Project Nexus delivery scenarios

Next Steps

As set out above, we would welcome clarification of the target model for CDSP funding and governance in the light of the proposed continuation of GT allowances. We would also encourage a closer dialogue on the CAT submission to aid Ofgem's understanding of the forecasts, and to understand how the risks of a contractual charging methodology outcome that is at variance with the basis of proposed allowances might be mitigated.

We are happy for Ofgem to share our response with the industry. If you would like to discuss further any particular aspect of our response, please contact Martin Baker, External Affairs Manager, on 0121 623 2692 or e-mail martin.baker@xoserve.com.

Yours sincerely

Nicholas J Salter
Director, Customer Engagement
nicholas.j.salter@xoserve.com

Annex – Estimated understatement of proposed GT allowances

All values are expressed in £m (2014/15 prices), and are in respect of the four year period from 1 April 2017 to 31 March 2021.

Change Driver	CDSP Forecast Costs	Transmission funded	Distribution Networks funded	Shipper and iGT funded
Rephasing of investment in rewrite of Gemini system	7.6	7.6	-	-
Rephasing of investment in Gemini system in response to changes in EU and GB gas market arrangements	2.8	2.8	-	-
Movement in UK Link delivery costs	0.7	0.1	0.4	0.2
Other changes in forecast investment profile	1.4	0.1	0.9	0.4
Smaller value projects outside scope of RRP reporting requirement	6.7	0.5	4.2	2.0
Employment costs following introduction of new role evaluation model, changes in pension scheme funding and restructuring following Project Nexus go live	4.7	1.2	2.2	1.3
Director fees and search costs (consistent with FGO Programme proposals)	1.8	0.4	0.8	0.6
Other movements in cost base, including impact of move to new office accommodation	2.8	0.7	1.3	0.8
TOTAL	**28.5**	**13.4**	**9.8**	**5.3**