

## **ENERGY MARKET INVESTIGATION**

### **Summary of hearing with Xoserve on 9 December 2014**

#### **Background**

1. Xoserve was a joint venture company which was owned by all of the Gas Transporters (GTs) in GB (National Grid, Scotland Gas Networks, Southern Gas Networks, Wales & West Utilities, and Northern Gas Networks). National Grid owned the majority shareholding in Xoserve. Xoserve had been founded ten years ago when National Grid had decided to sell a number of their gas networks. To enable the sale of the networks, there was a need for a central body (a 'Transporter Agency') to carry out a number of functions, some of which were previously performed by National Grid, so Xoserve had been set up to act as a common services provider to all the networks. This arrangement was more efficient than one where each GT performed these functions individually for each of its network(s). This provision for a Transporter Agency was set out in the GTs' Transporter Licences and in the Uniform Network Code (UNC).
2. Xoserve was not directly licenced or regulated by Ofgem, but it delivered services subject to a regulated framework. Xoserve's funding was principally through GTs whose price control submissions to Ofgem included an element for common service costs. Xoserve was incentivised to be efficient by its customers who wanted to ensure services were delivered efficiently.
3. On behalf of the GTs, Xoserve provided services to gas shippers. When Xoserve was set up, it was recognised that common service provision to gas shippers on behalf of the GTs would be the most efficient arrangement. Xoserve, established as the Transporter Agency, was seen as the single central service provider for the gas market. This arrangement has proved to be efficient as it has enabled gas shippers to come to Xoserve about any issues they had with GT Agent services. Xoserve ran a number of IT systems which underpinned the operation of the market and avoided the need for duplication of systems. In addition to delivery of GT Agent services Xoserve occasionally provided one-off services for its customers, and it earned a margin on these.
4. In the gas market, it was the commercial responsibility under the UNC for each gas shipper to balance their inputs with outputs from the network on a

daily basis. In many cases gas shippers were the same companies, or part of the same group of companies, as gas suppliers, but there were also gas shippers who operated independently of suppliers and traded to obtain the gas they then bought and sold on the network. Xoserve did not have a single comparator organisation in the electricity market as there were a number of entities in that market which carried out different aspects of the work that Xoserve performed in the gas market.

5. There were eight gas distribution networks (GDNs) and 13 electricity distribution network operators (DNOs) which performed roughly the same role in their respective markets, but they did not match up geographically. There were also some independent gas transporters and electricity distributors.
6. Xoserve had an annual 'run the business' budget of around £30 million, plus a variable project workload. It used offshore providers to develop and support its IT applications and infrastructure. Xoserve directly employed approximately 360 people at its offices in Solihull and around a further 15 to 20 contractors.
7. The Xoserve Structuring and Shareholders Agreement ('the Shareholders' Agreement') defined the working relationships between the shareholders of the company including aspects of the operation of its Board. Under the agreement, each shareholder, subject to certain provisos, was allowed to appoint, remove and replace one director for each network area for which it was the network operator/shareholder. The Chairman of the Board was independent and was not a director. The Shareholders' Agreement also included measures to protect minority shareholders as well as requiring special majorities for certain decisions. While not a requirement of the Shareholders' Agreement, Xoserve's Board members were all employees of the various network businesses and collectively were experienced in the commercial, financial, legal and technical aspects of the industry and matters relevant to directing the company.
8. Xoserve had a contract with all of the GTs, known as the Agency Services Agreement ('the ASA'), which defined the terms and conditions under which it provided the services by which the GTs' obligations were discharged. The ASA referred as necessary to relevant documentation in various industry codes and licences and was published on Xoserve's website, so its terms were fully visible.
9. The ASA also set out charging methodologies and pricing statements. Budgets for Xoserve's various activities were set annually, and the level of charges for each GT determined through a pricing statement and charging methodology. The UNC governed the relationship between shippers and transporters, and any significant changes in the UNC were approved by

Ofgem. Changes to the UNC were initially considered by the network code modification panel, which was made up of parties to the UNC and a chairman, who just recently has been required to be an independent person. Xoserve was not a party to the UNC, but it did attend code panel meetings and, where relevant, advised on implications of potential changes to the code. It was important for Xoserve to be able to advise the UNC Panel as it was able to use its experience and technical expertise to advise on the feasibility of proposed changes and the time and money required to implement them. Xoserve had no role in the administration of the UNC. This was done by the Joint Office of Gas Transporters.

10. The GTs, National Grid Transmission and the gas distribution network businesses have an allowance within their price control settlement for delivery of services through Xoserve. Xoserve provided a small number of GT obligations, such as where shippers had to provide meter readings to GTs and access to data, which were funded outside of the price control which were referred to as 'user pays' and were paid for on a usage basis rather than being part of a transportation charge based on shipper portfolio. Xoserve would also sometimes charge on this basis for any bespoke work it did in relation to modification proposals. Whether it did so or not would depend on who the beneficiary was. If the modification was intended to deliver shipper benefits, then it would generally be charged on a 'user pays' basis. 'User pays' charging was the exception rather than the rule, and most modification work would be charged to networks. There were UNC procedures to determine whether work fell into the GTs' allowances or user pays categories. Xoserve's primary source of revenue from the provision of common services (around 90%) was from transporters under the allowance formula with the remaining 10% coming from 'user pays'.
11. Xoserve acted as the interface between GTs and shippers. There were around 22 million gas supply points (ie meters) which included domestic, business and industrial premises. There were around 40 portfolio shippers (which included the Six Large Energy Firms) and around 120 trader-only shipper businesses which were active in the market to varying degrees. There were also some traders which were registered but were not currently active. The shippers operated in the space between the gas suppliers, the producers and the GTs. The shippers took the risk of balancing inputs and outputs on the transportation network. It was essential that inputs and outputs on the network balanced over a 24-hour period. National Grid Transmission had the ultimate responsibility to ensure that the network did physically balance and would take residual action to make sure it did, but the shippers were commercially incentivised to encourage them to do as much of the work of balancing the network as possible.

12. The GB gas network consisted of a National Transmission System, which was connected to external gas resources and was analogous to a motorway network, and a number of local distribution zones, which were connected to the National Transmission System and delivered gas to specific areas. Onshore gas did not normally go through the National Transmission System. It went straight into local distribution zones.
13. There were relatively few points, 'inputs', where gas could enter the network, and the amount entering at each point was measured. However, there were a huge number of 'output' points (around 22 million), and Xoserve operated the database which held GT information about each of these including what its expected gas consumption was, its usage profile, information about the type of meter at each point, its meter-reading history and its registered shipper. It was up to shippers to notify Xoserve when a new output point was set up and when a point was transferred from one shipper to another. When a customer switched their gas supplier, the supplier would need to tell the shipper delivering to that point, and the shipper would need to tell Xoserve as the transporter's agent. In many cases, shippers and suppliers were actually the same company, or part of the same group of companies. Xoserve coordinated and recorded switches between shippers and also kept track of changes of suppliers.
14. The fact that Xoserve held information about suppliers would be important for facilitating the introduction of smart meters, since this would allow the Data Communications Company, which would gather information from smart meters, to accurately charge suppliers based on their portfolios.
15. Xoserve provided regular information to Ofgem on behalf of GTs to assist regulatory monitoring of the retail market. The information provided to Ofgem focused on suppliers rather than shippers, but Xoserve could produce information from either perspective.
16. Xoserve supported shippers through their accession to the network code and ensured that they complied with various requirements, including access to the Gemini IT system which allowed shippers to actively engage in the market.
17. Shippers routinely entered and left the market at the rate of around one per month, but there were many which had been in the market for a number of years.
18. As an ASA service for the GTs, Xoserve provided a telephone meter-point enquiry service which customers could ring to find out what their meter-point numbers were when they switched suppliers. Xoserve noted that it now administered around 3 million switches per year. It estimated that around 35%

of customers had never switched their gas supplier. It took around 15 days for a switch to be completed. This included time to allow for the incumbent supplier to object to the switch, time for ensuring that arrangements could be put in place for a transfer reading, customers' cooling-off periods, and time to transfer data about supply points. Incumbent suppliers objected to around 8% of switches. Xoserve regularly provided information on behalf of GTs about switching objections and a range of other switching data to Ofgem.

19. The introduction of smart meters would enable shippers to provide Xoserve with much more regular and accurate information about energy use, particularly for smaller meter supply points. Xoserve currently used a combination of occasional meter readings and profiles to calculate smaller supply point usage, but smart meters would allow it to use higher frequency real data to make these calculations. Ofgem was currently consulting on reducing switching times and was looking particularly at whether objection periods were still appropriate and whether customers should be able to waive their right to a cooling-off period. The cooling-off period was subject to the EU Directive on Consumer Rights, and any changes to the current rules would need to align with it. If these two issues could be addressed, then using current systems it would be possible for Xoserve to support gas switching times of three working days and, with IT development, potentially less.
20. Around 2,000 of the 22 million output points which Xoserve handled were daily-metered. These points account for a significant amount of gas used. Gas supplied to the non-daily metered output points was allocated amongst shippers based on their portfolio. The total amount of gas which had been allocated by profile was compared with the amount which each shipper had put into the system, and this was used to determine whether a shipper should receive money (if inputs were greater than outputs) or would have to pay (if outputs were greater than inputs). There were further subsequent reconciliation stages in this process which would determine more accurately how much a shipper should receive or would have to contribute.
21. The reconciliation process for non-daily metered customers would be changing over the next 12 months. Currently, usage profiles for non-daily metered customers were calculated on their historical usage (based on meter readings taken at different times in the year to reflect seasonal changes in energy use). In future, it would be possible to update usage profiles as often as monthly based on meter readings, so these profiles should much better reflect recent usage.
22. These changes would help to address concerns expressed by some suppliers that under the current system if a supplier was effective at helping its customers reduce their gas demand, the supplier would not benefit from a

timely reduction in energy allocation. There had already been one modification to the code to address this issue in respect of pre-payment meters.

23. The forthcoming changes to the reconciliation process would also enable reconciliation for all 20 million meters at meter-point level. At present, reconciliation was based on meter point reconciliation at around 500,000 meters and the remainder were reconciled 'by difference', proportionately allocated to shippers based on profiles. It was understood that this would make the reconciliation process in gas more similar to that in electricity.
24. Shippers bore the risk associated with reconciliation processes as defined in the UNC. The extent of each shipper's exposure to this risk was a matter for its relationship with its supplier(s). Xoserve had no visibility of these arrangements.
25. Smart metering would mean that meter readings could be taken more often and more frequent information could be used in the reconciliation process.
26. Xoserve also invoiced on behalf of GTs and facilitated settlement between users of the network. The invoicing for both these functions used the same base data. Shippers were able to buy capacity at entry points. This was done primarily through auctions and then via a secondary-trading system where shippers could buy additional capacity.
27. Shippers could trade 'on-the-day' in order to try to balance their position. They were incentivised to balance their position as they would be exposed to imbalance charges if they were out of balance. If National Grid was concerned that the system as a whole would be out of balance it could also act to balance it. The rules on balancing were contained in the UNC, and these did not allow for retrospective trades to amend balance positions after the day.
28. Shippers were required to post collateral to cover their shipping activities. The collateral requirements were set out in the Energy Balancing Credit Rules. Xoserve monitored shippers' exposures on a daily basis and managed this process as an ASA service. The vast majority of collateral was posted in the form of letters of credit rather than cash. It was assumed that shippers would also require suppliers to provide collateral to them as well, but Xoserve did not have any visibility of this.
29. Xoserve supported for National Grid an IT platform known as Gemini which allowed market participants to communicate trades, book capacity, and participate in auctions. Gemini also captured inputs and outputs and performed the commercial balancing calculations.

30. Xoserve's funding arrangements had been under review since 2010. During the consultations on the 2013 to 2021 settlement for the gas networks, Ofgem had asked whether a fixed allowed GT revenue system was really appropriate for a service business such as Xoserve which would need to be responsive to market reforms, which could be difficult to predict, and whether a more flexible system should be put in place. In late 2013, Ofgem published the results of its consultation which was that Xoserve's funding model should become a co-operative one, which would allow GTs to pass through Xoserve costs to shippers and give gas shippers more involvement in and responsibility for the funding and governance of Xoserve's central services. Currently, it was the GTs which were principally responsible for funding Xoserve. While continuing its role as Transporter Agency, Xoserve would be 're-branded' as a central data services provider for the gas industry, although the conclusions of Ofgem's review did not of itself change the scope and nature of central services.
31. Under the prevailing funding arrangements, Xoserve's annual business planning and budgeting process did not require consultation with the shipper community. Under the new co-operative model, the funding of Xoserve's central services was proposed to be determined by a rolling annual budget which would be approved by the Xoserve Board after consultation with its stakeholders in order to ensure that it takes account of changes in their priorities, costs and service requirements. This would allow Xoserve's customers to better understand which part of its budget they were funding. There would also be an indication in the business plan as to how the budget would be expected to change over the next five years.
32. Xoserve's governance was proposed to be changed in response to the new funding arrangements. Ofgem has published documentation stating that among other changes the membership of its Board would be expanded to include gas shippers and other non-transporter stakeholders.
33. Xoserve was concerned to ensure that under its new governance arrangements there would still be a clear differentiation between its Board's role, ie to run the company and ensure that services were provided and changes were delivered efficiently, and decisions made via industry governance via the UNC about how the market should change. Xoserve's Board was not the right place to have discussions about how the network code worked; the place for those discussions was the UNC Panel. The changes to Xoserve's governance were targeted to be implemented by April 2016. It was important to note that although the make-up of Xoserve's Board could be changing, its ownership would not. A wider Board membership could make it clearer to all Xoserve's customers that it worked to implement the UNC and not on behalf of any one group of its customers. It

was important that Xoserve's Board consisted of persons who had the right skills.

34. The UNC Panel consisted of an independent Chairman, five transporter representatives, five shipper representatives and a consumer representative. The Panel could not unilaterally either implement or reject a proposed modification, but it could make decisions on whether to allocate a modification to a working group, and the Panel would then prepare a report based on the working group's analysis which would be submitted to Ofgem along with a recommendation as to whether the modification should go ahead, but it was Ofgem which had the final say as to whether the modification was implemented or not.
35. The UNC Panel determined how long its working groups had to deliver their reports, but there was no overall deadline for the modification process. How long it would take for a proposed modification to be decided on depended on its complexity. It was believed that Ofgem could only consider modifications that had gone through the UNC Panel process, although it was suggested that for detailed definitive advice on these arrangements, the Joint Office of Gas Transporters should be consulted.
36. Ofgem's Significant Code Reviews (SCR) were used when a modification affected a number of different codes, or had a potentially major impact on a single code. If an SCR concluded that changes were required to a number of codes, then the separate modification process for each code would be initiated. The SCR could therefore be a lengthy process.
37. If the proposer of a modification was able to make the case to Ofgem that the modification would have significant commercial implications, then Ofgem could decide that the modification would be classed as urgent, and it would be dealt with more speedily. However, there were examples of urgent modifications which had taken a long time to be processed.
38. On behalf of National Grid, Xoserve administered the energy balancing credit rules. Credit arrangements for transportation were handled by the GTs. The energy balancing credit rules were set out in a public document which was an ancillary document to the UNC. The rules set out the criteria that determine the levels of collateral required for parties to participate in the balancing system. The regime was fully collateralised and all parties were required to underwrite their exposures with either a letter of credit, deposit deed or cash. A minimum of £10,000 collateral was required. The collateral requirement for each participant was based on expected throughput, but it could change over time based on a party's performance and its level of exposure. [§]. Letters of credit had to be provided by financial institutions with a minimum rating of 'A'.



39. There had been around ten new participants in the market in each of the last five years with a similar number deciding to leave the market each year. Xoserve was not aware of how many parties had considered entry and then decided not to go ahead because of the collateral requirements.
40. Xoserve understood that the current collateral requirements in the electricity and gas markets were being reviewed by DECC. It was necessary to have a level of collateral that ensured parties could cover their commitments, but it should not be set so high as to inappropriately deter entry. A party's size was important, but its track record in balancing was also important. A large party that maintained an extremely imbalanced position would need to provide more cover than a large party whose position was closely balanced. Xoserve had been involved in the consultation on this issue, which was being led by DECC, and which might result in changes to the UNC.
41. There was a reconciliation process for any energy which remained unallocated to suppliers. This unallocated energy would be divided up amongst suppliers in proportion to their market shares at the end of the allocation process.