



Office of Gas and Electricity Markets

**Update assessment of GDN indirect opex based upon
2006/07 actual performance**

Confidential

24 September 2007

Contents

1	Executive summary	5
2	Introduction and scope of work	15
3	Total support service costs	23
4	Information systems	34
5	Finance, audit and regulation	43
6	Insurance	56
7	Property management	63
8	Corporate centre and communication	78
9	Human resources	86
10	Legal	96
11	Procurement and logistics	103
Appendix 1 :	Total support service costs normalisation adjustments	111
Appendix 2 :	IS support costs breakdown and normalisation adjustments	116
Appendix 3 :	Forecast IS support costs and normalisation adjustments	124
Appendix 4 :	FAR costs breakdown and normalisation adjustments	127
Appendix 5 :	Insurance breakdown and normalisation adjustments	134
Appendix 6 :	Property management breakdown and normalisation adjustments	138
Appendix 7 :	Benchmarking of 2006/07 rental costs	144

Appendix 8 :	C&C costs breakdown and normalisation adjustments	149
Appendix 9 :	HR costs breakdown and normalisation adjustments	155
Appendix 10 :	Legal breakdown and normalisation adjustments	161
Appendix 11 :	L&P costs breakdown and normalisation adjustments	168

Glossary

The following abbreviations are used in this report:

ANAO	The Australian National Audit Office
ASA	Asset services agreement
BPQ	Business planning questionnaire
C&C	Corporate centre and communication
EE	East of England GDN, owned by NGGD
F&A	Finance and audit
FAR	Finance, audit and regulation
FTE	Full time equivalent
GBP	Global Best Practices
GDNs	Gas distribution networks
GDPCR	Gas distribution price control review 2008-2013
GT	Gas transporters
HI & LS	Hildebrandt International and Laurence Simons European Law Department Benchmarking Study 2004-2005
HR	Human resources
IS	Information services
June 2007 update	The GDNs' BPQ responses, submitted in June 2007 and July 2007
LDZ	Local distribution zone
Lon	London GDN, owned by NGGD
NCC	National Computing Centre's Benchmark of IT spending, 2005
NE	North of England GDN, owned by NGN
NG	National Grid
NGGD	National Grid Gas Distribution
NGN	Northern Gas Networks

NW	North West GDN, owned by NGGD
Ofgem	Office of Gas and Electricity Markets, GB regulator for gas and electricity markets
ORR	Office for Rail Regulation
PLC	Practical Law Company Best Practice Survey 2006
R&D	Research and development
SC	Scotland GDN, owned by SGN
SE	South of England GDN, owned by SGN
SG&A	Sales, general and administration
SGN or Scotia	Scotia Gas Networks
The regulator	Ofgem
TPCR	Transmission price control review 2007-2012
UU	United Utilities
UUOL	United Utilities Operations Limited
WCCFO	Working Council for Chief Financial Officers 2003
WM	West Midlands GDN, owned by NGGD
WW	Wales and West GDN, owned by WWU
WWU	Wales and West Utilities

1 Executive summary

Introduction

- 1.1 The Office for Gas and Electricity Markets (“Ofgem”) has retained LECG to benchmark business support operating costs with respect to the Gas Distribution Price Control Review (“GDPCR”) 2008-2013. Ofgem is currently performing the GDPCR, which will seek to set new price controls from 1 April 2008 to 31 March 2013.
- 1.2 The benchmarking of the GDNs’ support service costs has been performed in two phases. In Phase 1, we were asked to assess the efficiency of each GDN’s support functions based on a forecast of costs in 2006/07. Our work focused on the following support functions: information systems; finance, audit and regulation; insurance; property management; corporate centre and communication; human resources; legal; and procurement and logistics. We set out our initial assessment in our reports to Ofgem dated April 2007¹ (“Phase 1 Reports”). Our Phase 1 Reports, and Ofgem’s initial proposals for GDPCR 2008-2013, were published on 3 July 2007.
- 1.3 In Phase 2, we have been asked to update our Phase 1 analysis based on the GDNs’ actual results for 2006/07. This report sets out our Phase 2 findings. This report should be read in conjunction with our Phase 1 Reports.

Scope and methodology

- 1.4 Our Phase 2 work consisted of two main tasks. First, we reviewed actual/outturn data in 2006/07 to determine the consistency of the data across the GDNs and with the data underpinning our Phase 1 Reports. Second, we updated our Phase 1 benchmarking analysis to take account of actual/outturn data in 2006/07.
- 1.5 The methodology we have used in Phase 2 is consistent with the approach adopted during Phase 1, which is detailed in Section 4 of our Phase 1 Reports. At the request of Ofgem, we have not changed the methodology adopted during Phase 1.
- 1.6 To ascertain data consistency across the GDNs we adjusted the cost figures provided by the GDNs. Most of the normalisation adjustments made during

¹ LECG. “Ofgem, Benchmarking the GDNs’ business support services”. 16 April, 2007.

Phase 2 were consistent with the adjustments made in Phase 1. However, fewer normalisation adjustments were required in Phase 2, because the GDNs incorporated some of our adjustments into the data they provided.

- 1.7 Some of our analysis required the use of forecast data. Ofgem did not explicitly request cost forecasts to be updated, but the GDNs were allowed to provide updated information if there were material differences between their revised forecasts and their initial submission. Except for revised forecasts relating to IS expenditure, which were provided by SGN and WWU, no revised forecasts for indirect opex were submitted. We have used the updated forecast information where such information has been provided.
- 1.8 We have relied on the information that the GDNs provided in their BPQ submissions (submitted in October 2006 and June 2007) and the GDNs' responses to our supplementary questions. The GDNs generally provided us with good information. However, in a number of key areas, the GDNs were unable to provide detailed bottom up explanations of the differences between the October 2006 BPQ submission and the June 2007 update. This prevented us from performing a more detailed review of the GDNs' support service costs. With the exception of NGGD, there were some significant delays in the GDNs' responses to our supplementary questions. On various occasions, the GDNs made subsequent changes to their BPQ submissions. These factors influenced the timing of our work.
- 1.9 For SGN and WWU, we identified significant differences between the data submitted in October 2006 and June 2007 in a number of cost categories. SGN and WWU explained that some of these differences were due to errors in data collection and changes in cost allocation. We have not been asked to review changes in the GDN's application of the cost allocation methodologies. Ofgem may wish to consider the appropriateness of these changes separately.

Conclusions

- 1.10 We have applied our efficiency savings to the GDNs' support services costs, after adjustments to achieve cost comparability across the GDNs. Our normalisation adjustments are provided in Appendix 2 to 11. The key adjustments we have made relate to (i) the reclassification of certain activity costs to other support categories to ensure consistency across GDNs, and (ii) adjusting costs for one-

off or exceptional circumstances to ensure that costs are stated at steady state levels.

- 1.11 The table below compares support services costs, after normalisation adjustments, in Phase 1 and Phase 2.

Table 1: Comparison of normalised support services costs

2005/06 prices, £m	NGGD		NGN		SGN		WWU	
	Phase 1	Phase 2	Phase 1	Phase 2	Phase 1	Phase 2	Phase 1	Phase 2
IS	30.98	28.60	7.00	7.02	10.41	12.24	7.92	7.29
FAR	18.22	11.23	3.42	2.57	4.74	3.24	3.40	3.80
Insurance	15.70	15.49	2.90	2.74	5.00	5.31	2.83	2.80
Property	23.79	20.66	2.70	2.18	3.55	6.01	4.11	4.30
C&C	7.94	8.77	1.76	1.44	1.70	1.17	2.16	1.79
HR	15.39	13.11	1.18	1.04	3.27	1.98	1.05	1.10
Legal	1.96	1.76	0.85	0.69	0.99	0.96	0.67	0.60
L&P	7.74	5.08	1.54	0.85	2.12	1.42	1.76	1.73
Total	121.72	104.69	21.34	18.52	31.78	32.32	23.90	23.44

Source: All GDNs. June 2007 updates. LECG analysis. Note: All costs stated after LECG adjustments and include non-benchmarked costs. For some of the cost categories, such as C&C costs and HR costs, we were unable to benchmark total costs, due to a lack of suitable benchmarks.

- 1.12 The decrease in NGGD's support services costs is primarily driven by the removal of non-formula activities costs from each of the support service costs. These costs were incorrectly included in support service costs in Phase 1. The inclusion of costs not related to the gas distribution business partly explains why NGGD was the least efficient GDN in our earlier work. The movements in NGN's support services costs are primarily due to higher than expected level of savings achieved in 2006/07. While SGN's total support services costs have not changed significantly, there are some offsetting movements at the individual support services costs level. This is due to the correction of previous cost coding errors made by SGN and a change to their business structure. WWU's support services costs did not change significantly between phases.

1.13 Our efficiency conclusions in relation to these adjusted costs, under the low savings scenario, are set out in the tables below.

Table 2: Potential efficiency savings for support service costs 2006/07 – low savings scenario

2005/06 prices, £m	NGGD		NGN		SGN		WWU	
	Efficiency savings	Costs after efficiency	Efficiency savings	Costs after efficiency	Efficiency savings	Costs after efficiency	Efficiency savings	Costs after efficiency
IS	-	28.60	0.36	6.65	-	12.24	0.94	6.36
FAR	0.62	10.61	0.11	2.46	0.04	3.20	0.77	3.04
Insurance	4.87	10.62	0.05	2.68	-	5.31	-	2.80
Property	1.47	19.19	-	2.18	0.52	5.49	1.35	2.95
C&C	2.71	6.06	-	1.44	-	1.17	0.13	1.66
HR	0.81	12.30	-	1.04	0.37	1.61	0.08	1.03
Legal	-	1.76	0.18	0.51	-	0.96	0.06	0.54
L&P	0.89	4.19	-	0.85	-	1.42	0.59	1.14
Total	11.37	93.32	0.71	17.81	0.93	31.39	3.92	19.52

Source: LECG analysis. Note: All costs stated after LECG adjustments and include non-benchmarked costs. For some of the cost categories, such as C&C costs and HR costs, we were unable to benchmark total costs, due to a lack of suitable benchmarks. The table above includes non-benchmarked costs within “costs after efficiency”.

1.14 Our conclusions in relation to support service costs, under the high savings scenario, are set out in the tables below.

Table 3: Potential efficiency savings for support service costs 2006/07 – high savings scenario

2005/06 prices, £m	NGGD		NGN		SGN		WWU	
	Efficiency savings	Costs after efficiency	Efficiency savings	Costs after efficiency	Efficiency savings	Costs after efficiency	Efficiency savings	Costs after efficiency
IS	1.59	27.01	1.09	5.93	-	12.24	1.63	5.67
FAR	3.60	7.63	0.72	1.85	0.08	3.16	1.59	2.22
Insurance	5.31	10.18	0.16	2.57	-	5.31	0.06	2.74
Property management	2.19	18.47	-	2.18	1.78	4.23	2.31	1.99
C&C	4.08	4.69	0.23	1.21	-	1.17	0.51	1.28
HR	1.91	11.20	0.10	0.94	0.98	1.00	0.38	0.73
Legal	0.00	1.76	0.24	0.44	-	0.96	0.13	0.47
L&P	1.99	3.08	0.05	0.80	-	1.42	0.89	0.84
Total	20.68	84.02	2.60	15.91	2.84	29.48	7.50	15.94

Source: LECG analysis. Note: All costs stated after LECG adjustments and include non-benchmarked costs. For some of the cost categories, such as C&C costs and HR costs, we were unable to benchmark total costs, due to a lack of suitable benchmarks. The table above includes non-benchmarked costs within "costs after efficiency".

- 1.15 Our analysis shows that, as a percentage of support services costs, efficiency savings are highest for WWU, followed by NGGD, NGN and SGN. This efficiency order was the same in Phase 1.
- 1.16 Our work is limited to forming a view on the efficiency of separate support functions within each GDN relative to a range of benchmarks. We have not been asked to determine efficiency on a wider basis. We understand that Ofgem will consider the findings of all their consultants, the GDNs' responses in consultations and bilateral meetings, and its industry knowledge to determine total allowable costs. Therefore, the findings presented in this report do not necessarily represent Ofgem's final determination of the allowable support service costs over the price control period. However, the table below shows the efficiency savings as a percentage of the total adjusted support services costs if Ofgem adopted the savings presented above.

Table 4: Efficiency savings as a percentage of the total adjusted support services costs

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Low savings	10.9%	3.8%	2.9%	16.7%
High savings	19.8%	14.1%	8.8%	32.0%

Source: LECG analysis.

1.17 For each of the support service cost categories, we compare the level of efficiency savings in Phase 1 and Phase 2, as shown in the table below, under the low savings scenario.

Table 5: Comparison of efficiency savings – low savings scenario

2005/06 prices, £m	NGGD		NGN		SGN		WWU	
	Phase 1	Phase 2	Phase 1	Phase 2	Phase 1	Phase 2	Phase 1	Phase 2
IS	-	-	0.52	0.36	-	-	1.31	0.94
FAR	1.21	0.62	0.18	0.11	-	0.04	0.01	0.77
Insurance	4.40	4.87	0.07	0.05	-	-	-	-
Property management	2.88	1.47	0.06	-	-	0.52	1.22	1.35
C&C	1.06	2.71	-	-	-	-	0.15	0.13
HR	1.77	0.81	0.02	-	1.55	0.37	-	0.08
Legal	-	-	0.28	0.18	-	-	0.08	0.06
L&P	1.79	0.89	-	-	-	-	0.10	0.59
Total	13.11	11.37	1.10	0.71	1.55	0.93	2.87	3.92

Source: LECG analysis.

1.18 The table below summarises the efficiency savings identified in Phase 1 and Phase 2, under the high savings scenario.

Table 6: Comparison of efficiency savings – high savings scenario

2005/06 prices, £m	NGGD		NGN		SGN		WWU	
	Phase 1	Phase 2	Phase 1	Phase 2	Phase 1	Phase 2	Phase 1	Phase 2
IS	1.96	1.59	1.49	1.09	-	-	2.23	1.63
FAR	5.84	3.60	1.38	0.72	0.72	0.08	1.23	1.59
Insurance	5.17	5.31	0.26	0.16	-	-	0.12	0.06
Property management	3.17	2.19	0.33	-	0.36	1.78	1.89	2.31
C&C	2.44	4.08	0.24	0.23	-	-	0.55	0.51
HR	2.96	1.91	0.32	0.10	2.20	0.98	0.28	0.38
Legal	0.04	0.00	0.37	0.24	-	-	0.18	0.13
L&P	2.63	1.99	0.13	0.05	-	-	0.33	0.89
Total	24.18	20.68	4.50	2.60	3.28	2.84	6.81	7.50

Source: LECG analysis.

1.19 In general, changes in efficiency savings are driven by movements in individual support services costs, which are lower in the June 2007 update. However, the change in the level of efficiency savings does not necessary equal in the total change in support services costs. In fact, for WWU, efficiency savings increased despite a decrease in total support costs. The relationship between the movement in total support costs and the movement in efficiency savings is influenced by a number of factors including:

- for some support services cost categories, such as IS support costs and L&P costs, efficiency savings are calculated by reference to the performance of the most efficient GDN(s). If an efficient GDN lowered say its IS costs, this would lead to a more challenging benchmark, which might not be offset by a reduction of IS costs across the other GDNs; and
- for some support services cost categories, such as FAR and HR, we are only able to benchmark a subset of total costs. A change in non-benchmark costs does not influence our efficiency proposals. So non-

benchmarked costs could fall, but our efficiency proposals would remain unchanged, assuming all other things are held constant.

- 1.20 Key movements in the level of efficiency savings are summarised below.
- 1.21 Total efficiency savings for NGGD have decreased by approximately £1.7m under the low savings scenarios, and £3.5m under the high savings scenario. This is driven by, *inter alia*, the following factors:
- a decrease in FAR costs savings, under both the low and the high savings scenarios, driven by a decrease in reported FAR costs in 2006/07;
 - a decrease in property management costs savings, under both the low and the high savings scenarios. WWU reported higher floor space in its June 2007 submission which lowered the efficiency benchmark;
 - an increase in reported C&C costs savings, under both the low savings and the high savings scenarios, driven by an increase in NGGD's reported C&C costs;
 - a decrease in HR costs savings, under both the low savings and the high savings scenarios driven by a decrease in NGGD's reported HR costs; and
 - a decrease in L&P costs savings, under both the low savings and the high savings scenarios, driven by a decrease in NGGD's reported L&P costs.
- 1.22 Total efficiency savings for NGN remained largely constant under the low savings scenario. Under the high savings scenario, efficiency savings decreased by approximately £1.9m. This is primarily driven by lower FAR savings given a decrease in NGN's actual reported FAR costs. Efficiency savings relating to property management costs also decreased driven by changes to the efficiency benchmarks (e.g. SGN reported higher facilities management costs and WWU reported higher floor space and this led to less challenging benchmarks based on facility management costs and floor space benchmarks).
- 1.23 Total efficiency savings for SGN decreased by £0.6m under the low savings scenario, and £0.4m under the high savings scenarios. This is driven by a decrease in HR costs savings, under both the low savings and the high savings scenarios, due to lower reported actual HR costs. This is partly off set by higher property management costs savings, due to the additions of new properties. In addition, under the high savings scenario, efficiency savings relating to FAR

costs decreased, driven by a re-calculation of the cost allocated to the category in the updated submission.

- 1.24 Total efficiency savings of WWU increased by approximately £1.0m under the low savings scenario, and £0.7m under the high savings scenarios. This is driven by a number of factors. Actual costs for FAR, relating to an increase in external fees, were higher than forecast. In addition, L&P costs savings increased due to the other GDNs reporting lower L&P costs in their June 2007 update. This leads to a more challenging benchmark, which increases WWU's efficiency savings.
- 1.25 Details of the movements in individual support services costs savings are provided in the individual cost benchmarking sections.
- 1.26 The results above should be considered in conjunction with our benchmarking of total support service costs, which are shown in the table below.

Table 7: Total support service costs benchmarking findings – implied efficiency savings

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Low savings	24.80	-	-	1.96
High savings	35.93	0.97	-	4.96

Source: LECG analysis.

- 1.27 The efficiency order from benchmarking individual support services costs and total support services costs is the same. The benchmarking of total support services costs has some merit of taking into account potential trade offs between support service cost categories. This explains the lower efficiency savings for three of the GDNs under the total support services costs approach.² We believe, however, that lower weight should be attached to this form of analysis due to its level of aggregation and because there are no reliable external (i.e. third party)

² NGGD's efficiency savings are higher under the benchmarking of total support service cost approach. This is because (i) we do not propose facilities management costs efficiency savings due to differences in the facilities provided by NGGD as compared to the other GDNs. We have adopted the Drivers Jonas Report conclusion in proposing efficiency savings over NGGD's facilities; and (ii) under individual support services costs benchmarking, we have not benchmarked certain support services costs (e.g. training costs) as they are being benchmarked by Ofgem. These costs are therefore not included in the individual support costs efficiency savings.

benchmarks for total support costs. However, Ofgem may wish to consider these results “in the mix” when making its final determinations.

- 1.28 We have been asked to consider if there is any evidence, in the June 2007 update figures, of cost movements from categories that were considered inefficient to categories that were considered efficient in our Phase 1 Report. Such “movements” might signal some form of game playing, whereby GDNs attempt to lower overall efficiency targets, without reducing total support costs. Our analysis shows no evidence of such movements for NGGD, NGN or WWU’s support service costs.
- 1.29 For SGN, there appears to be some unusual movements. SGN explained that the cost movements were partly a result of the correction of previous cost coding errors and a change in their business structure. We have highlighted to Ofgem that these cost movements might allow SGN to lower efficiency targets whilst retaining higher total support costs. Further details of the analysis supporting this conclusion are provided in Section 3.

Report structure

- 1.30 In Section 2, we summarise our terms of reference, certain scope limitations to our work, the information we have relied upon in developing the conclusions contained within this report, and the approach we have adopted. In Section 3, we provide a review of the GDNs’ total support service costs. In Sections 4 to 11, we summarise our analysis on a cost category-by-cost category basis.

2 Introduction and scope of work

Introduction

- 2.1 In this section, we provide background to the work we have been asked to perform and summarise our terms of reference. We also set out certain limitations to the scope of our work.

Background

- 2.2 Ofgem is performing the Gas Distribution Price Control Review 2008-2013 (“GDPCR”), which will seek to set new price controls from 1 April 2008 to 31 March 2013. LECG has supported Ofgem in carrying out this work and has already carried out an initial assessment of the appropriate level of indirect opex for each GDN. LECG’s initial reports were published on 3 July 2007³. We refer to our initial reports collectively as the “Phase 1 Reports”.
- 2.3 The degree of industry restructuring, which followed the sale of four GDNs by National Grid plc, could distort the financial results in 2005/06. In light of this, Ofgem believes that particular emphasis should be applied to actual reported results in 2006/07. Consequently, Ofgem commissioned an update of the initial analysis, to take account of actual reported results in 2006/07.

Terms of reference

- 2.4 In October 2006, Ofgem commissioned LECG to form a view on the relative efficiency of each GDN (by corporate group) and to form a view on the efficiency of the GDNs relative to external benchmarks. Our work involved an element of “bottom up” work focusing on the individual support functions. We were asked to focus on the following services: information systems; finance, audit and regulation; insurance; property management; corporate centre and communication; human resources; legal; and procurement and logistics. Our full terms of reference and our methodology were summarised in Sections 2 and 4, respectively, of our Phase 1 Reports.
- 2.5 This report sets out the work we have performed to update our benchmarking analysis, using updated figures for 2006/07, as submitted by the GDNs in June 2007 (we refer this data as the June 2007 update). We have reviewed the GDN

³ LECG. “Ofgem, Benchmarking the GDNs’ business support services”. 16 April 2007. The reports were published on 3 July 2007, and are available at <http://www.ofgem.gov.uk/CustomPages/Pages/Publications.aspx>.

data for 2006/07, to determine the consistency of data across the GDNs and with the data used in our Phase 1 Reports. Our work included *inter alia*:

- considering and applying Ofgem's accounting adjustments;
- carrying out consistency checks on the data to assess if the allocation of costs between activities had changed. We investigated the reasons for any cost increases or decreases, and considered the reasonableness of material changes. We agreed with Ofgem that we would investigate costs in further detail where the figures in the June 2007 update and the October 2006 BPQ differed by more than 5%;
- asking appropriate supplementary questions to the GDNs about significant cost movements;
- carrying out normalisation adjustments to ensure that data was presented on a consistent basis; and
- liaising with Ofgem and its consultants, who are working on direct opex, capex and repex, to ensure internal consistency.

2.6 We considered the comments made by the GDNs on our Phase 1 Reports. Our Phase 1 Report incorporated our response to those comments. We have updated our benchmarking analysis to take into account the June 2007 updated data. In doing so, we have considered the comments raised by the GDNs in relation to our Phase 1 Reports.

2.7 Most of the adjustments we have made in our Phase 2 Report are consistent with the adjustments made in Phase 1. In comparison to Phase 1, however, we have made significantly fewer adjustments. This is because the GDNs have incorporated some of the adjustments in the June 2007 update that they submitted.

2.8 We summarise our methodology in paragraphs 2.17 to 2.28 below. Having reviewed the GDN's comments relating to our Phase 1 Reports, Ofgem believes that our methodology is robust. Consequently, we were asked to focus on updating our analysis for the new data, rather than to carry out a significant methodology change.

LECG team

- 2.9 LECG is a global economics and consulting firm, which provides independent and objective advice and analysis on matters of economics, finance, and strategy, to law firms, businesses, regulators, and governments. Founded in 1988, LECG has over 900 professional staff, including over 275 experts, operating in 30 offices throughout the Americas, Europe, and Asia-Pacific.
- 2.10 The skills required for this work are embodied in the members of the team who have worked actively on the project. Members of the team have extensive first hand experience of regulation and accounting. The team consists of a combination of economists, accountants and industry experts. Our experts have advised a wide range of regulators and regulated companies in the UK, in Europe and in the US.

Limitations to our work

- 2.11 The limitations to our work were set out in detail in our Phase 1 Reports. The same limitations apply to this update. However, it is worth noting that our work did not constitute an audit of cost movements between the October 2006 BPQ submission and the June 2007 update. In reviewing cost movements, we have considered the nature of differences, their materiality and the directional impact they had on the efficiency analysis. Based on these criteria, we have made some adjustments to the support services costs submitted by the GDNs. These adjustments are discussed in the relevant cost category sections. Ofgem has reviewed the June 2007 update, and, at this stage, has accepted the data contained therein.

Information used

- 2.12 Much of the information we have used is set out in Section 3 of our Phase 1 Reports. Where possible this information has been updated for actual 2006/07 data, as supplied by the GDNs. We asked a number of additional supplementary questions, which were raised in June and July 2007. We have also reviewed the GDNs' comments on our draft Phase 2 Report, and incorporated the specific and relevant responses in our report. In a number of places, the GDNs' comments have been vague or have not been supported by sufficient explanation. We have not been able to incorporate these comments in our report.
- 2.13 Ofgem did not request an update of indirect operating cost forecasts post 2006/07. GDNs were only asked to provide updated information if there were

material differences between the submissions. Except for a revised forecast for IS expenditure provided by SGN and WWU, no revised forecasts for indirect opex were submitted by the GDNs. We have adopted the updated forecast information in our benchmarking analysis where such information has been provided.

- 2.14 The GDNs generally provided us with good quality information in key areas. However, there were important areas in which responses were deficient. In particular, in areas where we have identified major cost movements between the October 2006 BPQ submission and in the June 2007 update, we explicitly requested the GDNs to provide detailed, bottom up explanations and evidence to support these movements. In the majority of the cases, the GDNs only provided a high-level explanation of cost movements. This prevented us from performing a more detailed review of GDNs' costs. In each of the benchmarking sections, we have highlighted the areas where insufficient information has been provided for Ofgem's consideration.
- 2.15 With the exception of NGGD, there were major delays in the GDNs' responses to our supplementary questions. In various occasions, the GDNs have made changes to their BPQ submissions. These factors caused delays to our work.
- 2.16 For SGN and WWU, we identified significant differences between the data submitted in October 2006 and June 2007 in a number of cost categories. SGN and WWU explained that some these differences were due to errors in data collection and cost coding in their October 2006 submission. We have adopted the data in the June 2007 update. Ofgem may wish to obtain further explanations before making a final determination in these areas.

Methodology

- 2.17 We described our methodology in detail in Section 4 of our Phase 1 Reports. In accordance with our terms of reference for this update, we have adopted the same methodology as in Phase 1. We provide a summary of our methodology in the paragraphs below.
- 2.18 In updating our benchmarking analysis, we have recalculated the metrics we used for each cost category with updated 2006/07 figures. We have not updated the metrics that were rejected during Phase 1. The reasons for not using certain metrics and benchmarks were summarised in our Phase 1 Reports. However, in summary, reasons for excluding metrics included, *inter alia*:

- variations in GDN performance may be due to factors such as difference in organisational structure. For example, for FTE based metrics, a higher cost per FTE may be due to more outsourcing rather than inefficiency. Consequently, in some cases the results from FTE benchmarks may not be reliable; and
- a particular benchmarking metric might fail to take account of the trade off between different activity costs. For example, separate benchmarking of insurance premium costs and uninsured claims costs may fail to take account of the trade off between risk level, insurance premiums and uninsured claims costs.

2.19 We use revenue as one of the factors to normalise the support services costs across different scales of operation, to allow like for like comparisons across the GDNs and with third party benchmarks. The GDNs' actual revenue may be affected by a number of factors that are not indicative of the GDNs' scale of operation, most notably weather. For example, warmer weather could reduce a GDN's revenue, but the lower revenue does not represent a change in the scale of operation. It may be more appropriate to use season normal revenue as a normalisation factor, as it is based on long-term average weather condition. We have discussed the use of actual revenue with Ofgem. Ofgem believes that the use of actual revenue remains valid. This is because most of our benchmarks are calculated based on the GDNs' performance. Ofgem believes that it is reasonable to assume that a change in weather would have a similar impact across each of the GDN ownership groups. The benchmarking of the GDNs against each other would mitigate the impact of the weather.

2.20 We recognise that when we compare the GDNs' performance against third party benchmark using revenue-based benchmarks, the warmer weather may suggest worse performance. In these cases, we have included the results of benchmarking using the GDNs benchmarks (which we consider to be not subject to the distortion from changes in weather conditions). Ofgem may wish to consider the results of both the GDNs and the third party benchmarking analyses in making its final proposal.

2.21 As discussed in our Phase 1 Reports, it is necessary to adjust the GDNs' revenue to reflect the return based on natural regulated asset values ("RAVs") rather than the sculpted RAVs. We have performed the "sculpted revenue adjustments" on the GDNs' actual 2006/07 revenue, included in the June 2006

updates. The actual revenue (based on sculpted RAVs), and the revenue based on natural RAVs, which would be used for calculating the benchmarking metrics, are provided in the table below.

Table 8: Adjustment to 2006/07 revenue

2005/06 prices, £000	NGGD	NGN	SGN	WWU
Actual revenue (based on sculpted RAV)	1,063.1	250.3	556.1	221.2
Adjustment	(58.2)	3.6	5.2	49.3
Allowed revenue based on natural RAV	1,004.9	253.9	561.3	270.5

Source: Ofgem separation financial model. LECG analysis. In 2005/06 prices.

2.22 The methodology that we have adopted in making the sculpted revenue adjustments is consistent with the methodology in Phase 1. Further details of the methodology used, and the background of the sculpted revenue adjustments, are provided in Section 3 of our Phase 1 Reports. Adjusted revenue figures have been used in the rest of this report.

2.23 We have performed a benchmarking analysis of support services costs as defined by Ofgem in the GDPCR BPQ Guidance Appendix 2. In general, we have not sought to perform our benchmarking at a more granular level for the following reasons:

- in most cases, the costs within each support cost area could be calculated with some certainty. Performing benchmarking analysis across the GDNs at a more granular level, however, would almost certainly have required more subjective cost allocations;
- the cost category definitions adopted by Ofgem in the BPQ Guidance are generally consistent with the cost definitions used in third party benchmarks;
- in some cases there are clear trade offs between the constituent components within a support services cost category; and
- a number of GDNs indicated that there were practical difficulties in producing cost data at a more granular level.

- 2.24 We recognise, however, that additional insights can be gained by analysing support services costs at a more granular level if the data is robust. We have performed these extra analyses where sufficient information is available. The results of these extra analyses have been adopted in calculating potential efficiency savings only when (i) the trade offs between the constituent components are immaterial, and (ii) breaking down the support services costs into constituent components can be performed on a reasonable or objective basis. As noted above, in many instances, this additional analysis has been limited because the GDNs have been unable to provide detailed bottom up information.
- 2.25 In our low savings scenario, we compare the GDN's performance to the median benchmark performance. In our high savings scenario, we compare the GDN's performance to a more challenging (e.g. top quartile) benchmark. The third party studies we have identified present their benchmarking metrics in a number of different forms. Most data is presented in terms of the median or top quartile, but sometimes averages or cost ranges are presented. Benchmarks presented as a median or top quartile are generally preferred to benchmarks presented as an average, as they are less skewed by outliers in the underlying dataset. In addition, we prefer using a point benchmark to a benchmark presented as a cost range, as they allow better estimates of efficiency. Sometimes, a lack of information means this approach is not possible, and a cost range benchmark must be used.
- 2.26 We consider that a GDN should *at least* be able to achieve the GDN benchmarks, as the GDNs operate in highly comparable environments. Where an external benchmark presents a more challenging efficiency target, and where it is comparable to the GDN, this may indicate that the gas distribution industry, as a whole, is less efficient. In those cases, we adopt the third party benchmark in calculating both the low and high savings scenarios. We have applied this methodology consistently throughout this report, unless we have concerns with the validity of particular third party metrics. Based on the results of our benchmarking, we suggest a range of possible cost savings. In this phase, we have used GDNs benchmarks for six support service cost categories, and third party benchmarks for two support service cost categories.
- 2.27 We recognised that the efficient level of support services costs may be affected by factors such as economies of scale, regional factors, GDNs specific factors

and trade offs between different cost categories, and we would normally seek to consider these factors in performing our analysis. However, we have been instructed by Ofgem to consider the GDNs as equals. Consequently, whilst we have used metrics to normalise the data, we have made no further allowance to adjust for these factors between the GDNs. We understand that in its Initial Proposals, Ofgem has modified our proposed efficient support services costs to account for the some of the factors above, where appropriate. Ofgem has requested us to present our findings in the same format as in Phase 1, to allow it to make similar adjustment where appropriate.

- 2.28 For each of the support services costs we indicate the efficient cost level and the efficiency savings for 2006/07. We understand that Ofgem will separately consider how initial efficiency savings should be profiled, and whether a glide path to the efficiency frontier should be applied. In some cost categories, savings can only be achieved over time due to, for example, some costs components being fixed. We understand that Ofgem will consider any relevant factors in calculating future cost allowances. It is not within our scope to review how efficiency savings should be achieved.

3 Total support service costs

Introduction

- 3.1 In this section, we perform a review of total support service costs. We summarise the normalisation adjustments we have made to total support service costs in 2006/07, which were supplied by the GDNs in their June 2007 update. We compare support service costs in the October 2006 BPQ submission to the June 2007 update figures. We benchmark total support service costs in 2006/07 and provide a summary of our conclusions. Our findings are used to crosscheck our detailed function-by-function findings.

Normalisation adjustments

- 3.2 To some extent, the GDNs attempted to incorporate the normalisation adjustments made in our Phase 1 Reports in their June 2007 update figures. Consequently, we have made significantly fewer normalisation adjustments in this report. The table below provides a summary of each GDN's total support service costs, and the (net) adjustments we have made to ensure cost comparability. Further information on the adjustments is provided in Appendix 1.

Table 9: Controllable total support service costs and LECG normalisation adjustments

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Total support services costs supplied by the GDNs	99.05	16.98	35.52	24.21
LECG normalisation adjustments	6.31	1.54	(3.20)	(0.57)
Adjusted total support services costs	105.36	18.52	32.32	23.65

Source: All GDNs. June 2007 update Table B2.1. LECG analysis. Note: To maintain internal consistency, total support services costs are calculated by summing up individual support services costs. Where we have performed separate benchmarking analysis for sub-functions (e.g. on FAR costs), we have adopted the support services costs provided in Table B2.2. The total support services costs presented in the table above may be different from the figures that the GDNs provided due to rounding. We do not consider the difference to be material for further action.

- 3.3 Most of the normalisation adjustments made at an individual cost benchmarking level relate to a reclassification of activity costs between different support service cost categories. These adjustments “net out” and do not impact total support service costs. The table below provides a breakdown of adjusted total support service costs by support cost category.

Table 10: Adjusted total support service costs breakdown

2005/06 prices, £m	NGGD	NGN	SGN	WWU
IS	28.60	7.02	12.24	7.29
FAR	11.23	2.57	3.24	3.80
Insurance	15.49	2.74	5.31	2.80
Property management	20.66	2.18	6.01	4.30
C&C	8.77	1.44	1.17	1.79
HR	13.11	1.04	1.98	1.10
Legal	1.76	0.69	0.96	0.60
Procurement & logistics	5.08	0.85	1.42	1.73
R&D	0.67	-	-	-
Other support activities	0.00	-	-	0.21
Total shared services	105.36	18.52	32.32	23.65

Source: All GDNs. June 2007 update Table B2.1, B2.2. Note: All costs stated after LECG adjustments and include non-benchmarked costs. For some of the cost categories, such as C&C costs and HR costs, we were unable to benchmark total costs, due to a lack of suitable benchmarks.

3.4 We have adjusted support service costs to reflect Ofgem inflation adjustments. In preparing the June 2007 update, the GDNs adopted a forecast 2006/07 inflation rate to convert operating costs into 2005/06 prices. The actual inflation rate in 2006/07 was available subsequent to the GDNs submitting their June 2007 update, and Ofgem has made adjustments to reflect the difference between forecast and the actual inflation rates. Further details of these adjustments are provided in Ofgem accounting review reports⁴. Adjustments to individual cost categories are discussed further in subsequent sections of this report.

3.5 We have also adjusted the support service costs of NGGD and WWU to reflect Ofgem's FRS 17 adjustments. NGGD and WWU included non cash pension costs (i.e. FRS 17 charges) in support service costs in the June 2007 update. To ensure cost consistency across the GDNs, and to state costs on a cash basis, Ofgem removed the FRS 17 charges from controllable support service costs. The FRS 17 adjustments total £0.85m for NGGD and £0.12m for WWU⁵. This

⁴ Ofgem. "Review of Accounting Issues". August 2007.

⁵ Ofgem. "Review of Accounting Issues". August 2007.

adjustment is applied to all the support service cost categories.⁶ We refer to the Ofgem inflation adjustments and the FRS 17 adjustments collectively as the Ofgem accounting adjustments.

- 3.6 In Phase 1 we also made an adjustment to remove support service costs incurred by NGGD in the provision of de minimis activities. A similar adjustment was not necessary during this phase since NGGD presented their June 2007 update figures net of the de minimis costs. However, the total de minimis adjustment reflected in NGGD's June 2007 update is £1.4m higher than the de minimis adjustment in the October 2006 submission. NGGD stated that the actual level of 2006/07 de minimis activities was higher than expected. A higher level of support service costs was therefore recharged to the non regulated businesses⁷ and this has reduced the support service costs borne by NGGD's networks. NGGD confirmed that the higher de minimis margin relates, primarily, to the extension of SGN FOMSA from November 2006 to April 2007, and that this higher margin is one off.⁸ We have therefore added back this cost decrease in calculating our benchmarking metrics to achieve consistency across the GDNs.
- 3.7 In its June 2007 update, SGN has also made recharges from support services costs to repex/capex (totalled £0.49m) and to its non regulated businesses (totalled £4.03m). SGN did not make these recharges in its October 2006 BPQ submission. SGN stated that it has amended the recharges to reflect its changing business structure⁹. Ofgem has made adjustments to reclassify repex/capex recharges back to support service costs¹⁰.
- 3.8 As stated in our Phase 1 Report, SSE provides strategic and operational support to SGN management through the Managed Service Agreement ("MSA"). The costs that SSE incurs in providing the MSA services are recharged to SGN. With the exception of senior management time, SGN is not charged for services where SSE does not incur extra costs (e.g. certain overhead costs, services utilising SSE's current spare capacity, etc). The costs that SGN pays for the MSA services may therefore not represent the full arm's length prices for these services. We have agreed with Ofgem that we will adopt the cost figures that

⁶ With the exception of WWU's property management costs, which has an adjustment of nil.

⁷ NGGD. Response to LE-NGG-172.

⁸ NGGD. Response to LE-NGG-176.

⁹ SGN. Response to draft LECG Phase 2 Report.

¹⁰ Ofgem. "Review of Accounting Issues". August 2007.

SGN provided for benchmarking purposes. We understand that Ofgem is currently consider the impact of this pricing structure on our conclusions, and may propose further adjustment in its Final Proposals.

Comparison of submissions

- 3.9 We have compared the updated figures provided by the GDNs to prior submissions. Specifically, we have compared total support service costs in 2006/07, which were a “forecast” provided in the October 2006 BPQ submission, to the “actual” figures provided in the June 2007 update. The comparison, which is set out in the table below, is performed after LECG cost adjustments.

Table 11: Comparison of total adjusted support service costs in 2006/07

2005/06 prices	NGGD	NGN	SGN	WWU
October 2006 BPQ (£m)	122.70	21.34	31.78	23.88
June 2007 update (£m)	105.36	18.52	32.32	23.65
Difference (£m)	(17.34)	(2.82)	0.54	(0.23)
% difference	(14.1%)	(13.2%)	1.7%	(1.0%)

Source: All GDNs. June 2007 update Table B2.1. LECG analysis. In 2005/06 prices.

- 3.10 We provide a brief summary of each cost difference below.
- 3.11 NGGD’s adjusted total support service costs decreased from £122.70m to £105.36m. This movement is primarily driven by the removal of non-formula activities costs from each of the support service costs. In its October 2006 BPQ submission, NGGD subtracted total non-formula activities costs from direct costs, even though an element of non formula costs was included in support services. NGGD subsequently provided a breakdown of non-formula activities costs, but did so towards the end of our Phase 1 review. Consequently, this information was not incorporated within our Phase 1 Report. Support service costs relating to non-formula activities totalled £[REDACTED]¹¹ in the earlier submission and this explains a significant proportion of the cost movement shown above. The remainder of the cost decrease is due to FAR, L&P and other smaller cost decreases, which are partly offset by LECG normalisation adjustments.

¹¹ NGGD. June 2007 update. Table B2.1.

3.12 NGN's support service costs decreased from £21.34m to £18.52m. The movement is primarily driven by the following factors:

- £0.84m decrease in FAR costs;
- £0.5m decrease in property management costs; and
- £0.69m decrease in L&P costs.

3.13 SGN's support service costs increased from £31.78m to £32.32m. The movement is primarily driven by, *inter alia*:

- £1.83m increase in IS support costs;
- £2.46m increase in property management costs;
- £1.50m decrease in FAR costs; and
- £1.75m decrease in HR costs.

3.14 WWU's support service costs decreased from £23.88m to £23.65m. This cost difference is not material. It is possible that there were significant movements in individual support service costs that offset each other (and hence result in an immaterial net movement in total support service costs). To understand if such offsetting cost movements exist, we have reviewed the cost movement of each individual support service cost category. Our review found no significant offsetting costs movements. Further details of this review are provided in the paragraph 3.20.

3.15 Further details of the costs differences of each of the support services costs are provided in the individual benchmarking sections.

Review of Phase 1 proposed efficiency savings and cost differences

3.16 We have been asked to consider if there is any evidence, in the June 2007 update figures, of cost movements from cost categories that were considered inefficient to cost categories that were considered efficient in our Phase 1 Report. Such movements might allow GDNs to lower efficiency targets without any reduction in total costs. We have used the average annual efficiency savings, proposed by Ofgem in its GDPCR initial proposals, as an indication of the level of

efficiency of a GDN's support function¹². These efficiency savings are shown in the first column in the table below. The second column shows the cost difference between the June 2007 and the update October 2006 submission, after LECG normalisation adjustments¹³.

Table 12: Ofgem proposed average annual efficiency savings over the price control period (2008/09-2012/13) and the changes between GDNs' forecast 2006/07 costs in October 2006 submissions and actual costs in June 2007 updates

2005/06 prices, £m	NGGD		NGN		SGN		WWU	
	Average savings proposed*	Cost movement from forecast to actual	Average savings proposed*	Cost movement from forecast to actual	Average savings proposed*	Cost movement from forecast to actual	Average savings proposed*	Cost movement from forecast to actual
IS	(4.27)	(2.39)	(2.12)	0.02	1.50	1.83	(2.78)	(0.63)
FAR	(6.25)	(6.99)	(2.25)	(0.85)	(1.07)	(1.50)	(1.62)	0.41
Insurance	(6.95)	(0.20)	(0.46)	(0.16)	(0.34)	0.31	(0.54)	(0.03)
Property	(4.54)	(3.13)	(0.52)	(0.52)	(0.66)	2.46	(2.08)	0.19
C&C	(3.00)	0.82	(0.67)	(0.32)	1.04	(0.52)	(0.87)	(0.37)
HR	(13.71)	(2.28)	(0.66)	(0.13)	(1.40)	(1.30)	(0.65)	0.06
Legal	(0.35)	(0.20)	(0.70)	(0.16)	(0.04)	(0.03)	(0.24)	(0.07)
L&P	(2.91)	(2.66)	(0.52)	(0.69)	0.65	(0.70)	(0.50)	(0.03)
Total	(41.97)	(17.03)	(7.90)	(2.82)	(0.32)	0.54	(9.28)	(0.46)

Source: LECG analysis. Ofgem, "Gas Distribution Price Control Review, Initial Proposals Document", 29 May 2007. Note: *"Average savings proposed" would be negative if the allowances proposed by Ofgem were lower than the GDNs' forecast costs. "Average savings proposed" would be positive if the allowances proposed by Ofgem were higher than the GDNs' forecast costs.

3.17 The analysis above shows that NGGD's support services costs have decreased, in some cases by a similar amount as the average efficiency savings proposed by Ofgem. Most of these cost decreases relate to the adjustments to remove

¹² Calculated by i) deducting the GDN normalised indirect opex 2008/09-2012/13 from the Ofgem proposed allowances 2008/09-2012/13; and ii) dividing the difference from step i) by 5. Source: Ofgem, "Gas Distribution Price Control Review, Initial Proposals Document", 29 May 2007.

¹³ Calculated by deducting cost figures submitted in June 2007 from cost figures submitted in October 2006.

non-formula activities costs from each of the support service costs, as discussed in paragraph 3.10. NGGD stated that these adjustments calculated are based on their standard cost allocation methodology, which has been consistently applied and agreed with Ofgem. We have accepted the explanations provided above for the purposes of our work in this phase.

- 3.18 Our analysis shows that the pattern of movements in NGN's support services costs does not link closely to the average efficiency savings proposed by Ofgem. We highlight that NGN's support services costs have decreased by approximately a third of the efficiency savings proposed by Ofgem.
- 3.19 Our analysis above shows that for SGN, the net movement in support services costs was relatively small, as the decreases in FAR costs and HR costs were offset by the increases in IS support costs and property management costs. However, the decrease in FAR and HR costs were similar to the average efficiency savings proposed by Ofgem, while the increase in IS support costs was similar to the average additional allowance proposed by Ofgem¹⁴. SGN explained that the cost movements were partly a result of the correction of previous cost coding errors and a change to their business structure. We have accepted the explanations provided above for the purposes of our work in this phase, but highlight to Ofgem that these cost movements might allow SGN to lower efficiency targets without any reduction in total costs.
- 3.20 Our analysis shows that for WWU, the net movement in support services costs is small. It also appears that the movements of individual support services costs do not link closely to the average efficiency savings proposed by Ofgem.
- 3.21 Shifting costs across different costs categories may allow a GDN to reduce its overall efficiency savings. Changes in support services costs may also have an impact on the GDNs benchmarks, and hence the efficiency savings of the other GDNs. Our works above do not constitute an audit of cost movements between the October 2006 BPQ submission and the June 2007 update, and Ofgem may wish to perform further investigations, particularly on SGN, prior to making its final determinations.

¹⁴ We acknowledge that there were also some movements which were opposite to the efficiency/ out performance targets implied by Ofgem.

3.22 We have focused our analysis on the shift in costs between support services cost categories. We highlight that it may be possible for a GDN to shift some of its costs between support services costs and direct costs to reduce its total efficiency savings without any reduction in total costs. Further investigation on the cost movements of support services costs and direct costs, at an aggregate level, may therefore be required.

3.23 We have reviewed in detail the difference of each of the support services costs for each of the GDNs. We have summarised the results of this review in the individual cost benchmarking sections.

Benchmarking of total support service costs

3.24 We have performed a high level benchmarking exercise of each GDN's total support service costs, using the data provided in the June 2007 updates. The table below summarises the data we have used in calculating the benchmarking metrics.

Table 13: Data used in the LECG benchmarking exercise

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Revenue	1,063.1	250.3	556.1	221.2
LECG adjusted revenue	1,004.9	253.9	561.3	270.5
Adjusted total support services costs	105.36	18.52	32.32	23.65

Source: All GDNs. June 2007 update Table A1, B2.1, B2.2.

3.25 The table below summarises the GDNs' 2006/07 metrics that were used in our benchmarking analysis.

Table 14: GDN total support service costs benchmarking metrics

	NGGD	NGN	SGN	WWU
Adjusted total support service costs as a percentage of adjusted revenue	10.48%	7.29%	5.76%	8.74%

Source: LECG analysis.

3.26 The table below provides the GDNs benchmarks that we have used in assessing the efficiency of each GDN's total support service costs. As discussed in our Phase 1 Reports, the benchmarks are based on the median and the top quartile performance of the GDNs.

Table 15: GDNs benchmarks

	Low savings	High savings
GDNs benchmark - total support service costs as a percentage of revenue	8.02%	6.91%

Source: LECG analysis.

3.27 We have compared the GDNs' metrics against the benchmarks above. The table below summarises each GDN's performance, in terms of an efficiency score.

Table 16: GDNs performance (efficiency scores)

	NGGD	NGN	SGN	WWU
Low saving	0.76	1.10	1.39	0.92
High saving	0.66	0.95	1.20	0.79

Source: LECG analysis.

3.28 We have calculated the implied efficiency savings by applying the efficiency scores to the GDNs' total support service costs. The following table summarises the implied efficiency savings.

Table 17: Implied efficiency savings

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Low saving	24.80	-	-	1.96
High saving	35.93	0.97	-	4.96

Source: LECG analysis.

Conclusions

3.29 The table below summarises the conclusions of our benchmarking analysis under the low savings scenario.

Table 18: LECG conclusions – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Adjusted 2006/07 total support service costs	105.36	18.52	32.32	23.65
LECG conclusion	80.56	18.52	32.32	21.69
Implied efficiency savings	24.80	-	-	1.96

Source: LECG analysis.

3.30 The table below summarises our conclusions under the high savings scenario.

Table 19: LECG conclusions – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Adjusted 2006/07 total support service costs	105.36	18.52	32.32	23.65
LECG conclusion	69.43	17.54	32.32	18.69
Implied efficiency savings	35.93	0.97	-	4.96

Source: LECG analysis.

3.31 We have compared the above LECG conclusions against our conclusions in our Phase 1 Report. The results of the comparison, under the low savings scenario, are summarised below.

Table 20: Comparison LECG conclusions – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Phase 1 efficiency savings	33.62	-	-	0.98
Phase 2 efficiency savings	24.80	-	-	1.96
Movement	(8.82)	-	-	0.98

Source: LECG analysis.

3.32 The results of the comparison, under the high savings scenario, are summarised below.

Table 21: Comparison LECG conclusions – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Phase 1 efficiency savings	44.26	1.71	-	3.71
Phase 2 efficiency savings	35.93	0.97	-	4.96
Movement	(8.33)	(0.74)	-	1.25

Source: LECG analysis.

- 3.33 Our analysis shows that the efficiency order has not changed¹⁵. The efficiency savings of NGGD has decreased significantly. This is because NGGD reported a lower total support service costs in its June 2007 update, due to the removal of non-formula activities costs as discussed in paragraph 3.10 above.
- 3.34 The efficiency savings of NGN have decreased in the high case because its total support service costs have decreased, as discussed in paragraph 3.12 above. The lower costs of NGN also lead to a more challenging benchmark in both the low savings and the high savings scenarios. This explains the higher efficiency savings for WWU.
- 3.35 As discussed in our Phase 1 Report, total support service cost benchmarking can only provide a broad indicator of performance. It should be used as a high-level crosscheck to our more detailed review, which is provided in the subsequent sections.

¹⁵ Efficiency order is determined by efficiency scores.

4 Information systems

Introduction

- 4.1 In this section, we set out our findings in relation to controllable IS support costs. We summarise the normalisation adjustments we have made. We compare IS support costs and total IS costs in the October 2006 BPQ submission to the June 2007 update figures. We benchmark IS support costs in 2006/07 and provide a summary of our conclusions.

Normalisation adjustments

- 4.2 The activities performed within the IS support function are detailed in our Phase 1 Reports. The table below provides a summary of controllable IS support costs and the adjustments we have made to ensure cost comparability across GDNs. We provide a detailed breakdown of updated IS support costs and our normalisation adjustments in Appendix 2.

Table 22: Controllable IS support costs and normalisation adjustments

2005/06 prices, £m	NGGD	NGN ¹⁶	SGN	WWU
IS support costs supplied by the GDNs	22.20	6.94	16.67	7.75
LECG normalisation adjustments	6.40	0.08	(4.43)	(0.46)
Adjusted IS support costs	28.60	7.02	12.24	7.29

Source: All GDNs. June 2007 update Table B2.1. LECG analysis.

- 4.3 In addition to the Ofgem accounting adjustments, we have made adjustments to NGGD's IS support costs to add back the one off decrease in 2006/07 costs due to the extension of SGN's FOMSA, deferred IS project costs, and one off de minimis margins. We have also reclassified SAP support costs from finance costs, to achieve consistency across the GDNs.
- 4.4 With the exception of the Ofgem accounting adjustments, we did not need to adjust IS support costs for NGN, as it adjusted the June 2007 data based on the findings stated in our Phase 1 Report.

¹⁶ NGN submitted two sets of IS costs in its revised BPQ submission. We have used the numbers supplied in table B2.2, as these represent the summation of individual activity costs.

4.5 In addition to the Ofgem accounting adjustments, we adjusted SGN's IS support costs to remove a [REDACTED] [REDACTED], to reclassify £[REDACTED] of mobile communication costs to direct costs, and to remove the one off increase in integration services costs¹⁷.

4.6 In addition to the Ofgem accounting adjustments, we have adjusted WWU's IS support costs to remove FOMSA parallel running costs. This adjustment was discussed in our Phase 1 Report. We have also added back a £[REDACTED]m one off decrease in IT lease costs.

Comparison of submissions

4.7 We have compared the updated figures to prior submissions (i.e. to the numbers provided in the October 2006 BPQ submission). The comparison, which is set out in the table below, is performed after LECG cost adjustments, to ensure comparability across GDNs.

Table 23: Differences in 2006/07 IS support costs

2005/06 prices	NGGD	NGN	SGN	WWU
October 2006 BPQ (£m)	30.98	7.00	10.41	7.92
June 2007 update (£m)	28.60	7.02	12.24	7.29
Difference (£m)	(2.39)	0.02	1.83	(0.63)
% difference	(7.7%)	0.3%	17.6%	(7.9%)

Source: LECG analysis.

4.8 NGGD's adjusted 2006/07 IS support costs decreased from £30.98m to £28.60m. This is due to the following factors: i) a £[REDACTED]m decrease to remove support service costs relating to non-formula activities, as discussed in paragraph 3.10; ii) a [REDACTED] decrease due to lower IS spending than forecast¹⁸; and iii) [REDACTED] increase due to the reclassification of SAP support costs from finance costs to IS support costs. NGGD pointed out this cost misclassification in its response to

¹⁷ SGN. Response to LE-SGN-127.

¹⁸ NGGD. Response to LE-NGG-158.

Ofgem's initial proposal, subsequent to our Phase 1 Report being finalised. We were therefore only able to incorporate this information in this phase¹⁹.

- 4.9 NGN's adjusted 2006/07 IS support costs increased from £7.00m to £7.02m. This cost movement is not material.
- 4.10 SGN's adjusted 2006/07 IS support costs increased from £10.41m to £12.24m. This is due to a i) £[REDACTED]m increase in communication costs; and ii) [REDACTED] increase in staff/contractor costs²⁰. We have requested but SGN has not explained these movements in adequate detail for us to take a view in these increases²¹.
- 4.11 Given Ofgem's deadlines for completing this report, we have not made any adjustment in relation to these unexplained cost differences. We accept that Ofgem may wish to consider this cost increase further prior to making its final determinations.
- 4.12 WWU's adjusted 2006/07 IS support costs decreased from £7.92m to £7.29m. This is due to, *inter alia*: i) [REDACTED]; and ii) infrastructure support costs being [REDACTED] lower than forecast²².
- 4.13 As discussed in our Phase 1 Report, we have used average IS support costs in calculating our benchmarking metrics to smooth out the cost anomalies of any single years. We have requested the GDNs to confirm any material changes to their forecast IS support costs over the price control period. SGN and WWU reported a change in forecast IS support costs. SGN's forecast IS support costs, after LECG adjustments, are approximately £1.5m higher per year, due to the increases in communications costs and staff/contractors costs discussed in paragraph 4.10. WWU's forecast IS support costs, after LECG adjustments, are approximately £0.2m lower per year. We have also recalculated the SGN and WWU's total IS costs based on their updated IS support costs and their IS capex, as included in the October 2006 submission. We have adopted the GDNs' updated forecast IS costs, after LECG adjustments, in performing our benchmarking analysis. The GDNs' forecast IS costs are provided in Appendix 3.

¹⁹ NGGD. Response to draft LECG Phase 2 Report.

²⁰ SGN. Response to LE-SGN-127.

²¹ Our requests are included in supplementary question LE-SGN-127 and LE-SGN-145b.

²² WWU. Response to LE-WWU-119.

4.14 Our work did not constitute an audit of cost movements between the October 2006 BPQ submission and the June 2007 update. In reviewing cost movements, we have considered the nature of differences, their materiality and the directional impact they had on the efficiency analysis. Based on these criteria, we have made a number adjustments to the IS support costs submitted by the GDNs, as discussed above. Ofgem has reviewed the June 2007 update, and, at this stage, has accepted the data contained in the update.

Benchmarking analysis

4.15 The table below summarises the data we have used in calculating the IS costs benchmarking metrics.

Table 24: Data used in the LECG benchmarking exercise

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Average adjusted revenue 2005/06-2012/13	1,469.08	334.43	771.20	318.77
Average adjusted IS support costs 2005/06-2012/13	29.04	7.34	11.91	7.59
Average adjusted total IS costs 2005/06-2012/13	49.10	15.19	21.04	15.30

Source: All GDNs. June 2007 update Table A1, B2.1, C5.

4.16 In our Phase 1 Report, our benchmarking analysis used the following metrics: i) average IS costs as a percentage of average adjusted revenue; ii) IS costs per FTE; and iii) IS FTE per 1,000 users. As discussed in paragraph 2.18, we did not use the IS support costs per FTE and the IS FTE per 1,000 users benchmarking metrics, as they were more likely to be subject to distorting factors and might not reflect a GDN's underlying efficiency. We do not repeat the FTE based analysis here.

4.17 We have performed benchmarking analysis on IS support costs and total IS costs²³. We have benchmarked cost metrics across the GDNs and against independent studies, using the information contained in the June 2007 update. The table below summarises the GDNs' 2006/07 metrics that were used in our benchmarking analysis.

²³ We have recalculated the SGN and WWU's forecast total IS costs based on their IS support costs (as included in the June 2007 updates) and their IS capex (as included in the October 2006 submissions). Further details of our calculation are provided in Appendix 3.

Table 25: GDNs IS support costs benchmarking metrics

	NGGD	NGN	SGN	WWU
Average 2005/06 - 2012/13 IS support cost as a percentage of revenue	1.98%	2.19%	1.54%	2.38%
Average 2005/06 - 2012/13 total IS costs as a percentage of revenue	3.34%	4.54%	2.73%	4.80%

Source: LECG analysis.

- 4.18 The table below provides the GDNs and third party benchmarks we have used in assessing the efficiency of IS costs. We computed the GDNs benchmarks based on the performance of the median and the top quartile GDNs. Details of the third party benchmarks are provided in our Phase 1 Reports. We have adopted the Corporate Forum study as the third party benchmark for the GDNs' IS support costs, and the NCC study as the third party benchmark for the GDNs' total IS costs.

Table 26: GDNs and third party benchmarks

Benchmarks	Low savings	High savings
GDN benchmark - Average 2005/06 - 2012/13 IS support cost as a percentage of revenue	2.09%	1.87%
Third party benchmark (The Corporate Forum) - Average 2005/06 - 2012/13 IS support cost as a percentage of revenue	2.40%	N/A
GDN benchmark - Average 2005/06 - 2012/13 total IS costs as a percentage of revenue	3.94%	3.19%
Third party benchmark (NCC) - Average 2005/06 - 2012/13 total IS costs as a percentage of revenue	3.00%	0.80%

Source: LECG analysis. The Corporate Forum. CAA initial price control proposals. December 2006. NCC study (quoted in the CAA proposal).

- 4.19 We have compared the GDNs' metrics against the benchmarks above. The table below summarises each GDN's performance, in terms of efficiency score, under the low savings scenario.

Table 27: GDNs performance (efficiency scores) – low savings scenario

	NGGD	NGN	SGN	WWU
GDN benchmarking - Average 2005/06 - 2012/13 IS support cost as a percentage of revenue	1.06	0.95	1.35	0.88
Third party benchmarking (The Corporate Forum) - Average 2005/06 - 2012/13 IS support cost as a percentage of revenue	1.21	1.09	1.55	1.01
GDN benchmarking - Average 2005/06 - 2012/13 total IS costs as a percentage of revenue	1.18	0.87	1.45	0.82
Third party benchmarking (NCC) - Average 2005/06 - 2012/13 total IS costs as a percentage of revenue	0.90	0.66	1.10	0.62

Source: LECG analysis.

- 4.20 The table below summarises each GDN's performance, in terms of efficiency score, under the high savings scenario.

Table 28: GDNs performance (efficiency scores) – high savings scenario

	NGGD	NGN	SGN	WWU
GDN benchmarking - Average 2005/06 - 2012/13 IS support cost as a percentage of revenue	0.95	0.85	1.21	0.79
Third party benchmarking (The Corporate Forum) - Average 2005/06 - 2012/13 IS support cost as a percentage of revenue	N/A	N/A	N/A	N/A
GDN benchmarking - Average 2005/06 - 2012/13 total IS costs as a percentage of revenue	0.95	0.70	1.17	0.66
Third party benchmarking (NCC) - Average 2005/06 - 2012/13 total IS costs as a percentage of revenue	0.24	0.18	0.29	0.17

Source: LECG analysis.

- 4.21 We have calculated the implied efficiency savings by applying the efficiency scores to each GDN's IS support costs or total IS costs where appropriate. The table below summarises the implied efficiency savings under the low savings scenarios.

Table 29: Implied efficiency savings – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
GDN benchmarking - Average 2005/06 - 2012/13 IS support cost as a percentage of revenue	-	0.36	-	0.94
Third party benchmarking (The Corporate Forum) - Average 2005/06 - 2012/13 IS support cost as a percentage of revenue	-	-	-	-
GDN benchmarking - Average 2005/06 - 2012/13 total IS costs as a percentage of revenue	-	2.01	-	2.74
Third party benchmarking (NCC) - Average 2005/06 - 2012/13 total IS costs as a percentage of revenue	5.03	5.16	-	5.74

Source: LECG analysis.

4.22 The table below summarises the implied efficiency savings under the high savings scenarios.

Table 30: Implied efficiency savings – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
GDN benchmarking - Average 2005/06 - 2012/13 IS support cost as a percentage of revenue	1.59	1.09	-	1.63
Third party benchmarking (The Corporate Forum) - Average 2005/06 - 2012/13 IS support cost as a percentage of revenue	N/A	N/A	N/A	N/A
GDN benchmarking - Average 2005/06 - 2012/13 total IS costs as a percentage of revenue	2.26	4.53	-	5.14
Third party benchmarking (NCC) - Average 2005/06 - 2012/13 total IS costs as a percentage of revenue	37.35	12.52	14.87	12.75

Source: LECG analysis.

Conclusions

4.23 We adopted the results of the GDN benchmarking, based on the average IS support costs as a percentage of average adjusted revenue metric. This benchmark presents a more challenging target than the external benchmark. The use of these benchmarking results is consistent with our Phase 1 Reports.

4.24 During our updated work, we have considered whether our Phase 1 methodology was appropriate. We have found no reason to change our general methodology or our approach to benchmarking IS support costs. In line with our Phase 1 Reports, therefore, we continue to adopt the GDN benchmarking comparison to estimate efficiency savings relating to adjusted IS support costs.

4.25 We have not based our efficiency savings calculation on the benchmarking of total IS costs. As discussed in our Phase 1 Reports, IS capex is project driven and exhibits a high level of variability. Ofgem's technical consultants are performing a bottom up review of the major IS projects to assess the efficiency of IS capex. As such, we have not proposed any efficiency savings based on our top down benchmarking analysis of the total IS costs, but Ofgem may wish to use the results of this benchmarking to corroborate the findings of the technical consultants.

4.26 Our conclusions under the low savings scenario are shown in the table below.

Table 31: LECG conclusions – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Average 2005/06 - 2012/13 IS support costs (£m)	29.04	7.34	11.91	7.59
LECG conclusion	29.04	6.98	11.91	6.65
Implied efficiency savings	-	0.36	-	0.94

Source: LECG analysis.

4.27 Our conclusions under the high savings scenario are shown in the table below.

Table 32: LECG conclusions – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Average 2005/06 - 2012/13 IS support costs (£m)	29.04	7.34	11.91	7.59
LECG conclusion	27.45	6.25	11.91	5.96
Implied efficiency savings	1.59	1.09	-	1.63

Source: LECG analysis.

4.28 We have compared the above LECG conclusions against the conclusions in our Phase 1 Reports. The results of the comparison, under the low savings scenario, are summarised below.

Table 33: Comparison LECG conclusions – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Phase 1 efficiency savings	-	0.52	-	1.31
Phase 2 efficiency savings	-	0.36	-	0.94
Movement	-	(0.16)	-	(0.37)

Source: LECG analysis.

4.29 The results of the comparison, under the high savings scenario, are summarised below.

Table 34: Comparison LECG conclusions – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Phase 1 efficiency savings	1.96	1.49	-	2.23
Phase 2 efficiency savings	1.59	1.09	-	1.63
Movement	(0.37)	(0.40)	-	(0.60)

Source: LECG analysis.

4.30 Our analysis shows that the efficiency order has not changed²⁴. NGGD has lower efficiency savings. This is because NGGD reported a lower total support service costs in its June 2007 update, as discussed in paragraph 4.8. WWU has lower efficiency savings, as its actual 2006/07 IS support costs were lower than forecast. NGN's efficiency savings have decreased. This is because the GDNs benchmarks have become less challenging, due to an increase in SGN's IS support costs.

²⁴ Efficiency order is determined by efficiency scores.

5 Finance, audit and regulation

Introduction

5.1 In this section, we set out our findings in relation to controllable finance, audit and regulation (“FAR”) costs. We summarise the normalisation adjustments we have made. We compare controllable FAR costs in the October 2006 BPQ submission to the June 2007 update figures. We separately benchmark controllable finance and audit (“F&A”) and regulation costs in 2006/07 and provide a summary of our conclusions.

Normalisation adjustments

5.2 The activities performed within the FAR function are detailed in our Phase 1 Reports. The table below provides a summary of total controllable FAR costs and the adjustments that we have made to ensure cost comparability. Adjustments have been made in order to ensure consistency between the GDNs and with the external benchmarks. An updated FAR costs breakdown for each GDN, and further details of the normalisation adjustments are provided in Appendix 4.

Table 35: Normalisation adjustments

2006/07	NGGD	NGN ²⁵	SGN	WWU
FAR costs supplied by the GDNs	12.30	2.24	3.21	3.99
LECG normalisation adjustments	(1.07)	0.33	0.03	(0.18)
Adjusted FAR costs	11.23	2.57	3.24	3.80

Source: All GDNs. June 2007 update Table B2.2. Response to LE-NGG-155. NGG Response to LECG first draft, Phase 2. LECG analysis.

5.3 We have made adjustments to the FAR costs supplied by the GDNs as follows:

- for NGGD, we have i) moved payroll processing costs from HR to FAR; ii) moved SAP support costs to IS; iii) adjusted for actual inflation; iv) adjusted for changes to FRS17; v) added back £■■■■m of under spend against

²⁵ NGN submitted two sets of FAR costs in its revised BPQ submission. We have used the numbers supplied in table B2.2, as these represent the summation of individual activity costs.

budget, which was removed from 2006/07 as a one off reduction in costs²⁶; and vi) added back the increase in de minimis margin, which NGGD had reallocated to direct operating costs²⁷;

- for NGN, we have: i) moved payroll processing costs from HR to FAR; ii) adjusted for actual inflation; and iii) moved tax costs from corporate centre and communications to FAR;
- for SGN we have adjusted for actual inflation; and
- for WWU, we have i) adjusted for actual inflation; ii) removed one off setup costs relating to executive recruitment in line with Ofgem's policy on one off costs²⁸; and iii) adjusted for changes to FRS17.

Comparison of submissions

5.4 We have compared the updated figures provided by the GDNs to prior submissions. Specifically, we have compared controllable FAR costs in 2006/07, which were provided in the October 2006 BPQ submission to the figures provided in the June 2007 update. The comparison, which is set out in the table below, is performed after LECG cost adjustments to ensure comparability across the GDNs.

Table 36: Differences in 2006/07 FAR costs

2005/06 prices	NGGD	NGN	SGN	WWU
October 2006 BPQ (£m)	18.22	3.42	4.74	3.40
June 2007 update (£m)	11.23	2.57	3.24	3.80
Difference (£m)	(6.99)	(0.84)	(1.50)	0.41
% difference	(38.4%)	(24.7%)	(31.7%)	12.0%

Source: LECG analysis.

5.5 NGGD's adjusted 2006/07 FAR costs decreased from £18.22m to £11.23m. NGGD has attributed the difference between the two BPQs to:

²⁶ NGGD claims "under spend to forecast" of £0.50m for F&A costs. NGGD explains this in terms of a one off reduction in costs allocated to gas distribution from internal audit, which spent a greater amount of effort on transmission issues during 2006/07. NGGD further claims that this under spend "will not impact on future years". Response to LE-NGG-175.

²⁷ NGGD. Responses to LE-NGG-147 and LE-NGG-148.

²⁸ Ofgem's accounting adjustments.

- distribution support directorate costs amounting to around £2.3m are now excluded from FAR and are included in the work management cost category. In Phase 1, these costs were included in the initial FAR cost submission, but were excluded from the benchmarking because of inconsistencies across GDNs and with external benchmarks;
- NGGD claims that [REDACTED] of SAP support costs were allocated to F&A²⁹. NGGD did not make a similar claim during Phase 1. We have discussed this point with Ofgem and agreed to reallocate these costs to IS;
- non-formula overhead costs amounting to around £[REDACTED]m are no longer included in FAR costs³⁰; and
- NGGD claims “underspend to forecast” of around £0.2m, owing to a regulation project deferred from 2006/07 to 2007/08³¹. This deferment does not affect benchmarked regulation costs, which are averaged across the price control period, 2008/09 to 2012/13.

5.6 NGN’s adjusted 2006/07 FAR costs decreased from £3.42m to £2.57m. NGN has attributed the difference between the two BPQs to:

- a £0.2m reduction in salary (and pension) costs due to NGN not having “a full complement of budgeted FTEs for the full year, driven by the late start of some new employees; and that salaries and associated costs were not as high as forecast, driven by maternity leave not backfilled, and lower salary costs for some new employees”³²;
- a £0.2m reduction in non-salary staff costs “from budget for travel and subsistence”;
- a £0.1m reduction in salary costs from connections billing is recharged to work management³³; and
- NGN has not explained the remaining £0.38m reduction in costs³⁴.

²⁹ NGGD. Response to LECG first draft of Phase 2 document.

³⁰ See paragraph 3.10 for an explanation of NGGD’s non-formula overhead costs.

³¹ NGGD. Response to LE-NGG-175.

³² It is unclear from NGN’s explanation whether any of these elements represent one off reductions in cost.

³³ NGN. Response to LE-NGN-080.

³⁴ We have asked NGGD for further explanation (LE-NGN-103).

5.7 SGN's adjusted underlying 2006/07 FAR costs decreased from £4.74m to £4.45m³⁵. SGN believes that *"the forecast for 2006/07...remains a robust assumption going forward"*³⁶. It attributed the movement to:

- a reduction in financial management costs (including miscellaneous billing) of £1.00m because *"after a full years experience SGN are in a position to more accurately allocate costs across activities"*. In addition, staff previously attributed to F&A costs have now been attributed to regulation³⁶;
- regulation costs have risen from £0.31m to £0.85m in 2006/07. SGN claims that the *"October submission was based on the experience through 2005/06 where only core staff working on regulatory matters had been included under this activity. As the management of this activity has been formalised throughout 2006/07, with staff dedicated to regulation rather than working on regulatory matters on an ad hoc basis, it has been possible to more accurately identify the costs"*³⁷;
- the allocation of General MSA costs have decreased by £0.16m *"following a change in the activities pursued in the year and in better experience of the services being delivered"*³⁸;
- executive team costs, that were allocated from C&C to FAR, have decreased by £0.33m to *"more accurately reflect the cost of these activities"*³⁶; and
- payments to third parties have increased by £0.62m because *"a larger proportion [of cost] has been identified in finance"*³⁹.

5.8 SGN has reallocated a number of activity costs between cost categories, between the two BPQ submissions. SGN has typically justified these movements by explaining that it had better information on which to base its cost allocations for the June 2007 submission, compared with the original BPQ.

5.9 WWU's adjusted 2006/07 FAR costs increased from £3.40m to £3.80m. WWU attributed the difference between the two BPQs to:

³⁵ SGN's FAR cost of £4.42m includes the repex recharge of £1.21m.

³⁶ SGN. Response to LE-SGN-116.

³⁷ SGN. Responses to LE-SGN-113 and LE-SGN-116.

³⁸ SGN. Responses to LE-SGN-116 and LE-SGN-130.

³⁹ SGN. Responses to LE-SGN-111 and LE-SGN-116.

- “increased levels of professional fees and consultancy” in regulation, amounting to around £0.28m and in F&A, amounting to around £0.13m; and
- increased F&A employee costs, amounting to around £0.16m “due to higher levels of agency support required to operate non-transportation billing”⁴⁰.

5.10 Our work above did not constitute an audit of cost movements between the October 2006 BPQ submission and the June 2007 update. In reviewing cost movements, we have considered the nature of differences, their materiality and the directional impact they have on the efficiency analysis. Based on these criteria, we have made a number of adjustments to the FAR costs submitted by the GDNs, as discussed above. Ofgem has reviewed the June 2007 update, and, at this stage, has accepted the data contained in the update.

Benchmarking analysis

5.11 We have benchmarked F&A costs separately from regulation costs (including management of the UK business licences), both between the GDNs and against external comparisons. The table below shows the split of FAR costs between F&A and regulation costs. We have averaged regulation costs across the price control period, 2008/09 to 2012/13. In doing so, we have been able to control for variations and cycles in regulatory requirements over the price control period. We believe that it is fairer to judge GDNs cost performance based on the total regulatory costs over the price control cycle, rather than comparing GDNs at a fixed point in the cycle.

⁴⁰ WWU. Response to LE-WWU-112.

Table 37: Split between F&A and regulation costs

2005/06 prices, £m	NGGD	NGN	SGN	WWU
June 2007 update LECG adjusted FAR costs	11.23	2.57	3.24	3.80
Adjusted F&A (adjusted FAR costs less 2006/07 regulation and management of UK business licences)	9.83	2.22	2.38	3.40
Average regulation cost 2008/09-2012/13	1.16	0.49	0.91	0.43

Source: All GDNs. June 2007 update Table B2.2. Responses to LE-NGG-149, LE-NGN-079, LE-SGN-110 and LE-WWU-138. LECG analysis.

- 5.12 As in Phase 1, we have not been able to benchmark total F&A costs, as defined in the table above, due to reasons of compatibility between GDNs and external comparators. Therefore, we have created a subset of F&A costs to ensure consistency between comparators. Specifically, we have excluded non-finance connections work and other product work, including processing costs for IGTs and diversions, and shrinkage gas purchase costs. These activities were not included in each of the external benchmarks. In addition, they distort the comparison across the GDNs, as these costs are not always included within the FAR category, but are allocated to direct operating expenses categories.

Table 38: 2006/07 F&A costs used in the LECG benchmarking exercise

Controllable operating costs in 2005/06 prices, £m	NGGD	NGN	SGN	WWU
June 2007 LECG adjusted F&A costs	9.83	2.22	2.38	3.40
Less non-finance processing costs (including IGTs, diversions and connections)	-	-	(0.04)	(0.18)
Less shrinkage gas purchase costs	-	(0.05)	-	-
Total benchmarking F&A costs	9.83	2.17	2.34	3.22

Source: All GDNs. Response to question LE-NGN-079, LE-SGN-114 and LE-WWU-125; GDPCR 5 year BPQ table B2.2 June 2007.

- 5.13 The table below summarises the data we have used to calculate the F&A and regulation costs benchmarking metrics.

Table 39: Data used in the LECG benchmarking exercise

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Adjusted F&A cost (adjusted FAR costs less 2006/07 regulation and management of UK business licences)	9.83	2.17	2.34	3.22
Average regulation cost (2008/09-2012/13)	1.16	0.49	0.91	0.43
LECG adjusted revenue	1,004.92	253.93	561.33	270.52
Total controllable and non-controllable operating costs	584.09	150.66	338.68	159.75

Source: All GDNs. GDPCR 5 year BPQ June 2007 tables B2.1, B2.2 Responses to LE-NGG-149, LE-NGN-079, LE-SGN-110 and LE-WWU-138. LECG analysis.

- 5.14 Our benchmarking analysis is performed based on the following metrics: (i) F&A costs as a percentage of revenue; and (ii) regulation costs as a percentage of total controllable and non-controllable cost. The analysis we have undertaken in selecting these benchmarking metrics is set out in our Phase 1 Reports. We have benchmarked cost metrics across the GDNs and against independent studies. The results of the benchmarking analysis, using the information contained in the June 2007 update, are provided below.

Benchmarking F&A costs

- 5.15 The table below compares the GDNs' performance based on adjusted F&A costs as a percentage of total revenue.

Table 40: GDNs' F&A costs benchmarking metrics

	NGGD	NGN	SGN	WWU
F&A costs as a percentage of total revenue	0.98%	0.85%	0.42%	1.19%

Source: LECG analysis.

- 5.16 The table below provides the GDNs and third party benchmarks that we have used in assessing the efficiency of the GDNs' F&A costs. We have computed the GDNs' benchmarks based on the median and the top quartile GDN performance. Further details of the third party benchmarks that we have reviewed are provided in our Phase 1 Reports. We have adopted the results of Global Best Practices' ("GBP") analysis as our third party benchmark.

Table 41: GDNs and third party benchmarks

F&A costs as a percentage of total revenue	Low savings	High savings
GDNs benchmark	0.92%	0.75%
GBP benchmark	1.05%	0.62%

Source: All GDNs. GBP. LECG analysis.

- 5.17 We have compared the GDNs' metrics against the benchmarks above. The table below summarises the performance, in terms of an efficiency score, under the low savings scenario.

Table 42: GDNs performance (efficiencies score) – low savings scenario

F&A costs as a percentage of total revenue	NGGD	NGN	SGN	WWU
GDNs benchmark	0.94	1.07	2.20	0.77
GBP benchmark	1.07	1.23	2.52	0.88

Source: LECG analysis.

- 5.18 The table below summarises the performance, in terms of efficiency score under the high savings scenario.

Table 43: GDNs performance (efficiencies score) – high savings scenario

F&A costs as a percentage of total revenue	NGGD	NGN	SGN	WWU
GDNs benchmark	0.76	0.87	1.79	0.63
GBP benchmark	0.63	0.73	1.49	0.52

Source: LECG analysis.

- 5.19 We have calculated the implied efficiency savings by applying the efficiency scores to the F&A costs. The table below summarises the implied efficiency savings under the low savings scenarios.

Table 44: Implied savings – low savings scenario

F&A costs as a percentage of total revenue, 2005/06 prices, £m	NGGD	NGN	SGN	WWU
GDNs benchmark	0.62	-	-	0.74
GBP benchmark	-	-	-	0.38

Source: LECG analysis.

5.20 The table below summarises the implied efficiency savings under the high savings scenarios.

Table 45: Implied savings – high savings scenario

F&A costs as a percentage of total revenue, 2005/06 prices, £m	NGGD	NGN	SGN	WWU
GDNs benchmark	2.34	0.28	-	1.21
GBP benchmark	3.60	0.60	-	1.55

Source: LECG analysis.

Benchmarking regulation costs

5.21 The table below compares the GDNs' performance based on adjusted regulation costs (including management of the UK business licences)⁴¹, averaged across the price control period (2008/09 to 2012/13), as a percentage of total operating costs.

Table 46: GDNs' regulation benchmarking metrics

	NGGD	NGN	SGN	WWU
Regulation costs as a percentage of total operating costs	0.20%	0.33%	0.27%	0.27%

Source: LECG analysis.

5.22 The table below provides the third party benchmark we have used in assessing the efficiency of the GDNs' regulation costs. Our Phase 1 Reports described our third party benchmark, which is formed as the average between the GDN comparison and Deloitte's assessment of NGC's 2004/05 C&C costs, as shown in the table below.

⁴¹ We requested, and received updated forecasts for regulation costs over the price control period, given the June 2007 update figures. Any adjustments highlighted above have been passed through to regulation costs across the price control period.

Table 47: Third party benchmarks

Regulation costs as a percentage of total operating costs	Low savings	High savings
GDNs benchmark	0.27%	0.25%
Deloitte benchmark	0.24%	0.24%
Third party benchmark	0.25%	0.25%

Source: All GDNs. Arthur Andersen. LECG analysis.

5.23 We have compared the GDNs' metrics against the benchmarks above. The table below summarises each GDNs' performance, in terms of an efficiency score, under the low savings scenario.

Table 48: GDNs performance (efficiencies score) – low savings scenario

Regulation costs as a percentage of total operating costs	NGGD	NGN	SGN	WWU
Third party benchmark	1.28	0.78	0.95	0.94

Source: LECG analysis.

5.24 The table below summarises each GDNs' performance, in terms of an efficiency score, under the high savings scenario.

Table 49: GDNs performance (efficiencies score) – high savings scenario

Regulation costs as a percentage of total operating costs	NGGD	NGN	SGN	WWU
Third party benchmark	1.23	0.75	0.92	0.90

Source: LECG analysis.

5.25 We have calculated the implied efficiency savings by applying the efficiency scores to each GDNs' regulation costs. The table below summarises the implied efficiency savings under the low savings scenario.

Table 50: Implied savings – low savings scenario

Regulation costs as a percentage of total operating costs, 2005/06 prices, £m	NGGD	NGN	SGN	WWU
Third party benchmark	-	0.11	0.04	0.03

Source: LECG analysis.

5.26 The table below summarises the implied efficiency savings under the high savings scenario.

Table 51: Implied savings – high savings scenario (£m)

Regulation costs as a percentage of total operating costs, 2005/06 prices, £m	NGGD	NGN	SGN	WWU
Third party benchmark	-	0.12	0.08	0.04

Source: LECG analysis.

Conclusions

5.27 In our Phase 1 Reports, we noted that Ofgem expected the GDNs at least to achieve the benchmarks set by the other GDNs. Where an external benchmark presents a more challenging efficiency target, and where it is comparable to the GDN, we adopt the third party benchmark in calculating both the low and high savings scenarios.

5.28 Therefore, for F&A costs, as set out in our methodology section in 2.23, in the low savings scenario the GDN comparison is used, while the opposite is true in the high savings scenario⁴².

5.29 Our conclusions for combined F&A and regulation costs under the low savings scenario are shown in the table below.

⁴² One GDN noted that relative efficiency could be affected by weather related variations in revenue, where revenue is used to calculate the efficiency metric. As discussed in paragraph 2.19, we consider that benchmarking using the GDN comparison would not be subject to the distortion. To consider whether the results of benchmarking against an external benchmark could potentially be distorted, we considered the results when using both a revenue-based external benchmark, and a cost-based metric which is unaffected by weather variations. This was possible for the HR cost category and in that instance, the resulting efficiency difference between the two benchmarking metrics is minimal. We do not have an cost-based external benchmark metric for F&A costs, however we believe it reasonable to assume that based on the results in the HR comparison, weather related variations in revenue should not have a significant effect on the efficiency conclusions. We accept however, that Ofgem may opt to use the results from the GDN comparison benchmarking for F&A costs.

Table 52: LECG conclusions – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Adjusted 2006/07 FAR costs	11.23	2.57	3.24	3.80
Less non-benchmarked adjusted 2006/07 FAR costs	-	(0.05)	(0.04)	(0.18)
Benchmarked adjusted 2006/07 FAR costs	11.23	2.52	3.20	3.62
LECG conclusion (F&A)	9.21	2.17	2.34	2.48
LECG conclusion (Regulation)	1.40	0.24	0.81	0.37
Implied efficiency savings	0.62	0.11	0.04	0.77

Source: LECG analysis.

5.30 Our conclusions for combined F&A and regulation costs under the high savings scenario are shown in the table below.

Table 53: LECG conclusions – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Adjusted 2006/07 FAR costs	11.23	2.57	3.24	3.80
Less non-benchmarked adjusted 2006/07 FAR costs	-	(0.05)	(0.04)	(0.18)
Benchmarked adjusted 2006/07 FAR costs	11.23	2.52	3.20	3.62
LECG conclusion (F&A)	6.23	1.57	2.34	1.68
LECG conclusion (Regulation)	1.40	0.23	0.78	0.36
Implied efficiency savings	3.60	0.72	0.08	1.59

Source: LECG analysis.

5.31 We have compared the above LECG conclusions against our conclusions in our Phase 1 Reports. The results of the comparison, under the low savings scenario are summarised below:

Table 54: Comparison of LECG conclusions – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Phase 1 efficiency savings	1.21	0.18	-	0.01
Phase 2 efficiency savings	0.62	0.11	0.04	0.77
Movement	(0.59)	(0.07)	0.04	0.76

Source: LECG analysis.

5.32 The results of the comparison, under the high savings scenario are summarised below.

Table 55: Comparison of LECG conclusions – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Phase 1 efficiency savings	5.84	1.38	0.72	1.23
Phase 2 efficiency savings	3.60	0.72	0.08	1.59
Movement	(2.24)	(0.66)	(0.64)	0.36

Source: LECG analysis.

5.33 For F&A costs, in Phase 1, SGN was the least inefficient GDN, followed WWU, NGN and NGGD, respectively. In Phase 2, SGN is again the least inefficient GDN, followed by NGN, NGGD and WWU, respectively. Our analysis shows that both NGGD and NGN are now more efficient than WWU. This movement is because both NGGD and NGN's costs have fallen and WWU costs have risen, as explained from paragraph 5.5.

5.34 For regulation costs, in Phase 1, SGN was least inefficient, followed by NGGD, WWU and NGN respectively. In Phase 2, NGGD is now the least inefficient, followed by SGN, WWU and NGN, respectively. This movement between NGGD and SGN is explained by a growth in SGN's costs, as explained in paragraph 5.7.

6 Insurance

Introduction

- 6.1 In this section, we set out our findings in relation to controllable insurance costs. We summarise the normalisation adjustments we have made. We compare insurance costs in the October 2006 BPQ submission to the June 2007 update figures. We benchmark insurance costs in 2006/07 and provide a summary of our conclusions.

Normalisation adjustments

- 6.2 The activities performed within the insurance function are detailed in our Phase 1 Reports. The table below provides a summary of controllable insurance costs and the normalisation adjustments that we have made to ensure cost comparability across the GDNs. We provide a more detailed breakdown of updated insurance costs and our normalisation adjustments in Appendix 5.

Table 56: Controllable insurance costs and normalisation adjustments

2005/06 prices, £m	NGGD	NGN ⁴³	SGN	WWU
Insurance costs supplied by the GDNs	15.64	2.51	4.77	2.77
LECG normalisation adjustments	(0.14)	0.23	0.54	0.03
Adjusted legal costs	15.49	2.74	5.31	2.80

Source: All GDNs. June 2007 update Table B2.1. LECG analysis.

- 6.3 With the exception of Ofgem's adjustments, we did not need to make further adjustments to NGGD's or WWU's insurance costs, as they adjusted the June 2007 data based on the findings of our Phase 1 Reports.
- 6.4 In addition to the Ofgem inflation adjustment, NGN's insurance costs were adjusted for a reclassification of insurance claims processing costs from legal costs to insurance costs. We have also added back a one off decrease in uninsured claims costs in calculating the insurance costs benchmarking metrics.

⁴³ NGN submitted two sets of insurance costs in its revised BPQ submission. We have used the numbers supplied in table B2.2, as these represent the summation of individual activity costs.

- 6.5 In addition to the Ofgem inflation adjustment, SGN's insurance costs were adjusted to take account of an Ofgem accounting adjustment to add back the insurance costs that had been recharged to repex.

Comparison of submissions

- 6.6 We have compared the June 2007 update to the figures provided in the October 2006 BPQ submission. The comparison, which is set out in the table below, is performed after LECG cost adjustments, to ensure comparability across GDNs.

Table 57: Differences in 2006/07 insurance costs

2005/06 prices	NGGD	NGN	SGN	WWU
October 2006 BPQ (£m)	15.70	2.90	5.00	2.83
June 2007 update (£m)	15.49	2.74	5.31	2.80
Difference (£m)	(0.20)	(0.16)	0.31	(0.03)
% difference	(1.3%)	(5.6%)	6.2%	(1.0%)

Source: LECG analysis.

- 6.7 NGGD's adjusted 2006/07 insurance costs decreased from £15.70m to £15.49m. This movement is not material.
- 6.8 NGN's adjusted 2006/07 insurance cost decreased from £2.90m to £2.74m. This movement is not material.
- 6.9 SGN's adjusted 2006/07 insurance costs increase from £5.00m to £5.31m. This is due to a higher than expected level of uninsured claims costs⁴⁴. SGN has reviewed its 2006/07 uninsured claims history and concluded that there were no unusual claims⁴⁵. The higher uninsured claims costs level can be expected to be recurring, and no further normalisation adjustment is required. We noted in our Phase 1 Report that SGN's forecast uninsured claims costs were exceptionally low. The higher than forecast level of uninsured claims costs are consistent with our expectations.
- 6.10 WWU's adjusted 2006/07 insurance costs decreased from £2.83m to £2.80m. This movement is not material.

⁴⁴ SGN. Response to LE-SGN-124.

⁴⁵ SGN. Response to LE-SGN-145.

- 6.11 Our work above did not constitute an audit of cost movements between the October 2006 BPQ submission and the June 2007 update. In reviewing cost movements, we have considered the nature of differences, their materiality and the directional impact they have on the efficiency analysis. Based on these criteria, we have adjusted the insurance costs submitted by the GDNs, as discussed above. Ofgem has reviewed the June 2007 update, and, at this stage, has accepted the data contained in the update.

Benchmarking analysis

- 6.12 The table below summarises the data we have used in calculating the insurance costs benchmarking metrics.

Table 58: Data used in the LECG benchmarking exercise

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Revenue	1,063.10	250.30	556.10	221.20
LECG adjusted revenue	1,004.92	253.93	561.33	270.52
Insurance costs	15.49	2.74	5.31	2.80

Source: All GDNs. June 2007 update Table A1, B2.1, B2.2.

- 6.13 In our Phase 1 Reports, our benchmarking analysis used the following metrics: i) insurance costs as a percentage of revenue; ii) insurance costs per FTE; and iii) a comparison of insurance coverage. The analysis we have undertaken in selecting these benchmarking metrics is set out in our Phase 1 Reports. We concluded that it was not appropriate to use the insurance costs per FTE benchmarking metric, as it is more likely to be subject to distorting factors and might say little about underlying efficiency. Consequently, we do not repeat the FTE based analysis here.
- 6.14 In our Phase 1 Report, we concluded that it was inappropriate to use the results of the separate benchmarking of insurance premium costs, uninsured claims costs and insurance coverage in calculating efficiency savings. This is because the results of these benchmarking analyses may not fully recognise the trade offs between risk level, insurance premium and uninsured claims costs. As such, we do not repeat these analyses here.

- 6.15 We have benchmarked cost metrics across the GDNs. The table below summarises the GDNs' 2006/07 metrics we have used in our benchmarking analysis.

Table 59: GDNs insurance costs benchmarking metrics

	NGGD	NGN	SGN	WWU
Insurance costs as a percentage of revenue	1.54%	1.08%	0.95%	1.04%

Source: LECG analysis.

- 6.16 The table below provides the GDN and third party benchmarks that we have used. As before, GDNs benchmarks are based on median and the top quartile performance.

Table 60: GDNs and third party benchmarks

Benchmark	Low savings	High savings
GDNs benchmark - Insurance costs as a percentage of revenue	1.06%	1.01%

Source: LECG analysis.

- 6.17 We have compared the GDNs' metrics against the benchmarks above. The table below summarises each GDN's performance, in terms of an efficiency score, under the low savings scenario.

Table 61: GDNs performance (efficiency scores) – low savings scenario

	NGGD	NGN	SGN	WWU
GDNs benchmarking - Insurance costs as a percentage of revenue	0.69	0.98	1.12	1.02

Source: LECG analysis.

- 6.18 The table below summarises each GDN's performance, in terms of an efficiency score, under the high savings scenario.

Table 62: GDNs performance (efficiency scores) – high savings scenario

	NGGD	NGN	SGN	WWU
GDNs benchmarking - Insurance costs as a percentage of revenue	0.66	0.94	1.07	0.98

Source: LECG analysis.

- 6.19 We have calculated the implied efficiency savings by applying the efficiency scores to each GDN's insurance costs. The table below summarises the implied efficiency savings under the low savings scenarios.

Table 63: Implied efficiency savings – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
GDNs benchmarking - Insurance costs as a percentage of revenue	4.87	0.05	-	-

Source: LECG analysis.

- 6.20 The table below summarises the implied efficiency savings under the high savings scenarios.

Table 64: Implied efficiency savings – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
GDNs benchmarking - Insurance costs as a percentage of revenue	5.31	0.16	-	0.06

Source: LECG analysis.

Conclusions

- 6.21 During our updated work, we have considered whether our phase 1 methodology was appropriate. We have found no reason to change our general methodology or any reason to change our approach to benchmarking insurance costs. In line with our Phase 1 Reports, therefore, we continue to adopt the results of the GDN benchmarking analysis above in calculating the GDNs' efficiency savings.
- 6.22 Our conclusions under the low savings scenario are shown in the table below.

Table 65: LECG conclusions – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Adjusted 2006/07 insurance costs	15.49	2.74	5.31	2.80
LECG conclusion	10.62	2.68	5.31	2.80
Implied efficiency savings	4.87	0.05	-	-

Source: LECG analysis.

6.23 Our conclusions under the high savings scenario are shown in the table below.

Table 66: LECG conclusions – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Adjusted 2006/07 insurance costs	15.49	2.74	5.31	2.80
LECG conclusion	10.18	2.57	5.31	2.74
Implied efficiency savings	5.31	0.16	-	0.06

Source: LECG analysis.

6.24 We have compared our revised conclusions against the conclusions in our Phase 1 Report. The results of the comparison, under the low savings scenario, are summarised below.

Table 67: Comparison LECG conclusions – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Phase 1 efficiency savings	4.40	0.07	-	-
Phase 2 efficiency savings	4.87	0.05	-	-
Movement	0.47	(0.02)	-	-

Source: LECG analysis.

6.25 The results of the comparison, under the high savings scenario, are summarised below.

Table 68: Comparison LECG conclusions – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Phase 1 efficiency savings	5.17	0.26	-	0.12
Phase 2 efficiency savings	5.31	0.16	-	0.06
Movement	0.14	(0.10)	-	(0.06)

Source: LECG analysis.

6.26 Our analysis shows that the efficiency order has not changed⁴⁶ and there is no material difference in the amount of savings between Phase 1 and Phase 2.

⁴⁶ Efficiency order is determined by efficiency scores.

7 Property management

Introduction

7.1 In this section, we set out our findings in relation to controllable property management costs. We summarise the normalisation adjustments we have made. We compare property management costs in the October 2006 BPQ submission to the June 2007 update figures. We benchmark property management costs in 2006/07 and provide a summary of our conclusions.

Normalisation adjustments

7.2 The activities performed within the property management function are detailed in our Phase 1 Reports. The table below provides a summary of controllable property management costs and the normalisation adjustments that we have made to ensure cost comparability across the GDNs. We provide a more detailed breakdown of updated property management costs and our adjustments in Appendix 6.

Table 69: Controllable property management costs and normalisation adjustments

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Property management costs supplied by the GDNs	19.94	1.61	6.30	4.14
LECG normalisation adjustments	0.72	0.57	(0.29)	0.16
Adjusted costs	20.66	2.18	6.01	4.30

Source: All GDNs. June 2007 update Table B2.1. LECG analysis.

7.3 In its response to our Phase 1 Report, NGGD stated that the property management costs and the floor space data that it provided was not comparable to the floor space data that the other GDNs provided. NGGD currently uses some of its properties to provide services to the other GDNs. The key service relate to SOMSA. NGGD has removed the elements relating to these services from the property management costs and the floor space figures that it provided⁴⁷. The other GDNs, however, do not include the property management costs and the floor space relating to the SOMSA properties in their June 2007 updates, as the SOMSA properties did not come online in 2006/07. To achieve comparability

⁴⁷ NGGD. Response to LE-NGG-169.

across the GDNs, we asked the GDNs to provide an estimate of the additional property management costs and floor space required when the SOMSA systems are brought in house. We have included the additional property management costs and floor space in calculating the benchmarking metrics. We have provided further details of these adjustments in the paragraphs below.

- 7.4 In addition to the Ofgem accounting adjustments, we have made an adjustment to NGGD's property management costs to add back the £0.9m one off cost decrease due to a higher than expected de minimis margin, as discussed in paragraph 3.6. As discussed above, the adjustment for SOMSA properties is not required, as NGGD has removed the property management costs and the floor space relating to the SOMSA properties from the data submitted in June 2007.
- 7.5 For NGN, in addition to the Ofgem adjustment relating to inflation (as discussed in paragraph 3.4) and repex/capex recharges, we have made adjustments to include the property management costs and the floor space relating to the SOMSA property. The additional property management costs are £0.05m, and the additional floor space is approximately 2,260 square feet⁴⁸.
- 7.6 For SGN, in addition to the Ofgem inflation adjustment, we made adjustments to include property management costs and the floor space relating to the SOMSA property. The additional property management costs are £0.25m, and the additional floor space is approximately 5,000 square feet⁴⁹. We have also reclassified £0.16m relating to wayleave costs from rental costs to direct costs, and have removed £0.39m 2005/06 utility costs that were paid in 2006/07.
- 7.7 In addition to the Ofgem accounting adjustments, the normalisation adjustments for WWU relate to the Ofgem adjustments to reclassify non-salary recharges from capex/repex to support service costs. It is not necessary to adjust WWU's property management costs for the impact of bringing the SOMSA systems in house. As stated in our Phase 1 Report, WWU indicated that bringing the SOMSA systems in house would not lead to additional property management costs, as WWU's existing properties are already based on accommodating the control system.

⁴⁸ NGN. Response to LE-NGN-095.

⁴⁹ SGN. Response to LE-SGN-140.

Comparison of submissions

7.8 We have compared the updated figures to controllable property management costs provided in the October 2006 BPQ submission. The comparison, which is set out in the table below, is performed after LECG cost adjustments, to ensure comparability across GDNs.

Table 70: Differences in 2006/07 property management costs

In 2005/06 prices	NGGD	NGN	SGN	WWU
October 2006 BPQ (£m)	23.79	2.7	3.55	4.11
June 2007 update (£m)	20.66	2.18	6.01	4.30
Difference (£m)	(3.13)	(0.52)	2.46	0.19
% difference	(13.2%)	(19.3%)	69.3%	4.6%

Source: LECG analysis.

7.9 NGGD's adjusted 2006/07 property management costs decreased from £23.79m to £20.66m. The cost decrease is primarily due to a £[redacted]m adjustment to remove support service costs relating to non-formula activities⁵⁰, as discussed in paragraph 3.10.

7.10 NGN's adjusted 2006/07 property management costs decreased from £2.70m to £2.18m. This is due to property management costs savings relating to UUOL vacating sites earlier than expected, and lower operating costs at [redacted] property⁵¹.

7.11 SGN's adjusted 2006/07 property management costs increased from £3.55m to £6.01m. This is due to the following factors:

- £0.50m increase in rental costs, £0.18m due to increases in the rental costs of existing properties, and £0.34m due to the addition of new properties in Edinburgh subsequent to the October 2006 submission. We asked SGN to provide further explanation of why the rent on existing properties has increased and also why this increase was not reflected in the October 2006 forecast. SGN explained that it has approximately 38 leased properties. At these sites rents changed slightly (although the

⁵⁰ NGGD. Response to LE-NGG-166.

⁵¹ NGN. Response to LE-NGN-092.

annual rent per site has not increased significantly). These increases totalled £0.18m. SGN stated that *“as the increase per site wasn't substantial, we were unaware of these at the time of our October 2006 submission”*;

- £0.91m increase in property maintenance costs, primarily because in its October 2006 submission, SGN has incorrectly included £0.67m depot redecoration costs in work management costs rather than property management costs. The error was corrected in its June 2007 submission;
- £0.93m increase in utility costs, £0.22m of which was due to a higher unit electricity charges;
- £0.64m increase in other running costs and staff costs. This is partly because in its October 2006 submission, SGN has incorrectly included £0.30m security and cleaning costs in work management costs rather than property management costs. The error was corrected in its June 2007 submission⁵². In its October 2006 submission, SGN has also underestimated running and staff costs by £0.17m; and
- £0.25m underestimation of property maintenance costs. SGN stated that the forecasts included in its October 2006 submission were based on its experience to date. There are a number of areas that the forecasts have not been accurate due to insufficient experience⁵³.

7.12 We requested further information, but SGN has not provided a satisfactory explanation of the cost differences between its October 2006 submission and its June 2007 update⁵⁴. Specifically, SGN has not adequately explained £0.63m increase in utility costs⁵⁵. SGN stated in its response to question LE-SGN-149: *“As explained previously, our October 2006 submission, was based on our experience to date. The allocation of property costs across the relevant categories were produced on a best endeavour basis, for the October 2006 submission. During completion of 2006/07 actuals it was apparent that the split across the property management categories in the October 2006 submission was incorrect.”* Due to Ofgem's deadlines for completing this report, we have not

⁵² Our requests are included in LE-SGN-134, LE-SGN-144b and LE-SGN-149.

⁵³ SGN. Response to LE-SGN-149.

⁵⁴ SGN. Response to LE-SGN-134, LE-SGN-144b and LE-SGN-149.

⁵⁵ SGN provided explanations to these cost differences on 30 July 2007, in its response to question LE-SGN-149.

been able to follow this up further and consequently have not made any adjustment in relation to these cost differences. We accept that Ofgem may wish to consider this cost increase further prior to making its final determinations.

7.13 WWU's adjusted 2006/07 property management costs increased from £4.11m to £4.30m. This movement is below the 5% materiality threshold we discussed in Section 2.

7.14 Our work above did not constitute an audit of cost movements between the October 2006 BPQ submission and the June 2007 update. In reviewing cost movements, we have considered the nature of differences, their materiality and the directional impact they have on the efficiency analysis. Based on these criteria, we have adjusted the property management costs submitted by the GDNs, as discussed above. Ofgem has reviewed the June 2007 update, and, at this stage, has accepted the data contained in the update.

Benchmarking analysis

7.15 The table below summarises the data we have used in calculating the property management benchmarking metrics.

Table 71: Data used in the LECG benchmarking exercise

	NGGD	NGN	SGN	WWU
Total property costs (£m, in 2005/06 prices)	20.66	2.18	6.01	4.30
Total rental costs (£m, in 2005/06 prices)	5.14	1.01	1.91	0.76
Total facilities management costs, excluding rent and rates (£m, in 2005/06 prices)	14.93	0.83	3.72	3.49
Floor space (sq ft)	499,000	77,446	241,106	94,579
Total network size (km)	131,588	36,680	73,000	34,691

Source: All GDNs. June 2007 update Table A1, B2.1. NGGD. Response to question LE-NGG-169. Further details of NGGD's floor space information are provided in Appendix 6.

7.16 In our Phase 1 Report, our benchmarking analysis used the following metrics:

- rental costs per square foot for each property;
- total property management costs per square foot office space;
- total facilities costs per square foot of GDN floor space;

- total floor space per kilometre of pipeline; and
- floor space per FTE.

7.17 The analysis we have undertaken in selecting these benchmarking metrics is set out in our Phase 1 Reports. We decided not to use the floor space per FTE benchmarking metric, as it distorts the efficiency analysis. For that reason, we do not repeat the FTE based analysis here.

7.18 We also decided not to use the total property management costs per square foot office space benchmarking metric. We considered that the benchmarking of individual activity costs are better at taking into account regional costs variations, and they provide more granular information to identify specific saving areas. For these reasons, we do not repeat the benchmarking analysis of total property management costs per square foot of office space here.

7.19 In Phase 1, we adopted some of the findings of the Drivers Jonas Report on NGGD's total property management costs in calculating the efficiency savings of NGGD's property management costs. In line with our Phase 1 Report, we continue to include the same findings of Drivers Jonas Report in calculating NGGD's efficiency savings.

7.20 Floor space is needed to calculate all of the property management costs benchmarking metrics. We have requested each GDN to confirm their actual 2006/07 floor space data. A summary of the updated floor space data is provided below.

7.21 The rest of the benchmarking analysis section is structured as follow: first, we summarise the floor space data that the GDNs have provided in their June 2007 updates; second, we benchmark the GDNs' rental costs against third party benchmarks; third, we benchmark the GDNs' floor space and facilities management costs against each other; and finally, we summarise the Drivers Jonas Report's finding on NGGD's property management costs.

Update to floor space data

- 7.22 We have requested each GDN to confirm their actual 2006/07 floor space data. NGGD confirmed that there were no material changes between the forecast that they submitted in October 2006 and their current actual floor space⁵⁶.
- 7.23 NGN stated that the Avalon House and Seacroft properties have been vacated during the year. In NGN's June 2007 update, property management costs and the floor space of these properties have been correctly excluded.⁵⁷ No further adjustments were therefore required.
- 7.24 SGN stated that it has rented and acquired a number of additional properties subsequent to its October 2006 submission. These properties include a training centre, and depots in Ashford, Dickson Street and Horley. We have included the floor space of these new properties in calculating SGN's total floor space.
- 7.25 WWU indicated that it has significantly under-reported the floor space figure in its October 2006 submission. The floor space reported by WWU in its June 2007 update is 38.2% higher than in its October 2006 submission. The updated figures are produced based on a detailed survey of WWU's properties following the receipt of the LECG draft Phase 1 Report. The figures that WWU submitted in October 2006 were inherited from National Grid at the GDNs sales⁵⁸. WWU has also provided detailed explanations of a number of significant floor space movements⁵⁹. We have compared the implied efficiency savings calculated based on the two different sets of floor space information. Using the updated information, our analysis shows that efficiency savings based on the facilities management costs per square foot floor space metric are lower. The efficiency savings under the floor space per kilometre of pipeline metric, however, are higher using the updated information. Overall, these changes in efficiency savings partly offset each other. Based on the updated floor space figures, the net changes in efficiency savings, which was calculated by summing up the efficiency savings under difference benchmarking metrics, are £0.6m and £0.2m lower than the savings calculated based on the data submitted in October 2006, under the low savings and the high savings scenarios respectively.

⁵⁶ NGGD. Response to LE-NGG-169.

⁵⁷ NGN. Response to LE-NGN-095.

⁵⁸ WWU. Response to LE-WWU-132.

⁵⁹ WWU. Response to LE-WWU-140.

7.26 We have used the floor space data in the June 2007 updates throughout this report.

Benchmarking rental costs

7.27 We have benchmarked rental costs for each of the GDNs' properties. We have compared property rents paid by the GDNs to market rent data prepared by GVA Grimley. The rental costs efficiency savings are calculated by comparing the actual property rent with the lower end of the benchmark range, and multiplying the difference by the floor size of the property. We have adopted this excess rent as the potential rental costs saving under the high savings scenario. This approach is consistent with our Phase 1 Report, and the details of it were provided therein.

7.28 NGGD has confirmed that its forecast rental costs and floor space information in the October 2006 submission is consistent with the actual figures. The findings included in our Phase 1 Report therefore remain valid.

7.29 NGN will take occupation of a new property in 2007/08 to accommodate the SOMSA systems⁶⁰. We have compared the rental costs of the new property to the GVA Grimley Survey benchmark. The rental cost of the new property is below the third party benchmark, and hence there is no rental cost saving relating to this property. Our Phase 1 Report included an efficiency saving of £7,814 relating to NGN's Seacroft site⁶¹. The site has been vacated. In the June 2007 update, the costs of the Seacroft site have not been included in the property management costs⁶². We therefore remove the Seacroft property rental costs efficiency savings that we proposed in Phase 1 from the efficiency saving in this phase. Details of the rental costs efficiency savings are provided in our Phase 1 Report.

7.30 As discussed in paragraph 7.24, SGN has rented a number of additional properties subsequent to its October 2006 submission. In addition, as discussed in paragraph 7.11, the rental costs of some of SGN's properties have increased. We have re-performed the rental costs benchmarking analysis, as detailed in Appendix 7. Our analysis shows that the rental costs efficiency savings are approximately £0.29m per annum.

⁶⁰ NGN. Response to LE-NGN-095.

⁶¹ NGN. Response to LE-NGN-042. LECG analysis.

⁶² NGN. Response to LE-NGN-095.

7.31 WWU has reported a higher floor space in its June 2007 update in comparison to its October 2006 submission, as discussed in paragraph 7.25. We have re-performed the rental costs benchmarking analysis, as detailed in Appendix 7. Our analysis shows that the rental costs efficiency saving is £0.05m per annum.

7.32 The rental costs efficiency saving for each of the GDNs is summarised in the table below.

Table 72: Rental costs benchmarking efficiency savings

2005/06 prices, £m	NGGD	NGN	SGN	WWU
High savings	-	0.03	0.29	0.05

Source: LECG analysis. Note: We have applied rental costs efficiency savings only under the high savings scenario.

Benchmarking floor space and facilities management costs

7.33 We have benchmarked the floor space and the facilities management cost metrics across the GDNs, using the information contained in the June 2007 update. The table below summarises the GDNs' 2006/07 metrics used in our benchmarking analysis.

Table 73: GDNs property management benchmarking metrics

	NGGD	NGN	SGN	WWU
Facilities management costs per sq ft (£)	29.92	10.69	15.43	36.91
Floor space per km network (sq ft)	3.79	2.11	3.30	2.73

Source: LECG analysis. WWU. Response to LE-WWU-130.

7.34 The table below provides the GDNs benchmarks that we have used. As before, GDNs benchmarks are based on median and the top quartile performance. The third party benchmarks we considered, and used, were also summarised in our Phase 1 Reports.

Table 74: GDNs benchmarks

	Low savings	High savings
GDN benchmark - Facilities management costs per sq ft (£)	22.67	14.24
GDN benchmark - Floor space per km network (sq ft)	3.01	2.57

Source: LECG analysis.

7.35 We have compared the GDNs' metrics against the benchmarks above. The table below summarises each GDN's performance, in terms of an efficiency score, under the low savings scenario.

Table 75: GDNs performance (efficiency scores) – low savings scenario

	NGGD	NGN	SGN	WWU
GDN benchmarking - Facilities management costs per sq ft (£)	0.76	2.12	1.47	0.61
GDN benchmarking - Floor space per km network (sq ft)	0.79	1.43	0.91	1.11

Source: LECG analysis.

7.36 The table below summarises each GDN's performance, in terms of an efficiency score, under the high savings scenario.

Table 76: GDNs performance (efficiency scores) – high savings scenario

	NGGD	NGN	SGN	WWU
GDN benchmarking - Facilities management costs per sq ft (£)	0.48	1.33	0.92	0.39
GDN benchmarking - Floor space per km network (sq ft)	0.68	1.22	0.78	0.94

Source: LECG analysis.

7.37 We have calculated the implied efficiency savings by applying the efficiency scores to each GDN's property management costs or facilities management costs where appropriate. The table below summarises the implied efficiency savings under the low savings scenarios.

Table 77: Implied efficiency savings– low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
GDN benchmarking - Facilities management costs per sq ft	3.62	-	-	1.35
GDN benchmarking - Floor space per km network	1.28	-	0.52	-

Source: LECG analysis. Note: In order to calculate the potential cost savings based on the floor space per km network benchmark, we have applied the percentage of floor space savings to total property management costs. For NGGD, as discussed in our Phase 1 Report, the floor space spacing was applied to rental costs and property rates costs only.

7.38 The table below summarises the implied efficiency savings under the high savings scenarios.

Table 78: Implied efficiency savings – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
GDN benchmarking - Facilities management costs per sq ft	7.82	-	0.29	2.14
GDN benchmarking - Floor space per km network	2.00	-	1.33	0.24

Source: LECG analysis. Note: In order to calculate the potential cost savings based on the floor space per km network benchmark, we have applied the percentage of floor space savings to total property management costs. For NGGD, as discussed in our Phase 1 Report, the floor space spacing was applied to rental costs and property rates costs only.

Review of Drivers Jonas Report on NGGD's total property management costs

7.39 We have reviewed Drivers Jonas' assessment of NGGD's total property management costs. The details of our review are provided in our Phase 1 Report. Our review identified an annual saving of £0.19m. We have adopted this saving under both the low savings and the high savings scenarios. The background of the Drivers Jonas Report, and the reasons behind the adoption of its findings in the calculation of NGGD's efficiency savings, were discussed in our Phase 1 Report.

Conclusions

7.40 During our updated work, we have considered whether our phase 1 methodology was appropriate. We have found no reason to change our methodology or our approach to benchmarking property management costs. In line with our Phase 1 Report, therefore, we continue to adopt the results of all the analysis conducted

above, in calculating the GDNs' efficiency savings. The table below sets out the efficiency savings calculation under the low savings scenario.

Table 79: Calculation of efficiency savings - low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
GDN benchmarking - Facilities management costs per sq ft	-	-	-	1.35
GDN benchmarking - Floor space per km network	1.28	-	0.52	-
GDN benchmarking - Rental costs per sq ft	N/A	N/A	N/A	N/A
Review of Drivers Jonas Report on NGGD	0.19	N/A	N/A	N/A
Less overlapped cost savings*	-	-	-	-
Total efficiency savings	1.47	-	0.52	1.35

Source: LECG analysis. Note: As discussed in our Phase 1 Report, we do not adopt facilities management costs benchmarking results in calculating NGGD's property management costs efficiency savings. * Overlapped saving represents the potential double counting of cost saving under different benchmarking metrics. We have calculated overlapped cost savings by applying the percentage of floor space saving to the facilities management costs and the rental costs savings.

7.41 The table below set out the efficiency savings calculation under the high savings scenario.

Table 80: Calculation of efficiency savings - high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
GDN benchmarking - Facilities management costs per sq ft	-	-	0.29	2.14
GDN benchmarking - Floor space per km network	2.00	-	1.33	0.24
GDN benchmarking - Rental costs per sq ft	-	0.03	0.29	0.05
Review of Drivers Jonas Report on NGGD	0.19	N/A	N/A	N/A
Less overlapped cost savings*	-	-	(0.13)	(0.12)
Total efficiency savings	2.19	0.03	1.78	2.31

Source: LECG analysis. Note: As discussed in our Phase 1 Report, we do not adopt facilities management costs benchmarking results in calculating NGGD's property management costs efficiency savings. * Overlapped saving represents the potential double counting of cost saving under different benchmarking metrics. We have calculated overlapped cost savings by applying the percentage of floor space saving to the facilities management costs and the rental costs savings.

7.42 Our conclusions under the low savings scenario are shown in the table below.

Table 81: LECG conclusions – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Adjusted 2006/07 property management costs	20.66	2.18	6.01	4.30
LECG conclusion	19.19	2.18	5.49	2.95
Implied efficiency savings	1.47	-	0.52	1.35

Source: LECG analysis.

7.43 Our conclusions under the high savings scenario are shown in the table below.

Table 82: LECG conclusions – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Adjusted 2006/07 property management costs	20.66	2.18	6.01	4.30
LECG conclusion	18.47	2.15	4.23	1.99
Implied efficiency savings	2.19	0.03	1.78	2.31

Source: LECG analysis.

7.44 We have compared the above LECG conclusions against our conclusions in our Phase 1 Reports. The results of the comparison, under the low savings scenario, are summarised below.

Table 83: Comparison LECG conclusions – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Phase 1 efficiency savings	2.88	0.06	-	1.22
Phase 2 efficiency savings	1.47	-	0.52	1.35
Movement	(1.41)	(0.06)	0.52	0.13

Source: LECG analysis.

7.45 The results of the comparison, under the high savings scenario, are summarised below.

Table 84: Comparison LECG conclusions – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Phase 1 efficiency savings	3.17	0.33	0.36	1.89
Phase 2 efficiency savings	2.19	0.03	1.78	2.31
Movement	(0.98)	(0.30)	1.42	0.42

Source: LECG analysis.

7.46 The GDNs benchmarks have become less challenging in comparison to Phase 1 due to the following factors:

- in the case of the facilities management costs per square foot floor space benchmarking, this is because the facilities management costs per square foot floor space of SGN, previously the most efficient GDN, have increased by over 50%, for reasons discussed in paragraph 7.11; and
- in the case of the floor space per kilometre pipeline benchmarking, this is because the floor space per kilometre pipeline of WWU, previously the most efficient GDN, has increase by 36.3%, for reasons discussed in paragraph 7.25.

7.47 NGGD's efficiency savings have decreased. This is because of the lower efficiency savings from the floor space benchmarking, due to less challenging GDNs floor space benchmarks discussed above.

7.48 NGN's efficiency savings have decreased. This is because of the lower efficiency savings from the benchmarking of facilities management costs and floor space, due to less challenging GDNs benchmarks discussed in paragraph 7.46.

7.49 SGN's efficiency savings have increased due to the following factors:

- efficiency savings from the benchmarking of facilities management costs have increased due to an increase in SGN's facilities management costs, as discussed in paragraph 7.11; and
- efficiency savings from the benchmarking of floor space have increased, as the additions of new properties, as discussed in paragraph 7.24, have increase SGN's total floor space.

7.50 WWU's efficiency savings have increased. This is primarily due to an increase in the efficiency savings from the floor space benchmarking, as a result of its higher floor space.

8 Corporate centre and communication

Introduction

8.1 In this section, we set out our findings in relation to controllable corporate centre and communications (“C&C”) costs. We summarise the normalisation adjustments we have made. We compare controllable C&C costs in the October 2006 BPQ submission to the June 2007 update figures. We benchmark controllable C&C costs in 2006/07 and provide a summary of our conclusions.

Normalisation adjustments

8.2 The activities performed within the C&C function are detailed in our Phase 1 Reports. The table below provides a summary of the total C&C costs and the adjustments that we have made to ensure cost comparability across the GDNs. A more detailed breakdown of updated C&C costs and our adjustments is provided in Appendix 8.

Table 85: Normalisation adjustments

2006/07 £m	NGGD	NGN ⁶³	SGN	WWU
C&C costs supplied by the GDNs	8.90	1.60	1.16	1.99
LECG normalisation adjustments	(0.13)	(0.16)	0.01	(0.20)
Adjusted C&C costs	8.77	1.44	1.17	1.79

Source: All GDNs. June 2007 update Table B2.2. LECG analysis.

8.3 We have made adjustments to the C&C costs supplied by the other GDNs, as follows:

- for NGGD, we have: i) adjusted for actual inflation; ii) removed non cash costs relating to FRS17; and iii) accounted for the decrease in de minimis margins, which NGGD had reallocated to direct operating costs⁶⁴;
- for NGN, we have: i) moved tax costs to finance, audit and regulation; ii) adjusted for actual inflation; and iii) moved corporate finance costs from legal;
- for SGN, we have adjusted for actual inflation; and

⁶³ NGN submitted two sets of C&C costs in its revised BPQ submission. We have used the numbers supplied in table B2.2, as these represent the summation of individual activity costs.

⁶⁴ NGGD. Response to LE-NGG-145.

- for WWU, we: i) moved travel costs for operational staff to the work management cost category; ii) adjusted for actual inflation; and iii) removed non cash costs relating to FRS17.

Comparison of submissions

- 8.4 We have compared the updated 2006/07 figures provided by the GDNs in the June 2007 update to the C&C costs provided in the October 2006 BPQ submission. The comparison, which is set out in the table below, is performed after LECG cost adjustments, to ensure comparability across GDNs.

Table 86: Differences in 2006/07 C&C costs

2005/06 prices	NGGD	NGN	SGN	WWU
October 2006 BPQ (£m)	7.94	1.76	1.68	2.16
June 2007 update (£m)	8.77	1.44	1.17	1.79
Difference (£m)	0.82	(0.32)	(0.52)	(0.37)
% difference	10.3%	(18.2%)	(30.7%)	(17.2%)

Source: LECG analysis.

- 8.5 NGGD's adjusted 2006/07 C&C costs increased from £7.94m to £8.77m. NGGD explained this movement as follows. The first reason relates to non-formula overhead costs, amounting to around £█m, which are no longer included in C&C costs⁶⁵. Second, NGGD claims that an over spend of around █. It also claimed that costs were higher due to changes in Group Strategy⁶⁶.
- 8.6 NGN's adjusted 2006/07 C&C costs decreased from £1.76m to £1.44m. NGN attributed this movement to "*marginally lower staff costs... offset by marginally increased Corporate Social Responsibility spend... [and] rounding to the nearest £0.1m*"⁶⁷.

⁶⁵ See paragraph 3.10 for an explanation of NGGD's non-formula overhead costs.

⁶⁶ NGGD. Response to LE-NGG-145.

⁶⁷ NGN. Response to LE-NGN-078.

8.7 SGN's adjusted underlying 2006/07 C&C costs increased from £1.68m to £1.91m⁶⁸. SGN explained this movement as follows:

- executive team costs have increased by £0.14m “*due to better information being available to allocate exec costs to activities*”⁶⁹;
- payments to third parties have decreased by £0.35m. SGN explained that this movement was due to better information: “*analysing the actual costs for 2006/07... a larger proportion has been identified with finance and HR and as such, the corporate figure is lower*”⁷⁰;
- general MSA umbrella costs allocated to C&C have increased by £0.30m, however “*overall general MSA charges have remained static, the only difference is the allocation across activities*”⁶⁹; and
- minor increases in other activity costs, amounting to around £0.10m, are “*explained by the formalisation of the new structure, rather than any fundamental change in the activities performed*”⁷¹.

8.8 WWU's adjusted 2006/07 C&C costs decreased from £2.16m to £1.79m. WWU explained the movement between the two BPQs as follows:

- travel costs were “*more than anticipated*” by around £0.05m, once operational staff (i.e. non-support service staff) travel has been removed, as explained in paragraph 8.3⁷²;
- travel *relocation* costs of £0.10m⁷³ were excluded from the benchmarking in Phase 1, due to incompatibility, have been reallocated to work management costs; and
- actual consultancy costs were lower than forecast by around £0.21m⁷⁴.

8.9 Our work does not constitute an audit of cost movements between the October 2006 BPQ submission and the June 2007 update. In reviewing cost movements, we have considered the nature of differences, their materiality and

⁶⁸ SGN's C&C cost of £1.91m includes the repex recharge of £0.74m.

⁶⁹ SGN. Response to LE-SGN-108.

⁷⁰ SGN. Response to LE-SGN-107.

⁷¹ SGN. Responses to LE-SGN-102 and LE-SGN-108.

⁷² WWU. Responses to LE-WWU-105 and LE-WWU-137.

⁷³ WWU reported travel relocation costs of £0.10m in its cost visit activity breakdown.

⁷⁴ WWU. Response to LE-WWU-105.

the directional impact they have on the efficiency analysis. Based on these criteria, we have made a number of adjustments to the C&C costs submitted by the GDNs, as discussed above. Ofgem has reviewed the June 2007 update, and, at this stage, has accepted the data contained in the update.

Benchmarking analysis

- 8.10 The table below summarises the data we have used in calculating our C&C costs benchmarking metrics.

Table 87: Data used in the LECG benchmarking exercise

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Adjusted C&C cost	8.77	1.44	1.17	1.79
Total controllable and non-controllable operating costs	584.09	150.66	338.68	159.75

Source: All GDNs. GDPCR 5 year BPQ June 2007 tables B2.1, B2.2. LECG analysis.

- 8.11 Our analysis for selecting benchmarking metrics was set out in our Phase 1 Reports. We benchmarked cost metrics across the GDNs and against independent studies. We concluded that the relevant metric was C&C costs as a percentage of total controllable and non-controllable operating cost. The table below compares the GDNs' performance based on adjusted C&C costs as a percentage of total controllable and non-controllable operating costs.

Table 88: GDNs' C&C costs benchmarking metrics

	NGGD	NGN	SGN	WWU
C&C costs as a percentage of total operating costs	1.50%	0.96%	0.34%	1.12%

Source: LECG analysis.

- 8.12 The table below provides the GDN and third party benchmarks that we have used. As before, GDNs benchmarks are based on median and the top quartile performance. The third party benchmarks we considered and used were also summarised in our Phase 1 Reports. We have adopted, after restatement, Deloitte's assessment of National Grid's 2004/05 C&C costs.

Table 89: GDNs and third party benchmarks

C&C costs as a percentage of total operating costs	Low savings	High savings
GDNs benchmark	1.04%	0.80%
Deloitte benchmark	1.19%	1.10%

Source: All GDNs. Deloitte. LECG analysis.

- 8.13 We have compared the GDNs to the benchmarks above. The table below summarises each GDN's performance, in terms of an efficiency score, under the low savings scenario.

Table 90: GDNs performance (efficiency scores) – low savings scenario

C&C costs as a percentage of total operating costs	NGGD	NGN	SGN	WWU
GDNs benchmark	0.69	1.09	3.01	0.93
Deloitte benchmark	0.79	1.24	3.45	1.06

Source: LECG analysis.

- 8.14 The table below summarises each GDN's performance, in terms of an efficiency score, under the high savings scenario.

Table 91: GDNs performance (efficiency scores) – high savings scenario

C&C costs as a percentage of total operating costs	NGGD	NGN	SGN	WWU
GDNs benchmark	0.53	0.84	2.33	0.72
Deloitte benchmark	0.74	1.16	3.20	0.99

Source: LECG analysis.

- 8.15 We have calculated the implied efficiency savings by applying the efficiency scores to each GDN's C&C costs. The table below summarises the implied efficiency savings under the low savings scenario.

Table 92: Implied efficiency savings – low savings scenario

C&C costs as a percentage of total operating costs, 2005/06 prices, £m	NGGD	NGN	SGN	WWU
GDNs benchmark	2.71	-	-	0.13
Deloitte benchmark	1.82	-	-	-

Source: LECG analysis.

- 8.16 The table below summarises the implied efficiency savings under the high savings scenario.

Table 93: Implied efficiency savings – high savings scenario

C&C costs as a percentage of total operating costs, 2005/06 prices, £m	NGGD	NGN	SGN	WWU
GDNs benchmark	4.08	0.23	-	0.51
Deloitte benchmark	2.32	-	-	0.03

Source: LECG analysis.

Conclusions

- 8.17 Ofgem expects the GDNs to achieve the benchmarks set by the other GDNs. Where an external benchmark presents a more challenging efficiency target, and where it is comparable to the GDN, Ofgem expects the GDNs to be able to reach the third party benchmarks. For C&C costs, the GDN comparison benchmark is more binding than the external benchmark in both the low and high savings scenarios.
- 8.18 During our updated work, we have considered whether our phase 1 methodology was appropriate. We have found no reason to change our methodology. Specifically, we have found no reason to change our approach to benchmarking C&C costs. In line with our Phase 1 Report, therefore, we continue to adopt the GDN benchmarking comparison to estimate efficiency savings relating to C&C costs.
- 8.19 Our conclusions under the low savings scenario are shown in the table below.

Table 94: LECG conclusions – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Benchmarked adjusted 2006/07 C&C costs	8.77	1.44	1.17	1.79
LECG conclusion	6.06	1.44	1.17	1.66
Implied efficiency savings	2.71	-	-	0.13

Source: LECG analysis.

8.20 Our conclusions under the high savings scenario are shown in the table below.

Table 95: LECG conclusions – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Benchmarked adjusted 2006/07 C&C costs	8.77	1.44	1.17	1.79
LECG conclusion	4.69	1.21	1.17	1.28
Implied efficiency savings	4.08	0.23	-	0.51

Source: LECG analysis.

8.21 We have compared the results above to our conclusions in our Phase 1 Reports. The results of the comparison, under the low savings scenario are summarised below:

Table 96: Comparison of LECG conclusions – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Phase 1 efficiency savings	1.06	-	-	0.15
Phase 2 efficiency savings	2.71	-	-	0.13
Movement	1.65	-	-	(0.02)

Source: LECG analysis.

8.22 The results of the comparison, under the high savings scenario are summarised below.

Table 97: Comparison of LECG conclusions – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Phase 1 efficiency savings	2.44	0.24	-	0.55
Phase 2 efficiency savings	4.08	0.23	-	0.51
Movement	1.64	(0.01)	-	(0.04)

Source: LECG analysis.

- 8.23 Our analysis shows little movement in the overall efficiency savings required by the benchmark, except for a growth in NGGD required efficiencies. This is consistent with the fact that NGGD has increased its adjusted C&C cost by around £1m, while the other GDNs have reduced their adjusted C&C costs, as explained above⁷⁵.

⁷⁵ While SGN's underlying costs have increased, when the repex recharge is removed, benchmarked costs have decreased.

9 Human resources

Introduction

9.1 In this section, we set out our findings in relation to controllable human resources (“HR”) costs. We summarise the normalisation adjustments we have made. We compare HR costs in the October 2006 BPQ submission to the June 2007 update figures. We benchmark controllable HR costs in 2006/07 and provide a summary of our conclusions.

Normalisation adjustments

9.2 The activities performed within the HR function were detailed in our Phase 1 Reports. The table below provides a summary of the total controllable HR costs and the normalisation adjustments that we have made to ensure cost comparability across GDNs. A more detailed breakdown of updated HR costs and our adjustments is provided in Appendix 9.

Table 98: Total controllable HR costs and normalisation adjustments

2005/06 prices, £m	NGGD	NGN ⁷⁶	SGN	WWU
HR costs supplied by the GDNs	12.70	1.11	1.51	1.22
LECG normalisation adjustments	0.41	(0.07)	0.47	(0.12)
Adjusted HR costs	13.11	1.04	1.98	1.10

Source: All GDNs. June 2007 update Table B2.1. LECG analysis.

9.3 We have made adjustments to the HR costs supplied by the other GDNs as follows:

- for NGGD, we have: i) reclassified HR skills and competency costs from work management; ii) reclassified payroll processing costs from HR to FAR; iii) adjusted for actual inflation; iv) adjusted for non cash costs relating to FRS17; and v) added back the increase in de minimis margins, which NGGD had reallocated to direct operating costs⁷⁷;

⁷⁶ NGN submitted two sets of HR costs in its revised BPQ submission. We have used the numbers supplied in table B2.2, as these represent the summation of individual activity costs.

⁷⁷ NGGD. Response to LE-NGG-152.

- for NGN, we have: i) reclassified payroll processing costs from HR to FAR; ii) reclassified pension costs from legal to HR; and iii) adjusted for actual inflation;
- for SGN, we have i) reclassified training costs from work management⁷⁸; and ii) we have adjusted for actual inflation; and
- for WWU, we have i) reclassified occupational health costs from HR to health and safety costs, which are held within work management costs; ii) adjusted for actual inflation; and iii) adjusted for non cash costs relating to FRS17.

Comparison of submissions

9.4 We have compared the updated figures provided by the GDNs to HR costs provided in the October 2006 BPQ submission. The comparison, which is set out in the table below, is performed after LECG cost adjustments, to ensure comparability across GDNs.

Table 99: Differences in 2006/07 HR costs

2005/06 prices	NGGD	NGN	SGN	WWU
October 2006 BPQ (£m)	15.39	1.18	3.27	1.05
June 2007 update (£m)	13.11	1.04	1.98	1.10
Difference (£m)	(2.28)	(0.14)	(1.30)	0.06
% difference	(14.8%)	(12.0%)	(39.7%)	5.5%

Source: LECG analysis.

9.5 NGGD's adjusted 2006/07 HR costs decreased from £15.39m to £13.11m. NGGD attributed this movement to i) non-formula overhead costs that are no longer included in HR costs⁷⁹; and ii) £0.20m of under spent budget⁸⁰.

9.6 NGN's adjusted 2006/07 HR costs decreased from £1.18m to £1.04m. NGN explained this movement in terms of "*efficiencies in the scale of* [professional and

⁷⁸ SGN. Response to LE-SGN-121.

⁷⁹ NGGD. Response to LE-NGG-152.

⁸⁰ NGGD claims "underspend to forecast" of £0.20m. NGGD further claims that "this was due to savings been made ahead of forecast in the first phase of out shared services organisation". In addition, NGGD states that this underspend is one off in nature and "will not impact on numbers in the plan". We therefore do not believe that this underspend sets a new trend for HR costs across the price control period. Response to LE-NGG-174.

consultancy services] costs and the use being made of them⁸¹. This movement is under our materiality threshold.

9.7 SGN's adjusted 2006/07 HR costs decreased from £3.27m to £2.56m⁸². SGN claimed that "*smaller movements within the submissions can be explained by the formalisation of the new structure, rather than any fundamental change in the activities performed*"⁸³. Specifically, SGN explained the movement in costs as follows:

- actual general MSA costs spent on HR issues were smaller than forecast, amounting to £0.04m;
- actual training costs spent within the HR category were smaller than forecast, amounting to £0.2m;
- actual employee relations costs spent were smaller than forecast, amounting to £0.71m; and
- actual payments for professional and consultancy services were larger than forecast, amounting to £0.19m⁸⁴.

9.8 WWU's adjusted 2006/07 HR costs increased from £1.05m to £1.10m. This is because "*expenditure on external support and consultants was higher than forecast*"⁸⁵. This movement is under our materiality threshold.

9.9 Our work above did not constitute an audit of cost movements between the October 2006 BPQ submission and the June 2007 update. In reviewing cost movements, we have considered the nature of differences, their materiality and the directional impact they have on the efficiency analysis. Based on these criteria, we have made a number of adjustments to the HR costs submitted by the GDNs, as discussed above. Ofgem has reviewed the June 2007 update, and, at this stage, has accepted the data contained in the update.

⁸¹ NGN. Response to LE-NGN-082.

⁸² SGN's HR cost of £2.56m includes the repex recharge of £0.58m.

⁸³ SGN. Response to LE-SGN-102.

⁸⁴ SGN. Response to LE-SGN-123.

⁸⁵ WWU. Response to LE-WWU-114.

Benchmarking analysis

9.10 We have benchmarked HR costs between the GDNs and against external comparisons. We have not been able to benchmark total HR costs, as defined in the table above, due to reasons of compatibility between external and GDN comparators. Therefore, we have created a subset of HR costs to ensure consistency between comparators. Specifically, we have excluded learning and development, and apprentice training scheme costs. These activities were not included in each of the external benchmarks. In addition, they could also distort the comparison across the GDNs not all of whom include such costs in this category. This approach is comparable to the approach adopted in Phase 1. In addition, GDN costs in this area are broadly in line with the costs reported during Phase 1, apart from a £1.10m reduction in NGGD's learning and development budget, made after our Phase 1 conclusions.

Table 100: 2006/07 HR costs used in the LECG benchmarking exercise

2005/06 prices, £m	NGGD	NGN	SGN	WWU
June 2007 LECG adjusted	13.11	1.04	1.98	1.10
Less learning and development	(3.49)	(0.10)	(0.04)	(0.21)
Less apprentice scheme and salary costs	(4.30)	(0.40)	-	(0.05)
Less graduate scheme and salary costs	(1.70)		-	
HR benchmarked costs	3.62	0.54	1.94	0.84

Source: All GDNs. Responses to question LE-NGN-088, LE-SGN-117 and LE-WWU-125; GDPCR 5 year BPQ table B2.2 June 2007.

9.11 The table below summarises the data we have used in calculating the HR costs benchmarking metrics.

Table 101: Data used in the LECG benchmarking exercise

2005/06 prices, £m	NGGD	NGN	SGN	WWU
HR benchmarked costs	3.62	0.54	1.94	0.84
Total controllable and non-controllable operating costs	584.09	150.66	339.68	159.75
LECG adjusted revenue	1,004.92	253.93	561.33	270.52

Source: All GDNs. GDPCR 5 year BPQ June 2007 tables B2.1 and B2.2. LECG analysis.

- 9.12 Our benchmarking analysis is performed based on the following metrics: (i) HR costs as a percentage of adjusted revenue; and (ii) HR cost as a percentage of total controllable and non-controllable cost. Our overall assessment of benchmarking metrics was set out in our Phase 1 Reports. We have benchmarked cost metrics across the GDNs and against independent studies. The results of the benchmarking analysis, using the information contained in the June 2007 update, are provided below.

Benchmarking HR costs

- 9.13 The table below compares the GDNs' performance based on adjusted HR costs as a percentage of total revenue and as a percentage of total operating costs.

Table 102: GDNs' HR costs benchmarking metrics

Benchmark	NGGD	NGN	SGN	WWU
HR costs as a percentage of total revenue	0.36%	0.21%	0.35%	0.31%
HR costs as a percentage of total operating costs	0.62%	0.36%	0.57%	0.53%

Source: LECG analysis.

- 9.14 The table below provides the GDN and third party benchmarks that we have used. As before, GDNs benchmarks are based on median and the top quartile performance. The third party benchmarks we considered and used were also summarised in our Phase 1 Reports. We have adopted the Global Best Practices ("GBP") benchmark using an HR costs as a percentage of total revenue metric. For verification, we also used the Saratoga benchmark on HR costs as a percentage of total operating costs.

Table 103: GDNs and third party benchmarks

Benchmark	Low savings	High savings
HR costs as a percentage of total revenue		
GDNs benchmark	0.33%	0.29%
GBP benchmark	0.28%	0.17%
HR costs as a percentage of total operating costs		
GDNs benchmark	0.55%	0.48%
Saratoga benchmark	0.50%	0.30%

Source: All GDNs. GBP. Saratoga. LECG analysis.

9.15 We have compared the GDNs' metrics against the benchmarks above. The table below summarises each GDN's performance, in terms of an efficiency score, under the low savings scenario.

Table 104: GDNs performance (efficiency scores) – low savings scenario

Benchmark	NGGD	NGN	SGN	WWU
HR costs as a percentage of total revenue				
GDNs benchmark	0.91	1.56	0.95	1.06
GBP benchmark	0.78	1.33	0.81	0.90
HR costs as a percentage of total operating costs				
GDNs benchmark	0.89	1.55	0.96	1.04
Saratoga benchmark	0.81	1.41	0.87	0.95

Source: LECG analysis.

9.16 The table below summarises each GDN's performance, in terms of efficiency score, under the high savings scenario.

Table 105: GDNs performance (efficiency scores) – high savings scenario

Benchmark	NGGD	NGN	SGN	WWU
HR costs as a percentage of total revenue				
GDNs benchmark	0.79	1.36	0.83	0.92
GBP benchmark	0.47	0.81	0.49	0.55
HR costs as a percentage of total operating costs				
GDNs benchmark	0.78	1.36	0.85	0.92
Saratoga benchmark	0.48	0.84	0.52	0.57

Source: LECG analysis.

- 9.17 We have calculated the implied efficiency savings by applying the efficiency scores to each GDN's HR costs. The table below summarises the implied efficiency savings under the low savings scenario.

Table 106: Implied efficiency savings – low savings scenario (£m)

2005/06 prices, £m	NGGD	NGN	SGN	WWU
HR costs as a percentage of total revenue				
GDNs benchmark	0.33	-	0.10	-
GBP benchmark	0.81	-	0.37	0.08
HR costs as a percentage of total operating costs				
GDNs benchmark	0.41	-	0.08	-
Saratoga benchmark	0.70	-	0.24	0.04

Source: LECG analysis.

- 9.18 The table below summarises the implied efficiency savings under the high savings scenario.

Table 107: Implied efficiency savings – high savings scenario (£m)

2005/06 prices, £m	NGGD	NGN	SGN	WWU
HR costs as a percentage of total revenue				
GDNs benchmark	0.75	-	0.33	0.07
GBP benchmark	1.91	0.10	0.98	0.38
HR costs as a percentage of total operating costs				
GDNs benchmark	0.80	-	0.30	0.07
Saratoga benchmark	1.87	0.08	0.92	0.36

Source: LECG analysis.

Conclusions

- 9.19 Ofgem expects the GDNs to achieve the benchmarks set by the other GDNs. Where an external benchmark presents a more challenging efficiency target, and where it is comparable to the GDN, Ofgem expects the GDNs to be able to reach the third party benchmarks. For HR costs, the GDN comparison benchmark is less binding than the external benchmark in both the low and high savings scenarios.
- 9.20 During our updated work, we have considered whether our phase 1 methodology was appropriate. We have found no reason to change our general methodology or our approach to benchmarking HR costs. In line with our Phase 1 Report, therefore, we continue to adopt the GBP benchmarking comparison to estimate efficiency savings relating to adjusted HR costs⁸⁶.
- 9.21 Our conclusions under the low savings scenario are shown in the table below.

⁸⁶ One GDN noted that relative efficiency could be affected by annual variations in revenue. We note that the revenue based benchmark records similar figures to the cost based metrics. Hence we do not believe that our analysis is significantly affected by seasonal changes.

Table 108: LECG conclusions – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Adjusted 2006/07 HR costs	13.11	1.04	1.98	1.10
Less non-benchmarked adjusted 2006/07 HR costs	(9.49)	(0.50)	(0.04)	(0.26)
Benchmarked adjusted 2006/07 HR costs	3.62	0.54	1.94	0.84
LECG conclusion	2.81	0.54	1.57	0.76
Implied efficiency savings	0.81	-	0.37	0.08

Source: LECG analysis.

9.22 Our conclusions under the high savings scenario are shown in the table below.

Table 109: LECG conclusions – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Adjusted 2006/07 HR costs	13.11	1.04	1.98	1.10
Less non-benchmarked adjusted 2006/07 HR costs	(9.49)	(0.50)	(0.04)	(0.26)
Benchmarked adjusted 2006/07 HR costs	3.62	0.54	1.94	0.84
LECG conclusion	1.71	0.43	0.95	0.46
Implied efficiency savings	1.91	0.10	0.98	0.38

Source: LECG analysis.

9.23 We have compared the above LECG conclusions against our conclusions in our Phase 1 Reports. The results of the comparison, under the low savings scenario are summarised below:

Table 110: Comparison of LECG conclusions – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Phase 1 efficiency savings	1.77	0.02	1.55	-
Phase 2 efficiency savings	0.81	-	0.37	0.08
Movement	(0.96)	(0.02)	(1.18)	0.08

Source: LECG analysis.

- 9.24 The results of the comparison, under the high savings scenario are summarised below.

Table 111: Comparison of LECG conclusions – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Phase 1 efficiency savings	2.96	0.32	2.20	0.28
Phase 2 efficiency savings	1.91	0.10	0.98	0.38
Movement	(1.05)	(0.23)	(1.22)	0.10

Source: LECG analysis.

- 9.25 In Phase 1, WWU was the least inefficient GDN, followed NGN, NGGD and SGN, respectively. In Phase 2, NGN is the least inefficient GDN, followed by WWU, SGN and NGGD, respectively. Our analysis shows that NGN has become the most efficient GDN based on adjusted HR costs, ahead of WWU, however the movement in efficiencies is not significant. Suggested efficiencies for both NGGD and SGN have fallen significantly from Phase 1 to Phase 2, when compared against the same external benchmark. This is because the adjusted HR cost for both GDNs has been reduced in the update figures, as explained from paragraph 9.4.
- 9.26 Non-benchmarked costs have stayed broadly similar for the GDNs between the October 2006 BPQ and the June 2007 update, apart from NGGD's learning and development budget, which the GDN has reduced by £1.10m, made after our Phase 1 conclusions.

10 Legal

Introduction

10.1 In this section, we set out our findings in relation to controllable legal costs. We summarise the normalisation adjustments we have made. We compare legal costs in the October 2006 BPQ submission to the June 2007 update figures. We benchmark legal costs in 2006/07 and provide a summary of our conclusions.

Normalisation adjustments

10.2 The activities performed within the legal function are detailed in our Phase 1 Reports. The table below provides a summary of controllable legal costs and the adjustments made to ensure cost comparability across GDNs. We provide a more detailed breakdown of updated legal costs and normalisation adjustments in Appendix 10.

Table 112: Controllable legal costs and normalisation adjustments

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Legal costs supplied by the GDNs	1.67	0.52	0.51	0.60
LECG normalisation adjustments	0.09	0.17	0.46	0.00
Adjusted legal costs	1.76	0.69	0.96	0.60

Source: All GDNs. June 2007 update Table A1, B2.1, B2.2. LECG analysis.

10.3 In addition to the Ofgem accounting adjustments, we have adjusted the data provided by NGGD to add back the £0.1m one off decrease in legal costs due to higher de minimis margins, as discussed in paragraph 3.6.

10.4 In addition to the Ofgem inflation adjustment, we have adjust the data provided by NGN to reclassify insurance claims processing costs, corporate and corporate finance costs, and pension costs from legal to other cost categories. These adjustments are discussed in more detail in our Phase 1 Report.

10.5 We have also added back a one off decrease in legal costs due to a lower level of UNC modification legal work in 2006/07 and the delay of Interruption and Exit reform⁸⁷.

⁸⁷ NGN. Response to question LE-NGN-102.

10.6 In addition to the Ofgem accounting adjustments, we have adjusted SGN's legal costs to added back one off decreases in legal costs due to i) a delay in the recruitment of an additional solicitor; ii) the credit from the over-accrual in the previous period⁸⁸; and iii) a lower level of legal costs relating to energy & regulation matter, and on general commercial issues, than the long term average⁸⁹.

10.7 With the exception of the Ofgem accounting adjustments, we did not need to adjust the legal costs submitted by WWU, as WWU has adjusted the data based on the analysis contained in our Phase 1 Report.

Comparison of submissions

10.8 We have compared the updated figures, as provided by the GDNs, to controllable legal costs provided in the October 2006 BPQ submission. The comparison, which is set out in the table below, is performed after LECG cost adjustments, to ensure comparability across GDNs.

Table 113: Differences in 2006/07 legal costs

2005/06 prices	NGGD	NGN	SGN	WWU
October 2006 BPQ (£m)	1.96	0.85	0.99	0.67
June 2007 update (£m)	1.76	0.69	0.96	0.60
Difference (£m)	(0.20)	(0.16)	(0.03)	(0.07)
% difference	(10.2%)	(19.1%)	(2.7%)	(10.0%)

Source: LECG analysis.

10.9 For NGGD, adjusted legal costs in 2006/07 decreased from £1.96m to £1.76m. The movement is due to the removal of non-formula activities costs from controllable legal costs as discussed in paragraph 3.10 above⁹⁰.

10.10 For NGN, adjusted legal costs in 2006/07 decreased from £0.85m to £0.69m. This is primarily due to the cost savings from an increase in the proportion of legal work carried out in house following the recruitment of the second solicitor⁹¹.

⁸⁸ SGN. Responses to LE-SGN-129, LE-SGN-142 and LE-SGN-144.

⁸⁹ SGN. Response to LE-SGN-148.

⁹⁰ NGGD. Response to LE-NGG-159.

⁹¹ NGN. Responses to LE-NGN-087 and LE-SGN-102.

- 10.11 For SGN, adjusted legal costs in 2006/07 decreased from £0.99m to £0.96m. This is not material for further investigation.
- 10.12 For WWU, adjusted 2006/07 legal costs decreased from £0.67m to £0.60m. The change is driven by net savings generated by using internal legal staff rather than external legal services⁹².
- 10.13 Our work above did not constitute an audit of cost movements between the October 2006 BPQ submission and the June 2007 update. In reviewing cost movements, we have considered the nature of differences, their materiality and the directional impact they have on the efficiency analysis. Based on these criteria, we have adjusted the legal costs submitted by the GDNs, as discussed above. Ofgem has reviewed the June 2007 update, and, at this stage, has accepted the data contained in the update.

Benchmarking analysis

- 10.14 The table below summarises the data we have used in calculating the legal costs benchmarking metrics.

Table 114: Data used in the LECG benchmarking exercise

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Revenue	1,063.1	250.3	556.1	221.2
LECG adjusted revenue	1,004.9	253.9	561.3	270.5
Adjusted legal costs	1.76	0.69	0.96	0.60

Source: All GDNs. June 2007 update, Table A1, B2.1. LECG analysis.

- 10.15 In our Phase 1 Report, our benchmarking analysis used i) the legal costs as a percentage of revenue metric; and ii) the legal costs per FTE metric. The analysis we have undertaken in selecting these benchmarking metrics is set out in our Phase 1 Report. We decided not to use the legal costs per FTE benchmarking metric, as this is subject to distorting factors. For that reason, we do not repeat the FTE based analysis here.
- 10.16 We have benchmarked cost metrics across the GDNs and against an independent study, using the information contained in the June 2007 update.

⁹² WWU. Response to LE-WWU-123.

The table below summarises the GDNs' 2006/07 metrics that were used in our benchmarking analysis.

Table 115: GDNs legal costs benchmarking metrics

	NGGD	NGN	SGN	WWU
Legal costs as a percentage of revenue	0.18%	0.27%	0.17%	0.22%

Source: All GDNs. June 2007 update, Table A1, B2.1. LECG analysis.

- 10.17 The table below provides the GDN and third party benchmarks that we have used. As before, GDNs benchmarks are based on median and the top quartile performance. The third party benchmarks we considered and used were also summarised in our Phase 1 Reports. We have based our low savings and high savings benchmarks on the WCCFO study's median and top quartile data points.

Table 116: GDNs and third party benchmarks

	Low savings	High savings
GDNs benchmark - legal costs as a percentage of revenue	0.20%	0.17%
Third party benchmark (WCCFO) - legal costs as a percentage of revenue	0.58%	0.46%

Source: LECG analysis. WCCFO.

- 10.18 We have compared the GDNs' metrics against the benchmarks above. The table below summarises each GDN's performance, in terms of an efficiency score, under the low savings scenario.

Table 117: GDNs performance (efficiency scores) – low savings scenario

	NGGD	NGN	SGN	WWU
GDNs benchmarking - legal costs as a percentage of revenue	1.14	0.74	1.15	0.89
Third party benchmarking (WCCFO) - legal costs as a percentage of revenue	3.31	2.15	3.34	2.60

Source: LECG analysis.

- 10.19 The table below summarises each GDN's performance, in terms of an efficiency score, under the high savings scenario.

Table 118: GDNs performance (efficiency scores) – high savings scenario

	NGGD	NGN	SGN	WWU
GDNs benchmarking - legal costs as a percentage of revenue	1.00	0.65	1.01	0.78
Third party benchmarking (WCCFO) - legal costs as a percentage of revenue	2.63	1.70	2.65	2.06

Source: LECG analysis.

- 10.20 We have calculated the implied efficiency savings by applying the efficiency scores to each GDN's legal costs. The table below summarises the implied efficiency savings under the low savings scenarios.

Table 119: Implied efficiency savings – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
GDNs benchmarking - legal costs as a percentage of revenue	-	0.18	-	0.06
Third party benchmarking (WCCFO) - legal costs as a percentage of revenue	-	-	-	-

Source: LECG analysis.

- 10.21 The table below summarises the implied efficiency savings under the high savings scenarios.

Table 120: Implied efficiency savings – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
GDNs benchmarking - legal costs as a percentage of revenue	0.00	0.24	-	0.13
Third party benchmarking (WCCFO) - legal costs as a percentage of revenue	-	-	-	-

Source: LECG analysis.

Conclusions

- 10.22 Ofgem expects the GDNs to achieve the benchmarks set by the other GDNs. Where an external benchmark presents a more challenging efficiency target, and where it is comparable to the GDN, Ofgem expects the GDNs to be able to reach the third party benchmarks. For legal costs, the GDN comparison benchmark is

more binding than the external benchmark in both the low and high savings scenarios.

10.23 During our updated work, we have considered whether our Phase 1 methodology was appropriate. We have found no reason to change our general methodology and our approach to benchmarking legal costs. In line with our Phase 1 Reports, therefore, we continue to adopt the GDN benchmarking comparison to estimate efficiency savings relating to adjusted legal costs.

10.24 Our conclusions under the low savings scenario are shown in the table below.

Table 121: LECG conclusions – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Adjusted 2006/07 legal costs	1.76	0.69	0.96	0.60
LECG conclusion	1.76	0.51	0.96	0.54
Implied efficiency savings	-	0.18	-	0.06

Source: LECG analysis.

10.25 Our conclusions under the high savings scenario are shown in the table below.

Table 122: LECG conclusions – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Adjusted 2006/07 legal costs	1.76	0.69	0.96	0.60
LECG conclusion	1.76	0.44	0.96	0.47
Implied efficiency savings	-	0.24	-	0.13

Source: LECG analysis.

10.26 We have compared the above LECG conclusions against our conclusions in our Phase 1 Reports. The results of the comparison, under the low savings scenario, are summarised below.

10.27 Our analysis shows that efficiency order has not changed.⁹³ The level of savings for NGGD, NGN and WWU has decreased. This is primarily due to a reduction of the GDNs' 2006/07 legal costs, as discussed in paragraph 10.10 to 10.12 above.

⁹³ Efficiency order is determined by efficiency scores.

Table 123: Comparison LECG conclusions – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Phase 1 efficiency savings	-	0.28	-	0.08
Phase 2 efficiency savings	-	0.18	-	0.06
Movement	-	(0.10)	-	(0.02)

Source: LECG analysis.

10.28 The results of the comparison, under the high savings scenario, are summarised below.

Table 124: Comparison LECG conclusions – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Phase 1 efficiency savings	0.04	0.37	-	0.18
Phase 2 efficiency savings	0.00	0.24	-	0.13
Movement	(0.04)	(0.13)	-	(0.05)

Source: LECG analysis.

10.29 Our analysis shows that efficiency order has not changed⁹⁴. The level of savings for NGGD, NGN and WWU has decreased. This is primarily due to a reduction of the GDNs' 2006/07 legal costs, as discussed in paragraph 10.10 to 10.12 above.

⁹⁴ Efficiency order is determined by efficiency scores.

11 Procurement and logistics

Introduction

11.1 In this section, we set out our findings in relation to controllable procurement and logistics (“L&P”) costs. We summarise the normalisation adjustments we have made. We compare L&P costs in the October 2006 BPQ submission to the June 2007 update figures. We benchmark L&P costs in 2006/07 and provide a summary of our conclusions.

Normalisation adjustments

11.2 The activities performed within the L&P function are detailed in our Phase 1 Reports. The table below provides a summary of controllable L&P costs and the adjustments that we have made to ensure cost comparability across GDNs. We provide a more detailed breakdown of updated L&P support costs and our adjustments in Appendix 11.

Table 125: Controllable L&P costs and normalisation adjustments

2005/06 prices, £m	NGGD	NGN	SGN	WWU
L&P costs supplied by the GDNs	5.02	0.45	1.40	1.54
LECG normalisation adjustments	0.05	0.41	0.01	0.20
Adjusted L&P costs	5.08	0.85	1.42	1.73

Source: All GDNs. June 2007 update Table B2.1. LECG analysis.

11.3 For NGGD, in addition to the Ofgem accounting adjustments, we have added back a £0.1m one off decrease in L&P costs relating to higher de minimis margins, as discussed in paragraph 3.6.

11.4 For NGN, in addition to the Ofgem inflation adjustments, we needed to reclassify L&P costs incurred by NRG2 from direct costs to L&P costs. This adjustment was discussed in our Phase 1 Report.

11.5 With the exception of Ofgem inflation adjustment, we did not need to adjust the L&P costs submitted by SGN, as it adjusted the June 2007 data based on the analysis contained in our Phase 1 Report.

- 11.6 For WWU, in addition to the Ofgem accounting adjustments, we needed to reclassify logistics costs incurred by Exel from direct opex to L&P costs to achieve consistency of L&P costs across the GDNs⁹⁵.

Comparison of submissions

- 11.7 We have compared the updated figures, as provided by the GDNs, to controllable L&P costs provided in the October 2006 BPQ submission. The comparison, which is set out in the table below, is performed after LECG cost adjustments, to ensure comparability across GDNs.

Table 126: Differences in 2006/07 L&P costs

2005/06 prices	NGGD	NGN	SGN	WWU
October 2006 BPQ (£m)	7.74	1.54	2.12	1.76
June 2007 update (£m)	5.08	0.85	1.42	1.73
Difference (£m)	(2.66)	(0.69)	(0.70)	(0.03)
% difference	(34.4%)	(44.8%)	(33.2%)	(1.5%)

Source: LECG analysis.

- 11.8 NGGD's adjusted 2006/07 L&P costs decreased from £7.74m to £5.08m. The movement is due to the following factors:

- a reclassification of £█m relating to non-formula activities costs from L&P costs to non formula costs, as discussed in paragraph 3.10 above;
- in our Phase 1 Report, we reclassified £1.5m storage costs from repex to L&P costs. This adjustment is not required in this phase, as Ofgem has accepted NGGD's classification of the storage costs as repex⁹⁶; and
- underspend in comparison to forecast⁹⁷.

- 11.9 NGN's adjusted 2006/07 L&P costs decreased from £1.54m to £0.85m. This is due to the following factors:

- a £0.4m decrease in the procurement costs incurred by UUOL's commercial team. NGN explained that prior to October 2006, it did not

⁹⁵ WWU. Response to LE-WWU-135.

⁹⁶ Discussion with Ofgem.

⁹⁷ NGGD. Response to LE-NGG-163.

record the UUOL commercial team costs relating to procurement activities. The costs in its October 2006 submission therefore represented the costs incurred by the whole of the UUOL commercial team, rather than the costs relating specifically to procurement activities. Subsequent to its October 2006 submission, NGN has revisited the UUOL commercial team costs, and arrived at a more precise measurement of the procurement costs incurred by UUOL's commercial team⁹⁸; and

- a £0.3m decrease in the logistics costs incurred by NRG2. We have requested but NGN has not explained this movement in adequate detail⁹⁹. Due to Ofgem's deadlines for completing this report, we have not made any adjustment in relation to these unexplained cost differences. Ofgem may wish to consider this cost movement further prior to making its final determinations.

11.10 SGN's adjusted 2006/07 L&P costs decreased from £2.12m to £1.42m. This is due to the following factors:

- a £0.17m reduction of MSA umbrella recharges due to a change in the activities delivered under the MSA¹⁰⁰; and
- a £0.4m recharge from L&P costs to non-regulated activities that was not included in the October 2006 BPQ submission. Ofgem has accepted this recharge in its review of accounting issues¹⁰¹.

11.11 WWU's adjusted 2006/07 L&P costs decreased from £1.76m to £1.73m. This movement is immaterial.

11.12 Our work above did not constitute an audit of cost movements between the October 2006 BPQ submission and the June 2007 update. In reviewing cost movements, we have considered the nature of differences, their materiality and the directional impact they have on the efficiency analysis. Based on these criteria, we have adjusted the L&P costs submitted by the GDNs, as discussed above. Ofgem has reviewed the June 2007 update, and, at this stage, has accepted the data contained in the update.

⁹⁸ NGN. Response to LE-NGN-097.

⁹⁹ Our request is included in LE-NGN-104.

¹⁰⁰ SGN. Response to LE-SGN-132.

¹⁰¹ Ofgem. "Review of Accounting Issues". August 2007.

Benchmarking analysis

- 11.13 The table below summarises the data we have used in calculating the L&P costs benchmarking metrics.

Table 127: Data used in the LECG benchmarking exercise

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Total opex	584.09	150.66	338.68	159.75
L&P costs	5.08	0.85	1.42	1.73

Source: All GDNs. June 2007 update, Table A1, B2.1, B2.2. WWU. LECG analysis.

- 11.14 Our benchmarking analysis is performed based on i) the L&P cost as a percentage of total operating costs; and ii) the logistics costs per kilometre pipeline metric. The analysis we have undertaken in selecting these benchmarking metrics is set out in our Phase 1 Report. We concluded that it was inappropriate to use the results of the separate benchmarking of procurement costs and logistics costs in calculating efficiency savings. This is because the results of these benchmarking analyses may not fully recognise the trade offs between procurement costs and logistics costs. In addition, efficiency at the sub-function level (e.g. an efficient procurement function) may not imply that the L&P function as a whole is efficient, as efficiency of one sub-function may be offset by inefficiencies in other sub-functions. We do not repeat the separate benchmarking of procurement costs and logistics costs here.
- 11.15 We have benchmarked cost metrics across the GDNs and against independent studies. The table below summarises the GDNs' 2006/07 metrics that were used in our benchmarking analysis.

Table 128: GDNs L&P costs benchmarking metrics

	NGGD	NGN	SGN	WWU
L&P costs as a percentage of total opex	0.87%	0.56%	0.42%	1.09%

Source: LECG analysis.

- 11.16 The table below provides the GDNs and third party benchmarks that we have used. As before, GDNs benchmarks are based on median and the top quartile performance. The third party benchmarks we considered and used were also

summarised in our Phase 1 Reports. We have adopted the results of Deloitte's analysis on UK electricity distributors as our L&P costs third party benchmark.

Table 129: GDNs and third party benchmarks

	Low savings	High savings
GDNs benchmark	0.72%	0.53%
Third party benchmark (Deloitte)	5.41%	4.71%

Source: LECG analysis. Deloitte.

- 11.17 We have compared the GDNs' metrics against the benchmarks above. The table below summarises each GDN's performance, in terms of an efficiency score, under the low savings scenario.

Table 130: GDNs performance (efficiency scores) – low savings scenario

	NGGD	NGN	SGN	WWU
GDNs benchmarking	0.82	1.27	1.71	0.66
Third party benchmarking (Deloitte)	6.22	9.59	12.93	4.98

Source: LECG analysis.

- 11.18 The table below summarises each GDN's performance, in terms of an efficiency score, under the high savings scenario.

Table 131: GDNs performance (efficiency scores) – high savings scenario

	NGGD	NGN	SGN	WWU
GDNs benchmarking	0.61	0.94	1.26	0.49
Third party benchmarking (Deloitte)	5.42	8.35	11.26	4.34

Source: LECG analysis.

- 11.19 We have calculated the implied efficiency savings by applying the efficiency scores to each GDN's L&P costs. The table below summarises the implied efficiency savings under the low savings scenarios.

Table 132: Implied efficiency savings– low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
GDNs benchmarking	0.89	-	-	0.59
Third party benchmarking (Deloitte)	-	-	-	-

Source: LECG analysis.

- 11.20 The table below summarises the implied efficiency savings under the high savings scenarios.

Table 133: Implied efficiency savings – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
GDNs benchmarking	1.99	0.05	-	0.89
Third party benchmarking (Deloitte)	-	-	-	-

Source: LECG analysis.

Conclusions

- 11.21 Ofgem expects the GDNs to achieve the benchmarks set by the other GDNs. Where an external benchmark presents a more challenging efficiency target, and where it is comparable to the GDN, Ofgem expects the GDNs to be able to reach the third party benchmarks. For L&P costs, the GDN comparison benchmark is more binding than the external benchmark in both the low and high savings scenarios.
- 11.22 During our updated work, we have considered whether our Phase 1 methodology was appropriate. We have found no reason to change our general methodology or our approach to benchmarking L&P costs. In line with our Phase 1 Reports, therefore, we continue to adopt the GDN benchmarking comparison to estimate efficiency savings relating to adjusted L&P costs.
- 11.23 Our conclusions under the low savings scenario are shown in the table below.

Table 134: LECG conclusions – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Adjusted 2006/07 L&P costs	5.08	0.85	1.42	1.73
LECG conclusion	4.19	0.85	1.42	1.14
Implied efficiency savings	0.89	-	-	0.59

Source: LECG analysis.

11.24 Our conclusions under the high savings scenario are shown in the table below.

Table 135: LECG conclusions – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Adjusted 2006/07 L&P costs	5.08	0.85	1.42	1.73
LECG conclusion	3.08	0.80	1.42	0.84
Implied efficiency savings	1.99	0.05	-	0.89

Source: LECG analysis.

11.25 We have compared the above LECG conclusions against our conclusions in our Phase 1 Reports. The results of the comparison, under the low savings scenario, are summarised below.

Table 136: Comparison LECG conclusions – low savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Phase 1 efficiency savings	1.79	-	-	0.10
Phase 2 efficiency savings	0.89	-	-	0.59
Movement	(0.90)	-	-	0.49

Source: LECG analysis.

11.26 The results of the comparison, under the high savings scenario, are summarised below.

Table 137: Comparison LECG conclusions – high savings scenario

2005/06 prices, £m	NGGD	NGN	SGN	WWU
Phase 1 efficiency savings	2.63	0.13	-	0.33
Phase 2 efficiency savings	1.99	0.05	-	0.89
Movement	(0.64)	(0.08)	-	0.56

Source: LECG analysis.

11.27 Our analysis shows that the efficiency order has not changed¹⁰². SGN remains the most efficient GDN, followed by NGN, NGGD and WWU¹⁰³. There are, however, changes to the efficiency savings, which can be summarised as follows:

- NGGD's efficiency savings have decreased significantly. This is because NGGD's actual L&P costs were significantly lower than forecast, due to the exclusion of non-formula activities costs and storage costs, as discussed in paragraph 11.8; and
- WWU's efficiency savings have increased. This is because in comparison to the data in the October 2006 BPQ submission, NGGD, NGN and SGN reported lower L&P costs in the June 2007 update. This leads to more challenging GDNs benchmarks.

¹⁰² Efficiency order is determined by efficiency scores.

¹⁰³ Efficiency order is determined by efficiency scores.

Appendix 1: Total support service costs normalisation adjustments

Introduction

A.1.1 In this appendix, we provide further details on the normalisation adjustments that we have made to total support service costs, to ensure consistency across GDNs.

NGGD

A.1.2 The table below summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 138: 2006/07 NGGD total support service costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Costs provided by NGGD	99.05
Add: Skills and competency costs (reclassified from work management to HR)	0.60
Add: One off decrease in IS costs due to extension of SGN FOMSA (IS support costs)	2.80
Less: Ofgem inflation adjustment	(0.06)
Add: one off cost decrease due to higher de minimis margins*	1.52
Add: deferred IS project costs (IS support costs)	1.80
Less: Ofgem FRS 17 adjustment	(0.85)
Add: One off underspend in audit costs	0.50
Adjusted costs	105.36

Source: NGGD. June 2007 update Table B2.1. LECG analysis. Note: *The adjustment for one off cost decrease due to higher de minimis margins was calculated by summing up the one off de minimis margin of the individual support services costs. This is different from the £1.4m that NGGD provided in LE-NGG-176 due to rounding. We have adopted the £1.52m figure to maintain consistent between the total support services costs section and individual costs benchmarking sections.

A.1.3 Further details of the Ofgem inflation adjustment are provided in paragraph 3.4. Further details of the adjustment to add back the one off cost decrease due to higher de minimis margins are provided in paragraph 3.6. Details of the other adjustments are provided in the individual benchmarking sections.

A.1.4 Our Phase 1 Report included an Ofgem adjustment to reclassify support services costs previously included in repex. These adjustments are not required in this

phase, as Ofgem has accepted the recharges that NGGD made from support service costs to repex.

NGN

A.1.5 The table below summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 139: 2006/07 NGN total support service costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Costs provided by NGN	16.98
Add: Logistics costs incurred by NRG2 (L&P costs)	0.40
Add: Ofgem inflation adjustment	0.19
Add: Ofgem adjustments to reclassify salary recharges from repex/capex (property management costs)	0.50
Add: One off decrease in uninsured claims costs	0.10
Add: One off decrease in legal costs relating to UNC modification work	0.10
Add: SOMSA property management costs	0.05
Add: One off decrease in legal costs due to delay of Interruption and Exit reform	0.20
Adjusted costs	18.52

Source: NGN. June 2007 update Table B2.1. LECG analysis.

A.1.6 Further details of the Ofgem inflation adjustment are provided in paragraph 3.4. Details of the other adjustments are provided in the individual benchmarking sections.

A.1.7 Our Phase 1 Report included the following additional adjustments, which have not been required in this report:

- removing FOMSA parallel running costs. NGN did not include FOMSA parallel running costs in the figures submitted in June 2007;
- adding procurement costs incurred by the UUOL commercial team. NGN has included the UUOL commercial team costs in the L&P costs submitted in June 2007; and

- Ofgem adjustments to reclassify non salary recharges. NGN did not make non salary recharges from support service costs to repex/capex in the cost figures submitted in June 2007.

SGN

A.1.8 The table below summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 140: 2006/07 SGN total support service costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Costs provided by SGN	35.52
Add: Ofgem inflation adjustment	0.37
Add: Ofgem adjustment to include repex recharges	0.49
Add: SOMSA property costs (property management costs)	0.25
Less: One off SOMSA extension costs (IS support costs)	(2.70)
Less: Reclassification of mobile phone costs from IS support costs to direct costs	(1.30)
Less: One off integration services costs	(0.60)
Less: Reclassification of wayleave costs from rental costs to direct costs	(0.16)
Less: Remove 2005/06 utility costs that were paid in 2006/07	(0.39)
Add: Decrease in legal costs due to a delay in the recruitment of an additional solicitor	0.05
Add: One off decrease in legal costs due the credit from the over-accrual in the previous period	0.20
Add: One off lower legal costs relating to energy & regulation matter, and also on general commercial issues	0.20
Less: 2005/06 additional charges for Dundee depot	(0.06)
Add: Reclassification of training costs to HR from work management	0.45
Adjusted costs	32.32

Source: SGN. June 2007 update Table B2.1. LECG analysis.

A.1.9 Further details of the Ofgem inflation adjustment are provided in paragraph 3.4. As discussed in paragraph 3.7, SGN made recharges from support services costs to repex/capex and to its non regulated businesses. Ofgem has made

adjustments to reclassify repex/capex recharges back to support service costs¹⁰⁴. These adjustments total £0.49m. Details of the other adjustments are provided in the individual benchmarking sections.

A.1.10 Our Phase 1 Report included the following additional adjustments, which have not been required in this report:

- reclassification of a portion of umbrella MSA charges and executive team costs from C&C costs to direct costs. SGN incorporated the adjustment in the costs figures that it submitted in June 2007;
- reclassification of wayleave costs from property management costs to direct costs. SGN did not include wayleave costs in the property management costs figure that it submitted in June 2007; and
- reclassification of £9.8m NSA charges from other support activities costs to direct costs. SGN did not include the NSA charged in the support service costs that it submitted in June 2007.

WWU

A.1.11 The table below summarises the normalisation adjustments required to ensure consistency across GDNs.

¹⁰⁴ Ofgem. "Review of Accounting Issues". August 2007.

Table 141: 2006/07 WWU total support service costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Costs provided by WWU	24.21
Less: FOMSA parallel running costs (IS support costs)	(1.04)
Less: Ofgem adjustment to remove disallowed one off executive recruitment costs (FAR costs)	(0.17)
Add: Ofgem adjustment to reclassify repex/capex recharges	0.11
Less: Occupational health to SHEs (HR costs)	(0.12)
Less: reclassification of travel costs (C&C costs)	(0.20)
Add: One off decrease in IT lease costs (IS support costs)	0.50
Add: Reclassification of logistics costs incurred by Exel (L&P costs)	0.20
Add: Ofgem inflation adjustment	0.27
Less: Ofgem FRS 17 adjustment	(0.12)
Adjusted costs	23.65

Source: WWU. June 2007 update Table B2.1.

- A.1.12 Further details of the Ofgem inflation adjustment are provided in paragraph 3.4. WWU made recharges from support services costs to repex/capex. Ofgem has made adjustments to reclassify repex/capex recharges back to support service costs.¹⁰⁵ These adjustments total £0.11m. Details of the other adjustments are provided in the individual benchmarking sections.

¹⁰⁵ Ofgem. "Review of Accounting Issues". August 2007.

Appendix 2: IS support costs breakdown and normalisation adjustments

Introduction

A.2.1 In this appendix we provide breakdowns of the GDNs' 2006/07 IS support costs. We summarise our normalisation adjustments, which were made to the 2006/07 IS costs figures in the June 2007 updates, and compare these normalisation adjustments to the adjustments that we made in our Phase 1 Reports.

NGGD

A.2.2 NGGD has confirmed that its IS support function performed the following activities:

- help desk;
- data centre;
- application support;
- non-operational telecoms;
- establishing and managing IS applications;
- establishing and managing infrastructure projects;
- assessing IS investment; and
- payments to third party outsourcing services providers for performing the above activities.

A.2.3 NGGD has not provided a breakdown of IS support costs. The table below summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 142: Total 2006/07 NGGD IS support costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Total costs provided by NGGD	22.20
Add: one off decrease in IS costs due to extension of SGN FOMSA	2.80
Add: deferred IS project costs	1.80
Add: one off cost decrease due to a higher level of de minimis activities	0.10
Less: Ofgem inflation adjustment	(0.01)
Less: Ofgem FRS 17 adjustment	(0.19)
Add: reclassification of SAP support costs from finance costs	1.90
Adjusted costs	28.60

Source: NGGD. June 2007 update Table B2.2.

A.2.4 In addition to the Ofgem inflation and the Ofgem FRS 17 adjustment, we have normalised for the following:

- add back a £2.8m one off decrease in IS support costs due to SGN FOMSA extension. In producing its October 2006 submission, NGGD expected that the SGN FOMSA would terminate in November 2006. This assumption was used in estimating the 2006/07 FOMSA revenue, which is offset against IS support costs. SGN has subsequently extended the FOMSA from November 2006 to April 2007.¹⁰⁶ This leads to a one off increase in revenue from FOMSA, and a one off decrease in IS support costs;
- add back a £1.8m deferred project IS costs to 2006/07 IS support costs. Certain IS opex projects included in its October 2006 submission were deferred due to SGN FOMSA extension, as discussed above. The cost reduction in 2006/07 will be compensated by an increase in the future. We have adopted the average 2005/06 to 2012/13 IS support costs in our benchmarking analysis, and the change in the timing of IS project costs would not affect benchmarked IS costs. Since NGGD has not updated its IS support costs forecast, we have added back the £1.8m deferred project

¹⁰⁶ NGG. Response to question LE-NGG-158.

IS costs in calculating the average IS support costs for the period 2005/06 to 2012/13;

- add back a £0.1m one off decrease in IS support costs due to a higher level of de minimis activities. Further details of these adjustments are provided in paragraph 3.6; and
- reclassification £1.9m SAP support costs from finance costs to IS support costs. This is to achieve consistency across the GDNs.

A.2.5 We have not proposed any further normalisation adjustment to NGGD's IS support costs in this phase. Our Phase 1 report included an adjustment to remove the margin of de minimis activities from regulated controllable IS support costs. This adjustment is not required in this phase, as the margins have already been removed from the controllable IS support costs that NGGD submitted in June 2007.

NGN

A.2.6 The table below provides a breakdown of NGN's 2006/07 IS support costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 143: Total 2006/07 NGN IS support costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Help desk	0.10
Data centre*	0.00
Application support	0.20
Non-operational telecoms	0.50
Establishing and managing IS applications	0.20
Establishing and managing infrastructure projects	0.05
Assessing IS investment	0.60
FOMSA payment	2.70
UUOL IS support costs	1.60
Payments to other third party outsourcing services	1.00
Total costs provided by NGN	6.94
Add: Ofgem inflation adjustment	0.08
Adjusted costs	7.02

Source: NGN. June 2007 update Table B2.2. Note: * These costs were reported to be immaterial.

A.2.7 With the exception of the Ofgem inflation adjustment, as discussed in paragraph 3.4, no further normalisation adjustment to NGN's IS support costs was required in this phase. Our Phase 1 Report included the following normalisation adjustments, which have not been required in this report:

- adjustment to remove FOMSA parallel running costs. These costs have not been included in the IS support costs that NGN submitted in June 2007¹⁰⁷; and
- reclassification of non salary recharges previously capitalised. NGN has not capitalised any IS support costs in the data that it submitted in June 2007.

¹⁰⁷ NGN. Response to question LE-NGN-085.

SGN

A.2.8 The table below provides a breakdown of SGN's IS support costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 144: 2006/07 SGN IS support costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Help desk	0.44
Data centre & Application Support	8.91
Communications (voice and data)	6.40
Executive team costs	0.20
Establishing and managing IS applications	0.60
Establishing and managing infrastructure projects	0.38
Total costs provided by SGN (as per Table B2.1)	16.67
Add: Ofgem inflation adjustment	0.17
Less: One off SOMSA extension costs	(2.70)
Less: Reclassification of mobile phone costs to direct costs	(1.30)
Less: One off integration services costs	(0.60)
Adjusted costs	12.24

Source: SGN. June 2007 update Table B2.2.

A.2.9 In addition to the Ofgem inflation adjustments, as discussed in paragraph 3.4, we have made the following adjustments to SGN's IS support costs:

- removed £2.7m of additional costs due to the extension of SGN FOMSA from November 2006 to April 2007. This cost increase appears to be one off. As such, we have remove this cost increase when calculating our benchmarking metric;
- reclassify £1.3m mobile phone costs from IS support costs to direct costs. This is to ascertain consistency of cost classification across the GDNs¹⁰⁸; and

¹⁰⁸ SGN. Response to question LE-SGN-127.

- remove £0.6m one off increase in integration services costs. SGN stated that £0.6m of the increase in integration services between the October 2006 submission and the June 2007 update was due to an increase in integration services costs. SGN stated these services would not be required in the future. While SGN stated that some consultancy costs would be incurred in the future, it has not identified specific projects on which these consultancy costs would arise¹⁰⁹. We have discussed with Ofgem the treatment of forecasted costs that have not been designated for specific purposes. As agreed with Ofgem, these forecasted costs should be considered as an unsubstantiated general provision, and should be disallowed. We consider that these forecast consultancy costs represent an unsubstantiated general provision, and we have removed these costs for benchmarking purposes. This approach is in line with our Phase 1 Reports, and has been consistently applied across the GDNs¹¹⁰.

A.2.10 Our Phase 1 Report included adjustments to reclassify IS support costs' share of MSA umbrella charges and executive team costs from C&C costs to IS support costs. These adjustments are not required in this phase, as SGN has incorporated these costs in the IS support costs submitted in June 2007.

WWU

A.2.11 The table below provides a breakdown of WWU's IS support costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

¹⁰⁹ SGN. Response to question LE-SGN-145b.

¹¹⁰ SGN. Response to question LE-SGN-127.

Table 145: 2006/07 WWU IS support costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Establishing and managing IS applications and infrastructure projects, assessing IS investment	0.44
Help desk, data centre, desktop support, network support	1.93
Application support	1.16
Software/hardware maintenance and telecoms	2.20
FOMSA	0.99
FOMSA additional charge	1.04
Total costs provided by WWU	7.75
Less: Disallowed FOMSA additional charges	(1.04)
Add: One off decrease in IT lease costs	0.50
Add: Ofgem inflation adjustment	0.09
Less: Ofgem FRS 17 adjustment	(0.01)
Adjusted costs	7.29

Source: WWU. June 2007 update Table B2.2.

A.2.12 In addition to the Ofgem inflation adjustment and the Ofgem FRS 17 adjustment, as discussed in paragraph 3.4 and 3.5, the normalisation adjustments include the following:

- disallow FOMSA additional charges. This relates to an Ofgem accounting adjustment to remove the additional costs incurred due to the parallel running of FOMSA and the FOMSA replacement system¹¹¹. This adjustment is consistent with the adjustment in our Phase 1 Report, and the details of the adjustment were provided therein; and
- add back a one off decrease in IT lease costs. WWU stated that part of the decrease in IS support costs between the October 2006 submission and the June 2007 update was due to IT lease costs being £0.5m lower than forecast. WWU confirmed that the cost decrease is one off (i.e. the reduced use of IT leasing arrangement is limited to 2006/07 only), and that future IT lease costs are expected to return to their forecast level¹¹².

¹¹¹ Ofgem. "Gas distribution price control review: Review of accounting issues – WWU". 2007.

¹¹² WWU. Response to question LE-WWU-139.

A.2.13 No further normalisation adjustments were required. Our Phase 1 Report included the following normalisation adjustments that were not required in this phase:

- allocation of staff bonus previously classified under C&C costs. WWU has included a staff bonus in the IS support costs figure that it submitted in June 2007¹¹³; and
- reclassification of rent and salary recharges previously capitalised. WWU has not capitalised any IS support costs in the data that it submitted in June 2007¹¹⁴.

¹¹³ WWU. Response to question LE-WWU-124.

¹¹⁴ WWU. Table B2.1 June 2007 update.

Appendix 3: Forecast IS support costs and normalisation adjustments

Introduction

- A.3.1 In this appendix, we summarise the GDNs' forecasts of IS support costs, and summarise the normalisation adjustments that we have made to forecast costs.
- A.3.2 As discussed in paragraph 2.13, Ofgem did not request an update of indirect opex forecasts post 2006/07 from the GDNs. GDNs were only asked to provide updated forecasts if there was a material difference between revised forecast and original submissions. In calculating our IS support costs benchmarking metrics, we have adopted average IS support costs over the period of 2005/06 to 2012/13. We have therefore requested the GDNs to update their forecast IS support costs figures if they considered that the figures in the October 2006 submission were not valid for benchmarking purposes. Both SGN and WWU provided an update of their forecast IS support costs. The updated SGN and WWU IS support costs, and our normalisation adjustments, are provided below.

SGN

- A.3.3 SGN provided an update of its forecast IS support costs. We summarise the updated IS support costs and our adjustments to SGN's forecast in the table below.

Table 146: Forecast IS support costs and normalisation adjustments

2005/06 prices, £m	06/07	07/08	08/09	09/10	10/11	11/12	12/13
IS support costs provided by WWU	16.67	13.72	13.49	13.26	13.03	12.94	12.85
LECG adjustments	(4.43)	(1.51)	(1.01)	(1.01)	(1.01)	(1.02)	(1.01)
Adjusted IS support costs	12.24	12.21	12.48	12.25	12.02	11.92	11.84

Source: SGN. Response to question LE-SGN-145b, LE-SGN-146 and LE-SGN-147. LECG analysis.

- A.3.4 In addition to the normalisation adjustments that we made in our Phase 1 Report, which primarily related to the reclassification of £0.5m to £1.3m per annum IT lease costs from direct costs to IS support costs, we have made the following normalisation adjustments to SGN's forecast IS support costs:

- reclassify £1.3m mobile communication costs from IS support costs to direct costs; and
- remove £0.6m unsubstantiated general provision of consultancy costs.

A.3.5 These adjustments are consistent with the adjustments that we have made to SGN's 2006/07 actual IS support costs. Further details of these adjustments are provided in Appendix 2.

A.3.6 We have recalculated the SGN forecast total IS costs based on its updated IS support costs and its IS capex, as included in the October 2006 submission. The table below summarises our calculation.

Table 147: SGN forecast adjusted total IS costs

2005/06 prices, £m	06/07	07/08	08/09	09/10	10/11	11/12	12/13
Adjusted IS support	12.24	12.21	12.48	12.25	12.02	11.92	11.84
IS capex	24.61	16.15	17.10	9.30	1.30	2.80	1.30
Total IS costs	36.85	28.36	29.58	21.55	13.32	14.72	13.14

Source: SGN. June 2007 update. Table B2.1, C5. LECG analysis.

WWU

A.3.7 WWU provided an update of its forecast IS support costs. We summarise updated IS support costs and our adjustments to WWU's forecast in the table below.

Table 148: Forecast IS support costs and normalisation adjustments

2005/06 prices, £m	06/07	07/08	08/09	09/10	10/11	11/12	12/13
IS support costs provided by WWU	7.75	6.64	6.65	6.85	7.01	7.02	6.98
LECG adjustments	(0.46)	1.38	1.38	1.38	1.38	0.88	0.08
Adjusted IS support costs	7.29	8.02	8.03	8.23	8.39	7.90	7.06

Source: WWU. Response to question LE-WWU-122. LECG analysis.

A.3.8 Our adjustments to WWU's forecast relate primarily to the reclassification of IT lease costs from direct costs to IS support costs. WWU has not made any changes to the IT leasing arrangement and IT lease costs from its October 2006

BPQ submission¹¹⁵. Our normalisation adjustments are consistent with the adjustments that we made in our Phase 1 Report, and the details of the adjustments are provided therein.

A.3.9 We have recalculated the WWU forecast total IS costs based on its updated IS support costs and its IS capex, as included in the October 2006 submission. The table below summarises our calculation.

Table 149: WWU forecast adjusted total IS costs

2005/06 prices, £m	06/07	07/08	08/09	09/10	10/11	11/12	12/13
Adjusted IS support	7.29	8.02	8.03	8.23	8.39	7.90	7.06
IS capex	13.22	3.07	3.07	3.07	3.07	9.87	9.87
Total IS costs	20.51	11.09	11.10	11.30	11.46	17.76	16.92

Source: WWU. June 2007 update. Table B2.1, C5. LECG analysis.

¹¹⁵ WWU. Response to question LE-WWU-139.

Appendix 4: FAR costs breakdown and normalisation adjustments

Introduction

A.4.1 In this appendix we provide a breakdown of each GDN's 2006/07 FAR support costs. We summarise our normalisation adjustments, which were made to the 2006/07 FAR costs figures in the June 2007 updates, and compare these normalisation adjustments to the adjustments that we made in our Phase 1 Reports.

NGGD

A.4.2 NGGD has confirmed that its FAR function performed the following activities:

- financial management (e.g. payments, credit & risk);
- financial reporting;
- management of UK business licences;
- group finance;
- tax;
- regulation, compliance and regulatory reporting;
- internal audit and related assurance activities; and
- payments to third party outsourcing services providers.

A.4.3 NGGD has not provided a breakdown of FAR activity costs. The table below summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 150: Total 2006/07 NGGD FAR costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Total costs provided by NGGD	12.30
Add: payroll processing from HR	0.25
Add: one off underspend	0.50
Add: one off cost decrease due to a higher level of de minimis activities	0.19
Less: SAP support costs to IS	(1.90)
Less: Ofgem inflation adjustment	(0.01)
Less: Ofgem FRS17 adjustment	(0.11)
Adjusted costs	11.23

Source: NGGD. June 2007 update Table B2.2. Responses to LE-NGG-147, LE-NGG-148, LE-NGG-155 and LE-NGG-175; response to first draft, Phase 2 report. Ofgem.

A.4.4 We have moved payroll processing costs from HR to FAR; we have included £0.50m of underspent budget, which was removed from 2006/07 as a one off reduced allocation of cost for that year¹¹⁶; we have added back the increase in de minimis margin, which NGGD had been reallocated to direct operating costs¹¹⁷; we have reclassified SAP support costs to IS¹¹⁸; we have adjusted for actual inflation; and we have adjusted for changes to FRS17. We have made these adjustments to ensure consistency with Ofgem's policies and between FAR costs across the GDNs and against external benchmarks. Where applicable, these adjustments are consistent with the adjustments that we made in our Phase 1 Report, and are explained in more detail therein.

A.4.5 Our Phase 1 Report included the following normalisation adjustments, which have not been required in this report:

- adjustment to remove de minimis margins from regulated controllable FAR costs. NGGD's updated margins have been removed from the controllable FAR costs submitted in June 2007;

¹¹⁶ NGGD claims "underspend to forecast" of £0.50m for F&A costs. NGGD explains this in terms of a one off reduction in costs allocated to gas distribution from internal audit, which spent a greater amount of effort on transmission issues during 2006/07. NGGD further claims that this underspend "will not impact on future years". Response to LE-NGG-175.

¹¹⁷ NGGD. Responses to LE-NGG-147 and LE-NGG-148.

¹¹⁸ NGGD. Response to first draft, Phase 2 report.

- reclassification of group level tax costs, internal audit costs and finance costs from the other support service cost categories to FAR. NGGD has included these costs in the FAR costs submitted in June 2007; and
- we excluded Distribution Support Directorate front office F&A costs from our Phase 1 benchmarking. NGGD has classified these costs as direct operating cost in the June 2007 update.

NGN

A.4.6 The table below provides a breakdown of NGN's FAR costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 151: Total 2006/07 NGN FAR costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Internal audit and related assurance activities	0.04
Financial management	0.70
Financial reporting	0.60
Regulation	0.18
Management of UK business licences	0.18
Shrinkage gas purchase	0.05
Payments to third party outsourcing services providers	0.50
Total costs provided by NGN	2.24
Add: payroll processing reclassified from HR	0.10
Add: tax reclassified from corporate centre and communication	0.20
Add: inflation adjustment	0.03
Adjusted costs	2.57

Source: NGN. June 2007 update Table B2.2. Ofgem.

A.4.7 We have made adjustments to reclassify payroll processing costs from HR to FAR, and tax costs from C&C to FAR¹¹⁹; and we have also adjusted for actual inflation consistent with Ofgem's policy decision. We have made these adjustments to ensure consistency with Ofgem's policies and between FAR costs across the GDNs and against external benchmarks. Where applicable, these

¹¹⁹ NGN. June 2007 update Table B2.2.

adjustments are consistent with the adjustments made in our Phase 1 Report, and are explained in more detail therein.

A.4.8 Our Phase 1 Report include the following normalisation adjustments, which have not been required in this report:

- reclassification of treasury costs from FAR to C&C. NGN has included treasury costs in the C&C costs figure submitted in June 2007; and
- reclassification of salary and non-salary recharge capitalised (Ofgem findings). NGN did not make any recharge from FAR costs to repex/capex in this phase.

SGN

A.4.9 The table below provides a breakdown of SGN's FAR costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 152: 2006/07 SGN FAR costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Payroll	0.10
Tax	0.05
Internal audit and related assurance activities	0.07
Financial management	1.18
Financial reporting	0.15
Regulation and management of the UK business licenses	0.85
Payments to third party outsourcing providers for performing the above activities	0.82
Individual daily log (i.e. payroll) processing	0.28
General Managed Service Agreement	0.44
Executive Team costs	0.48
Total Charge to repex/non regulated business	(1.21)
Total costs provided by SGN	3.21
Add: Ofgem inflation adjustment	0.03
Adjusted costs	3.24

Source: SGN. June 2007 update Table B2.2.

A.4.10 In our Phase 2 analysis, we adjusted for actual inflation following certain Ofgem decisions. We have made this adjustment to ensure consistency with Ofgem's policies and between FAR costs across the GDNs and against external benchmarks.

A.4.11 Our Phase 1 Report included the following adjustments:

- reclassification of treasury costs from FAR to C&C, pension advisory costs from FAR to HR, and payroll processing costs from HR to FAR. These costs have been included in the appropriate cost categories in the data that SGN submitted in June 2007; and
- reclassification of FAR costs' share of the executive team costs and the MSA umbrella charges from C&C to FAR. A share of the executive team costs and the MSA umbrella charges have been included in the FAR costs figure submitted in June 2007.

WWU

A.4.12 The table below provides a breakdown of WWU's FAR costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 153: 2006/07 WWU FAR costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Financial management	1.03
Funding and Debt Management	0.02
Financial and management accounting	0.67
Internal audit and related assurance activities	0.03
Risk and compliance	0.04
Regulation	0.33
Management of UK business licences	0.07
Payments to third party outsourcing	1.69
Payroll	0.09
Total costs provided by WWU	3.99
Less: one-off executive recruitment costs	(0.17)
Less: Ofgem FRS17 adjustment	(0.05)
Add: Ofgem inflation adjustment	0.04
Adjusted costs	3.80

Source: WWU. June 2007 update Table B2.2. Ofgem.

A.4.13 We have removed one-off setup costs for executive recruitment, following Ofgem's policy on one-off costs; and we have adjusted for changes to FRS17 and for actual inflation following Ofgem's policy decisions. We have made these adjustments to ensure consistency with Ofgem's policies and between FAR costs across the GDNs and against external benchmarks. Where applicable, these adjustments are consistent with the adjustments made in our Phase 1 Report, and are explained in more detail therein.

A.4.14 Our Phase 1 Report included the following adjustments:

- reclassification of debt collection costs from FAR to legal, treasury costs from FAR to C&C, insurance costs from FAR to insurance, commercial strategy costs from FAR to C&C, and payroll costs from FAR to HR. These costs have been included in the correct appropriate cost categories in the data submitted in June 2007;

- allocation of FAR costs' share of staff bonus costs from C&C to FAR. Staff bonus costs have been allocated to the individual support service cost categories in the data submitted in June 2007; and
- reclassification of capitalised FAR costs from capex to FAR (Ofgem findings). Ofgem has not adjusted for these recharges in this phase.

Appendix 5: Insurance breakdown and normalisation adjustments

Introduction

A.5.1 In this appendix we provide a breakdown of each GDN's 2006/07 insurance costs. We summarise our normalisation adjustments, which were made to the 2006/07 insurance costs figures in the June 2007 updates, and compare these normalisation adjustments to the adjustments that were made in our Phase 1 Reports.

NGGD

A.5.2 The table below provides a breakdown of NGGD's insurance costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 154: Total 2006/07 NGGD insurance costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Insurance premium	10.20
Insurance contract negotiation and monitoring	0.10
Insurance claim processing	0.19
Risk management*	0.00
Uninsured claims costs	5.15
Total costs provided by NGG (as per B2.1 table)	15.64
Less: Ofgem inflation adjustment	(0.01)
Less: Ofgem FRS 17 adjustment	(0.13)
Adjusted costs	15.49

Source: NGGD. Response to question LE-NGG-156. Note: * These costs were reported to be immaterial.

A.5.3 With the exception of the Ofgem inflation and FRS 17 adjustment, as discussed in paragraph 3.4 and 3.5, no further normalisation adjustments were required. Our Phase 1 Report included the following adjustments, which have not been required in this report:

- an adjustment to reclassify group insurance costs from C&C costs to insurance costs. Group insurance costs have been included in the insurance cost data that NGGD submitted in June 2007¹²⁰; and
- an adjustment to remove the margins associated with de minimis activities from regulated controllable insurance costs. Margins have been removed from the controllable insurance costs supplied by NGGD.

NGN

A.5.4 The table below provides a breakdown of NGN's insurance costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 155: Total 2006/07 NGN insurance costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Insurance premium	2.10
Insurance contract negotiation and monitoring*	0.00
Insurance claim processing*	0.00
Risk management*	0.00
Payouts relating to uninsured claims and insurance claim processing	0.40
Total costs provided by NGN	2.51
Add: Insurance claim processing (reclassified from Legal)	0.10
Add: Ofgem inflation adjustment	0.03
Add: one off decrease in uninsured claims costs	0.10
Adjusted costs	2.74

Source: NGN. June 2007 update Table B2.2. Note: * These costs are reported to be immaterial.

A.5.5 In addition to the Ofgem inflation adjustment, as discussed in paragraph 3.4, we have reclassified £0.10m relating to insurance claim processing costs from legal costs to insurance costs¹²¹. This adjustment is required to ensure cost consistency across the GDNs. NGN stated that the actual 2006/07 uninsured claims costs was £0.1m lower than the long term average¹²². The lower

¹²⁰ NGGD. Response to question LE-NGG-146.

¹²¹ NGN. June 2007 update Table B2.2.

¹²² NGN. Response to question LE-NGN-101.

uninsured claims costs can therefore be considered as a one off. We have added back this difference in calculating the insurance costs benchmarking metrics (to account for the steady state level).

- A.5.6 Our Phase 1 Report included an adjustment to reclassify £0.7m non-salary recharges from repex/capex to insurance. This adjustment is no longer required, as there is no recharge from insurance to capex in the data submitted in June 2007.

SGN

- A.5.7 The table below provides a breakdown of SGN's insurance costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 156: Total 2006/07 SGN insurance costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Insurance premium	4.56
Insurance contract negotiation and monitoring	0.11
Insurance claim processing	0.37
Payouts relating to uninsured claims	0.64
Total Charge to repex/non regulated	(0.89)
Total costs provided by SGN	4.77
Add: Ofgem adjustments to reclassify recharges to repex	0.49
Add: Ofgem inflation adjustment	0.05
Adjusted costs	5.31

Source: SGN. June 2007 update Table B2.2.

- A.5.8 In addition to the Ofgem inflation adjustment, as discussed in paragraph 3.4, we have applied Ofgem's accounting adjustment to reclassify repex recharges. As discussed in paragraph 3.7, SGN has made recharges from support services costs to repex/capex and to its non regulated businesses. Ofgem has made adjustments to reclassify repex/capex recharges back to support service costs. The recharges that relate to insurance costs totalled £0.49m¹²³.

¹²³ Ofgem. "Gas distribution price control review: Review of accounting issues – SGN". 2007.

- A.5.9 We did not make any additional normalisation adjustment to SGN's insurance costs in our Phase 1 Report.

WWU

- A.5.10 The table below provides a breakdown of WWU's insurance costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 157: Total 2006/07 WWU insurance costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Insurance contract negotiation and monitoring	0.04
Insurance claim processing	0.03
Insurance premium	1.76
Payouts relating to uninsured claims	0.95
Total costs provided by WWU	2.77
Add: Ofgem inflation adjustment	0.03
Adjusted costs	2.80

Source: WWU. June 2007 update Table B2.2.

- A.5.11 With the exception of Ofgem inflation adjustment, as discussed in paragraph 3.4, no further adjustments to WWU's insurance costs were required. Our Phase 1 Report included an adjustment to reclassify £0.10m insurance contracting and claim handling costs from finance costs to insurance costs. This adjustment is not required in this phase, as WWU has now included these costs within insurance.

Appendix 6: Property management breakdown and normalisation adjustments

Introduction

- A.6.1 In this appendix we provide a breakdown of each GDN's 2006/07 property management costs. We summarise our normalisation adjustments we have made to the 2006/07 property management costs figures contained in the June 2007 updates, and compare these normalisation adjustments to the adjustments made in our Phase 1 Reports.

NGGD

- A.6.2 The table below provides a breakdown of NGGD's property management costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 158: Total 2006/07 NGGD property management costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Rent	4.96
Rates	1.04
Property maintenance	3.28
Utilities costs	2.48
Running costs	6.01
Property records and monitoring	2.00
Payments to third party	0.00
Property management costs provided by NGGD	19.94
Add: one off cost decrease due to a higher level of de minimis activities	0.90
Less: Ofgem inflation adjustment	(0.01)
Less: Ofgem FRS 17 adjustment	(0.17)
Adjusted property management costs	20.66

Source: NGGD. Response to question LE-NGG-167.

- A.6.3 In addition to the Ofgem inflation and FRS 17 adjustment, as discussed in paragraph 3.4 and 3.5, we have added back a £0.9m one off decrease in

property management costs due to a higher level of de minimis activities. Further details of this adjustment is provided in paragraph 3.6.

- A.6.4 No further normalisation adjustments were required to NGGD's property management costs. Our Phase 1 Report included an adjustment to remove margins associated with de minimis activities from regulated controllable opex. This adjustment is not required in this phase, as the margins have already been removed from the controllable property management costs submitted in June 2007.
- A.6.5 In our Phase 1 Report, we also adjusted the floor space information provided by NGGD to remove the other GDNs' share of NGGD's call centre and national system operation facilities. NGGD has made this adjustment in the floor space data that it supplied in June 2007¹²⁴.

NGN

- A.6.6 The table below provides a breakdown of NGN's property management costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

¹²⁴ NGGD. Response to question LE-NGG-169.

Table 159: Total 2006/07 NGN property management costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Rent	1.00
Property maintenance	0.30
Utilities costs, e.g. power, water, rates	0.30
Running costs, e.g. reception, security, cleaning, catering, mailroom	0.30
Maintenance of property records and monitoring of site usage*	0.00
Payments to other third party outsourcing services providers for performing the above activities	0.10
Non salary recharges	(0.50)
Total costs provided by NGN	1.61
Add Ofgem adjustment to include disallowed non-salary recharges	0.50
Add: Ofgem inflation adjustment	0.02
Add: Facilities management costs of SOMSA property	0.01
Add: Rental costs of SOMSA property	0.03
Add: Property rates of SOMSA property	0.01
Adjusted costs	2.18

Source: NGN. June 2007 update Table B2.2. Note: * These costs were reported to be immaterial.

A.6.7 In addition to the Ofgem inflation adjustment, as discussed in paragraph 3.4, we have made the following normalisation adjustments to NGN's property management costs:

- incorporate Ofgem's adjustment to add back disallowed recharges to repex/capex. These recharges relate to non-salary costs that NGN recharged from property management costs to repex/capex¹²⁵. This normalisation adjustment is consistent with the adjustment in our Phase 1 Report, and further details are provided therein; and
- added back the additional property management costs required in bringing the SOMSA replacement system in house. This is to ascertain the comparability of property management costs across the GDNs (i.e. the property management costs of all the GDNs include the costs of the

¹²⁵ Ofgem. "Gas distribution price control review: Review of accounting issues – NGN". 2007.

SOMSA property). These costs include property rates of £0.01m, facilities management costs of £0.03m and rental costs of £0.01m per annum¹²⁶.

SGN

A.6.8 The table below provides a breakdown of SGN's property management costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 160: 2006/07 SGN property management costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Rent	1.95
Property maintenance	1.51
Utilities costs, e.g. power, water, rates	2.52
Running costs, e.g. reception, security, cleaning, catering, mailroom	0.77
Maintenance of property records and monitoring of site usage*	0.00
Payments to third party outsourcing services providers for performing the above activities*	0.00
Total Charge to repex/non regulated business	(0.43)
Total costs provided by SGN (as per B2.1 Table)	6.30
Add: Facilities management costs of SOMSA property	0.17
Add: Property rates costs of SOMSA property	0.08
Add: Ofgem inflation adjustment	0.07
Less: Reclassification of wayleave costs from rental costs to direct costs	(0.16)
Less: Remove 2005/06 utility costs that were paid in 2006/07	(0.39)
Less: 2005/06 additional charges for Dundee depot	(0.06)
Adjusted costs	6.01

Source: SGN. June 2007 update Table B2.2. Note: * These costs were reported to be immaterial.

A.6.9 In addition to the Ofgem inflation adjustment, we have made the following normalisation adjustments to SGN's property management costs:

¹²⁶ NGN. Response to question LE-NGN-095.

- added back the additional property management costs required in bringing the SOMSA replacement system in house. This is to ascertain the comparability of property management costs across the GDNs (i.e. the property management costs of all the GDNs include the costs of the SOMSA property. These costs include property rates of £0.08m and facilities management costs of £0.17 per annum. The property will be owned by SGN and hence the rental costs will be nil¹²⁷;
- reclassify £0.16m wayleave costs from rental costs to direct costs;
- remove £0.39m 2005/06 utility costs that were paid in 2006/07, and were included in the 2006/07 property management in the June 2007 update¹²⁸; and
- remove £0.06m 2005/06 Dundee depot service charges that were paid in 2006/07, and were included in the 2006/07 property management in the June 2007 update.

WWU

A.6.10 The table below provides a breakdown of WWU's property management costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

¹²⁷ SGN. Response to question LE-SGN-140.

¹²⁸ SGN. Response to question LE-SGN-134 and LE-SGN-144b.

Table 161: 2006/07 WWU property management costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Rent & rates	0.93
Property maintenance	0.61
Utilities costs, e.g. gas, power, water, telephones	1.22
Running costs, e.g. reception, security, cleaning, catering, mailroom	0.56
Printing and stationery	0.61
Other property management	0.05
Payments to third parties	0.16
Total costs provided by WWU	4.14
Add: Ofgem adjustment to reclassify disallowed capex/repex recharges	0.11
Add: Ofgem inflation adjustment	0.05
Adjusted costs	4.30

Source: WWU. June 2007 update Table B2.2.

- A.6.11 In addition to the Ofgem inflation adjustment, we have incorporated Ofgem's adjustment to add back disallowed recharges to repex/capex¹²⁹. This adjustment is consistent with the adjustment made in our Phase 1 Report, and is discussed further therein.
- A.6.12 Our Phase 1 Report also included an adjustment to reclassify some facilities management costs from "other support activities" costs to property management costs. This adjustment is not required, as all facilities management costs have been included in the property management costs figures submitted in June 2007.

¹²⁹ Ofgem. "Gas distribution price control review: Review of accounting issues – WWU". 2007.

Appendix 7: Benchmarking of 2006/07 rental costs

Introduction

A.7.1 There are major movements in the rental costs and the floor space information that SGN and WWU provided in their October 2006 submissions and their June 2007 updates. This leads to changes in the GDNs' rental cost benchmarking metrics. In this appendix, we provide a breakdown of SGN and WWU's rental costs, and summarise the results of our benchmarking analysis.

SGN

A.7.2 We have compared property rents paid by SGN to market rent data prepared by GVA Grimley. The details of the GVA Grimley benchmarks were provided in our Phase 1 Report.

A.7.3 We have compared the rental costs of SGN's offices to the out of town office rental charges, and the rental costs of SGN's depots to the industrial rental charges, as provided in the GVA Grimley Survey. The table below details SGN's performance against the GVA Grimley benchmarks.

Table 162: SGN rental costs against third party regional benchmarks

SGN property	Region	Property type	Annual rent (£)	Area sq ft	Annual rent £/sq ft	GVA benchmark £/sq ft
Inchcolm House, Edinburgh	Scotland	Office	██████	██████	██	13.5 - 20.0
Kilbirnie Street, Glasgow	Scotland	Office	██████	██████	██	13.5 - 20.0
Burnbank Street, Coatbridge	Scotland	Depot	██████	██████	██	5.5 - 6.5
Cupar Rd, Strathden	Scotland	Depot	██████	█	██	5.5 - 6.5
Provan	Scotland	Site	██████	██████	██	5.5 - 6.5
Sighthill	Scotland	Depot	██████	██████	██	5.5 - 6.5
Kilmarnock	Scotland	Depot	██████	██████	██	5.5 - 6.5
Hillington	Scotland	Office	██████	██████	██	13.5 - 20.0

Thornton	Scotland	Depot	■	■	■	5.5 - 6.5
Elgin	Scotland	Depot	■	■	■	5.5 - 6.5
Bathgate	Scotland	Depot	■	■	■	5.5 - 6.5
Perth	Scotland	Depot	■	■	■	5.5 - 6.5
Aberdeen	Scotland	Depot	■	■	■	5.5 - 6.5
Falkirk	Scotland	Depot	■	■	■	5.5 - 6.5
Dundee	Scotland	Office	■	■	■	13.5 - 20.0
Inverness	Scotland	Office	■	■	■	13.5 - 20.0
Rothesay	Scotland	Depot	■	■	■	5.5 - 6.5
Dumfries	Scotland	Depot	■	■	■	5.5 - 6.5
Dunoon	Scotland	Depot	■	■	■	5.5 - 6.5
Dunfermline	Scotland	Depot	■	■	■	5.5 - 6.5
Training centre	Scotland	Depot	■	■	■	5.5 - 6.5
St Mary Cray	South East	Office	■	■	■	16.0 - 25.0
Epsom	South East	Depot	■	■	■	7.0 - 10.5
Brighton & Worthing	South East	Depot	■	■	■	7.0 - 10.5
Cowes	South East	Depot	■	■	■	7.0 - 10.5
Horsham	South East	Depot	■	■	■	7.0 - 10.5
Gillingham	South West	Depot	■	■	■	4.5 - 6.3
Fareham, Segensworth	South East	workshop	■	■	■	7.0 - 10.5
Bicester	South East	Depot	■	■	■	7.0 - 10.5
Herne Bay	South East	Depot	■	■	■	7.0 - 10.5
Southampton	South East	Depot	■	■	■	7.0 - 10.5

Aldershot	South East	Depot	████	████	██	7.0 - 10.5
Poole	South West	Depot	████	████	██	4.5 - 6.3
Bexhill	South East	Depot	████	████	██	7.0 - 10.5
Havant	South East	Depot	████	████	██	7.0 - 10.5
Crayford	South East	Depot	████	██	████	7.0 - 10.5
Malwood	South East	Office	████	████	████	16.0 - 25.0
Weymouth	South West	Depot	████	████	██	4.5 - 6.3
Worthing	South East	Depot	████	████	██	7.0 - 10.5
Ashford	South West	Depot	████	████	████	4.5 - 6.3
Dover	South East	Depot	████	██	████	7.0 - 10.5

Source: SGN. Response to LE-SGN-136. GVA Grimley Report. Note: A number of SGN properties have zero usable office floor space. These properties relate to sites or depots.

A.7.4 The property rents for the main SGN sites appear to be within the benchmark range of market rents provided by GVA Grimley. The three key SGN properties, measured by costs, (i.e. Inchcolm House, Kilbirnie Street and St Mary Cray) have a rental cost either at the low end of the range provided by GVA Grimley, or below the GVA Grimley benchmarks. Some of the smaller sites, however, appear to have rental cost levels in excess of the relevant market benchmarks. The rental costs efficiency savings, calculated based on the methodology described in paragraph 7.27 is approximately £0.29m per annum.

WWU

A.7.5 We have compared property rents paid by WWU to market rent data prepared by GVA Grimley. The details of the GVA Grimley benchmarks were provided in our Phase 1 Report.

A.7.6 We have compared the rental costs of WWU's offices to the out of town office rental charges, and the rental costs of WWU's depots to the industrial rental charges, as provided in the GVA Grimley Survey. The table below details WWU's performance against the GVA Grimley benchmarks.

Table 163: WWU rental costs against third party regional benchmarks

WWU property	Region	Property type	Annual rent (£)	Area sq ft	Annual rent £/sq ft	GVA benchmark £/sq ft
Celtic Spring	Wales	Office	██████	██████	██	11.5 - 15.0
Lambourne House	Wales	Office	██████	██████	██	11.5 - 15.0
Exeter	South West	Industrial	██████	██████	██	12.5 - 20.5
Wrexham	Wales	Industrial	██████	██████	██	3.4 - 5.1
Cheltenham	South West	Industrial	██████	██████	██	4.5 - 6.3
Swindon	South West	Industrial	██████	██████	██	4.5 - 6.3
Trowbridge	South West	Industrial	██████	██████	██	4.5 - 6.3
Barnstaple	South West	Industrial	██████	██████	██	4.5 - 6.3
Bridgewater	South West	Industrial	██████	██████	██	4.5 - 6.3
Glenfrome House	South West	Industrial	██████	██████	██	4.5 - 6.3
Flint	Wales	Industrial	██████	██████	██	3.4 - 5.1
Haverfordwest	Wales	Industrial	██████	██████	██	3.4 - 5.1
Llandarcy	Wales	Industrial	██████	██████	██	3.4 - 5.1
Pontypool	Wales	Industrial	██████	██████	██	3.4 - 5.1
Redruth Cornwall	South West	Industrial	██████	██████	██	4.5 - 6.3
Torquay	South West	Industrial	██████	██████	██	4.5 - 6.3
Plymouth	South West	Industrial	██████	██████	██	4.5 - 6.3
Bath	South West	Industrial	██████	██████	██	4.5 - 6.3
Colwyn Bay	Wales	Industrial	██████	██████	██	3.4 - 5.1
Evesham	South West	Industrial	██████	██████	██	4.5 - 6.3
Gloucester Ops	South West	Industrial	██████	██████	██	4.5 - 6.3

Merthyr	Wales	Industrial	■	■	■	3.4 - 5.1
Grangetown Cardiff	Wales	Industrial	■	■	■	3.4 - 5.1
St Austell	South West	Industrial	■	■	■	4.5 - 6.3
Caernarfon	Wales	Industrial	■	■	■	3.4 - 5.1
Beddau	Wales	Industrial	■	■	■	3.4 - 5.1
Newtown	South West	Industrial	■	■	■	4.5 - 6.3
Minehead	South West	Industrial	■	■	■	4.5 - 6.3

Source: WWU. Response to LE-WWU-132. GVA Grimley Report. The WWU benchmarking metrics above are calculated based on rental cost per total floor space. Note: A number of WWU properties have zero usable floor space.

A.7.7 The property rents for the main WWU sites appear to be within the benchmark range of market rents provided by GVA. However, some of the smaller, mainly industrial, sites do appear to have rental levels in excess of the market benchmark for the region. The rental costs efficiency savings, calculated based on the methodology described in paragraph 7.27, is approximately £0.05m per annum.

Appendix 8: C&C costs breakdown and normalisation adjustments

Introduction

A.8.1 In this appendix we provide a breakdown of each GDN's 2006/07 C&C support costs. We summarise our normalisation adjustments and compare these to the adjustments that we made in our Phase 1 Reports.

NGGD

A.8.2 NGGD has confirmed that its C&C function performed the following activities:

- treasury;
- investor relations and stakeholder management;
- company secretariat and corporate affairs;
- internal communication;
- marketing and advertising;
- intranet and internet site; and
- payments to third party outsourcing services providers for performing the above activities.

A.8.3 NGGD has not provided a breakdown of C&C activity costs. The table below summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 164: Total 2006/07 NGGD C&C costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Total costs provided by NGGD	8.90
Less: one off cost decrease due to a higher level of de minimis activities	(0.05)
Less: Ofgem inflation adjustment	(0.01)
Less: Ofgem FRS17 adjustment	(0.08)
Adjusted costs	8.77

Source: NGGD. June 2007 update Table B2.2. Response to LE-NGG-145. Ofgem.

A.8.4 We have taken away the decrease in de minimis margin, which NGGD had been reallocated to direct operating costs¹³⁰; and we have adjusted for actual inflation and for changes to FRS17 following Ofgem's policy decisions. We have made these adjustments to ensure consistency with Ofgem's policies and between C&C costs across the GDNs and against external benchmarks. Where applicable, these adjustments are consistent with the adjustments that we made in our Phase 1 Report, and are explained in more detail therein.

A.8.5 Our Phase 1 Report include the following normalisation adjustments, which were not required in this phase:

- adjustment to remove de minimis margins from regulated controllable C&C costs. NGGD's updated margins have been removed from the controllable C&C costs submitted in June 2007; and
- reclassification of group costs to the individual support service cost categories. NGGD has allocated group costs to the individual support service cost categories in the data submitted in June 2007; and
- reclassification of tax costs to FAR. NGGD has included tax costs in FAR in the data submitted in June 2007.

NGN

A.8.6 The table below provides a breakdown of NGN's C&C costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

¹³⁰ NGGD. Responses to LE-NGG-145.

Table 165: Total 2006/07 NGN C&C costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Tax	0.20
Investor relations, stakeholder management, company secretariat and corporate affairs	0.90
Internal communication, public relations, event management, marketing & advertising	0.20
Payments to third party outsourcing services providers	0.20
Treasury	0.10
Total costs provided by NGN	1.60
Less: tax reclassified to FAR	(0.20)
Add: corporate finance reclassified from legal	0.02
Add: Ofgem inflation adjustment	0.02
Adjusted costs	1.44

Source: NGN. June 2007 update Table B2.2.

A.8.7 We have moved tax costs to finance, audit and regulation; we have moved corporate finance costs from legal¹³¹; and we have adjusted for actual inflation following Ofgem's policy decision. We have made these adjustments to ensure consistency with Ofgem's policies and between C&C costs across the GDNs and against external benchmarks. Where applicable, these adjustments are consistent with the adjustments that we made in our Phase 1 Report, and are explained in more detail therein.

A.8.8 Our Phase 1 Report include the following normalisation adjustments:

- reclassification of treasury costs from FAR to C&C. NGN has included treasury costs in the C&C figures submitted in June 2007; and
- reclassification of non-salary recharge capitalisation (Ofgem findings). NGN did not make any recharge from C&C costs to repex/capex in this phase.

¹³¹ NGN. June 2007 update Table B2.2.

SGN

A.8.9 The table below provides a breakdown of SGN's C&C costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 166: 2006/07 SGN C&C costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Internal communications	0.47
Payments to third party outsourcing services providers	0.15
Treasury	0.03
Company secretariat and corporate affairs	0.06
Executive team costs	0.44
General MSA	0.73
Internet and intranet	0.02
Total Charge to repex/non regulated business	(0.74)
Total costs provided by SGN	1.16
Add: Ofgem's inflation adjustment	0.01
Adjusted costs	1.17

Source: SGN. June 2007 update Table B2.2.

A.8.10 In our Phase 2 analysis, we have adjusted for actual inflation following Ofgem's policy decision. We have made this adjustment to ensure consistency with Ofgem's policies and between C&C costs across the GDNs and against external benchmarks.

A.8.11 Our Phase 1 Report included the following adjustments, that have not be required in this phase:

- allocation of MSA umbrella charges and executive team costs from C&C costs to individual support service cost categories. These costs have been allocated to the individual support service cost categories in the data submitted in June 2007;
- reclassification of treasury costs from FAR to C&C. SGN has included treasury costs within the C&C costs submitted in June 2007; and

- reclassification of company secretary costs from legal to C&C. SGN has included company secretary costs within the C&C costs figure submitted in June 2007.

WWU

A.8.12 The table below provides a breakdown of WWU's C&C costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 167: 2006/07 WWU C&C costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Chief Executive, internal communication, PR, event management, corporate affairs, charitable donations, and intranet and internet site	0.41
Company secretariat*	0.00
Investor relations*	0.00
Marketing and advertising*	0.00
Consultancy	0.24
Payments to third party outsourcing services providers for performing the above activities	0.39
Commercial	0.14
Other staff costs	0.18
Travel costs	0.33
Treasury and Tax	0.10
Business performance and benchmarking	0.18
Corporate and corporate finance	0.01
Total costs provided by WWU	1.99
Less: travel costs for operational staff to work management	(0.20)
Less: Ofgem FRS17 adjustment	(0.02)
Add: Ofgem inflation adjustment	0.02
Adjusted costs	1.79

Source: WWU. June 2007 update Table B2.2. Note: *These costs are reported to be immaterial.

A.8.13 We have moved travel costs for operational staff to the work management cost category¹³²; we have adjusted for changes to FRS17 and for actual inflation following Ofgem's policy decisions. We have made these adjustments to ensure consistency with Ofgem's policies and between C&C costs across the GDNs and against external benchmarks. Where applicable, these adjustments are consistent with the adjustments that we made in our Phase 1 Report, and are explained in more detail therein.

A.8.14 Our Phase 1 Report included the following adjustments, which are not required in this phase:

- allocation of staff bonus costs to individual support service cost categories. These costs have already been allocated to the individual support service cost categories in the data submitted in June 2007; and
- reclassification of treasury costs, commercial strategy and development costs, corporate and corporate finance costs, and business performance and benchmarking from the other support service cost categories to C&C. These costs have been included in the C&C costs submitted in June 2007.

¹³² WWU. Response to LE-WWU-137.

Appendix 9: HR costs breakdown and normalisation adjustments

Introduction

A.9.1 In this appendix we provide breakdowns of the GDNs' 2006/07 HR support costs. We summarise our normalisation adjustments and compare these to the adjustments made in our Phase 1 Reports.

NGGD

A.9.2 The table below provides a breakdown of NGGD's HR costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 168: Total 2006/07 NGGD HR costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Core HR (non group level)	1.72
Group HR	1.49
L&D	3.49
Apprentices	4.30
Graduates and other trainees	1.70
Total costs provided by NGGD	12.70
Less: payroll processing costs reclassified to finance, audit and regulation	(0.25)
Less: Ofgem inflation adjustment	(0.01)
Less: Ofgem FRS17 adjustment	(0.11)
Add: Skills and Competency costs reclassified from work management to HR	0.60
Add: one off cost increase due to a higher level of de minimis activities	0.18
Adjusted costs	13.11

Source: NGGD. June 2007 update Table B2.2. Responses to LE-NGG-152, LE-NGG-155 and LE-NGG-160.

A.9.3 We have moved payroll processing costs from HR to FAR; we have adjusted for actual inflation and for changes to FRS17 following Ofgem's policy decisions; we

have reclassified HR skills and competency costs from work management¹³³; we have added back the increase in de minimis margin, which NGGD had been reallocated to direct operating costs¹³⁴. We have made these adjustments to ensure consistency with Ofgem's policies and between HR costs across the GDNs and against external benchmarks. Where applicable, these adjustments are consistent with the adjustments that we made in our Phase 1 Report, and are explained in more detail therein.

A.9.4 Our Phase 1 Report included the following normalisation adjustments, which have not been required in this report:

- adjustment to remove de minimis margins from regulated controllable HR costs. These margins have been removed from the controllable HR costs that NGGD submitted in June 2007; and
- reclassification of group HR costs from C&C to HR. NGGD included these costs in the correct cost categories in the data submitted in June 2007.

NGN

A.9.5 The table below provides a breakdown of NGN's HR costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

¹³³ NGGD. Response to LE-NGG-160.

¹³⁴ NGGD. Responses to LE-NGG-147 and LE-NGG-148.

Table 169: Total 2006/07 NGN HR costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Recruitment	0.03
Payroll processing	0.10
Employee relations	0.10
Retirement costs (non-pension)	0.03
Running training courses	0.05
Procurement of training courses	0.70
L&D	0.10
Total costs provided by NGN	1.11
Less: payroll processing costs reclassified to finance, audit and regulation	(0.10)
Add: pension costs from legal	0.02
Add: Ofgem inflation adjustment	0.01
Adjusted costs	1.04

Source: NGN. June 2007 update Table B2.2.

A.9.6 We reclassified payroll processing costs from HR to FAR; we have reclassified pension costs from legal to HR¹³⁵; and we have adjusted for actual inflation following Ofgem's policy decision. We have made these adjustments to ensure consistency with Ofgem's policies and between HR costs across the GDNs and against external benchmarks. Where applicable, these adjustments are consistent with the adjustments that we made in our Phase 1 Report, and are explained in more detail therein.

A.9.7 Our Phase 1 Report included normalisation adjustments to reclassify salary and non-salary recharge capitalised (Ofgem findings). This adjustment is not required in this phase, as NGN did not make any recharge from HR costs to repex/capex in this phase.

SGN

A.9.8 The table below provides a breakdown of SGN's HR costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

¹³⁵ NGN. June 2007 update Table B2.2.

Table 170: 2006/07 SGN HR costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Pensions administration costs	0.02
Employee relations (including industrial relations, succession planning, retention and rewards, advice to staff and recruitment)	0.68
Running training, both internal and external courses	0.71
L&D	0.04
Travel Desk	0.07
Payments to professional and consultancy services	0.18
General Managed Services Agreement	0.20
Executive team costs	0.18
Total charge to repex/non regulated business	(0.58)
Total costs provided by SGN	1.51
Add: reallocated training costs	0.45
Add: Ofgem inflation adjustment	0.02
Adjusted costs	1.98

Source: SGN. June 2007 update Table B2.2.

A.9.9 We have reclassified training costs that SGN had allocated into other cost categories and adjusted for actual inflation following Ofgem's policy decision. We have made these adjustments to ensure consistency with Ofgem's policies and between HR costs across the GDNs and against external benchmarks.

A.9.10 Our Phase 1 Report included the following adjustments, which have not been required in this report:

- reclassification of payroll processing costs from HR to FAR, and pension advisory costs from FAR to HR. The costs have been included in the correct cost categories in the data that SGN submitted in June 2007; and
- reclassification of HR costs' share of the executive team costs and the MSA umbrella charges from C&C to HR. A share of the executive team costs and the MSA umbrella charges have been included in the HR costs figure that SGN submitted in June 2007.

WWU

A.9.11 The table below provides a breakdown of WWU's HR costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 171: 2006/07 WWU HR costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Relocation	0.03
Learning and development	0.21
Training	0.57
Employee relations	0.11
Payments to third party outsourcing services providers	0.18
Occupational health	0.12
Total costs provided by WWU	1.22
Less: occupational health reclassified to work management	(0.12)
Less: Ofgem FRS17 adjustment	(0.01)
Add: Ofgem inflation adjustment	0.01
Adjusted costs	1.10

Source: WWU. June 2007 update Table B2.2.

A.9.12 We have reclassified occupational health costs from HR to health and safety costs, which are held within work management costs¹³⁶; and we have adjusted for actual inflation and for changes to FRS17 following Ofgem's policy decisions. We have made these adjustments to ensure consistency with Ofgem's policies and between HR costs across the GDNs and against external benchmarks. Where applicable, these adjustments are consistent with the adjustments that we made in our Phase 1 Report, and are explained in more detail therein.

A.9.13 Our Phase 1 Report included the following adjustments, which have not been required in this report:

- reclassification of payroll processing costs from HR to FAR. Payroll processing costs have been included in FAR costs figure that WWU submitted in June 2007; and

¹³⁶ WWU. June 2007 update Table B2.2.

- allocation of HR costs' share of staff bonus costs from C&C to HR. The staff bonus costs have already been allocated to the individual support service cost categories in the data that WWU submitted in June 2007.

Appendix 10: Legal breakdown and normalisation adjustments

Introduction

A.10.1 In this appendix we provide a breakdown of each GDN's legal costs in 2006/07. We summarise our normalisation adjustments and compare these to the adjustments made in our Phase 1 Reports.

NGGD

A.10.2 NGGD has confirmed that its legal function performed the following activities:

- legal advice on energy law and regulation;
- legal advice on general commercial issues;
- litigation and disputes;
- information assurance;
- employment;
- risk and compliance;
- debt collection;
- property related;
- general legal services;
- trading advice;
- solicitor secondment; and
- intellectual property.

A.10.3 NGGD has not provide a breakdown of legal costs. The table below summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 172: Total 2006/07 NGGD legal costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Total costs provided by NGGD	1.67
Add: one off cost decrease due to a higher level of de minimis activities	0.10
Less: Ofgem FRS 17 adjustment	(0.01)
Adjusted costs	1.76

Source: NGGD. June 2007 update Table B2.2.

- A.10.4 In addition to the Ofgem FRS 17 adjustment, we have adjusted NGGD's legal costs to add back the one off cost reduction due to a higher level of de minimis activities. Details of this adjustment are provided in paragraph 3.7.
- A.10.5 Our Phase 1 Report included an adjustment to remove margins associated with de minimis activities from regulated controllable legal costs. This adjustment is not required in this phase, as these margins have been excluded from the controllable legal costs supplied by NGGD.

NGN

- A.10.6 The table below provides a breakdown of NGN's legal costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 173: Total 2006/07 NGN legal costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Legal advice on energy law and regulation	0.05
Legal advice on general commercial issues	0.10
Litigation and disputes*	0.00
Information assurance*	0.00
Employment*	0.00
Risk and compliance*	0.00
Debt collection*	0.00
General legal services	0.08
Trading advice*	0.00
Solicitor secondment*	0.00
Intellectual property*	0.00
Insurance claim processing	0.10
Property related	0.10
Corporate and corporate finance	0.02
Pension	0.02
Total costs provided by NGN	0.52
Less: Corporate and corporate finance costs (reclassified to corporate centre and communication)	(0.02)
Less: Pension costs (reclassified to HR)	(0.02)
Less: Insurance claim processing (reclassified to Insurance)	(0.10)
Add: Ofgem inflation adjustment	0.01
Add: One off decrease in legal costs relating to UNC modification work	0.10
Add: One off cost decrease due to delay in Interruption and Exit reform	0.20
Adjusted costs	0.69

Source: NGN. June 2007 update Table B2.2. Note: * These costs were reported to be immaterial.

A.10.7 In addition to the Ofgem inflation adjustment, as discussed in paragraph 3.4, we have reclassified corporate and corporate finance costs, pension costs and insurance claim processing costs to C&C, HR and insurance respectively. This is

to ascertain consistency across the GDNs. These adjustments are consistent with the adjustments in our Phase 1 Report, and are discussed further therein.

- A.10.8 NGN indicated that there the costs relating to the UNC modification legal work was £0.1m lower than forecasted. NGN did not expect the lower costs to be recurring. NGN also stated that due to the delay of Interruption and Exit reform, the £0.2m legal costs relating to Interruption and Exit reform would start to be incurred after 2006/07. The 2006/07 legal costs would therefore be £0.2m lower than the long term average. We have added back these cost differences in calculating the legal costs benchmarking metric¹³⁷.
- A.10.9 Our Phase 1 Report included an adjustment to reclassify non salary recharges from repex/capex to legal costs. This adjustment is not required in this phase, as data that NGN submitted in June 2007 did not include non salary recharges from legal costs to repex/capex.

SGN

- A.10.10 The table below provides a breakdown of SGN's legal costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

¹³⁷ NGN. Response to question LE-NGN-102.

Table 174: Total 2006/07 SGN legal costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Legal advice on energy law and regulation	0.07
Legal advice on general commercial issues	0.12
Litigation and disputes*	0.00
Information assurance*	0.00
Risk and compliance*	0.00
Debt collection*	0.00
General legal services	0.32
Trading advice*	0.00
Intellectual property*	0.00
Total costs provided by SGN	0.51
Add: Ofgem inflation adjustment	0.01
Add: Decrease in legal costs due to a delay in the recruitment of an additional solicitor	0.05
Add: One off decrease in legal costs due the credit from the over-accrual in the previous period	0.20
Add: One off lower legal costs relating to energy & regulation matter, and also on general commercial issues	0.20
Adjusted costs	0.96

Source: SGN. June 2007 update Table B2.2. Note: * These costs were reported to be immaterial.

A.10.11 With the exception of the Ofgem inflation adjustment, we have made the following normalisation adjustments to SGN's legal costs:

- added back the £0.05m decrease in legal costs due to a delay in the recruitment of an additional solicitor;
- added back the £0.2m one off decrease in legal costs due the credit from the over-accrual in the previous period¹³⁸;
- added back the £0.2m lower legal costs relating to energy & regulation matter, and also on general commercial issues. SGN consider the level of legal works in these areas were lower than the long term average¹³⁹.

¹³⁸ SGN. Responses to LE-SGN-129, LE-SGN-142 and LE-SGN-144.

¹³⁹ SGN. Responses to LE-SGN-148.

A.10.12 Our Phase 1 Report included the following adjustments, which have not been required in this report:

- allocation of MSA umbrella charges; and
- classification of company secretary costs from legal costs to C&C costs.

A.10.13 In the data that SGN provided in June 2007, SGN allocated the MSA umbrella charges to individual support services cost categories. Company secretary costs were already included under C&C costs.

WWU

A.10.14 The table below provides a breakdown of WWU's legal costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 175: Total 2006/07 WWU legal costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Legal advice on energy law and regulation	0.02
Legal advice on general commercial issues	0.05
Litigation and disputes	0.01
Wayleaves procurement	0.07
Property related	0.02
Employment	0.01
General legal services	0.03
Payments for external support	0.27
Debt collection	0.12
Total legal costs provided by WWU	0.60
Add: Ofgem inflation adjustment	0.01
Less: Ofgem FRS 17 adjustment	(0.01)
Adjusted costs	0.60

Source: WWU. June 2007 update Table B2.2.

A.10.15 With the exception of the Ofgem accounting adjustments, as discussed in paragraph 3.4, no further normalisation adjustments were required. Our Phase 1 Report included the following adjustments, which have not been required in this report:

- reclassification of corporate and corporate finance costs from legal costs to C&C costs;
- reclassification of wayleave payments from legal costs to direct opex; and
- reclassification of debt collection costs from finance costs to legal costs.

A.10.16 Each of the above activity costs has been included in the correct cost category in the data that WWU submitted in June 2007.

Appendix 11: L&P costs breakdown and normalisation adjustments

Introduction

A.11.1 In this appendix we provide a breakdown of each GDN's 2006/07 L&P costs. We summarise our normalisation adjustments and compare these to the adjustments made in our Phase 1 Reports.

NGGD

A.11.2 NGGD has confirmed that its L&P function performed the following activities:

- day-to-day procurement of goods and services;
- procurement of capital goods;
- contract negotiation and monitoring;
- setting procurement guidelines and monitor adherence to the guidelines by business units;
- managing procurement related IT system;
- fleet management;
- warehousing;
- transportation;
- management of third party logistics services providers;
- inventory management (e.g. monitoring stock level and the making procurement decisions); and
- payments to third party logistics services providers for performing the above activities.

A.11.3 NGGD has not provided a detailed breakdown of its L&P costs. The table below summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 176: Total 2006/07 NGGD L&P costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Procurement costs provided by NGG	3.84
Logistics costs provided by NGG	1.21
L&P costs provided by NGG	5.02
Add: One off cost decrease due to a higher level of de minimis activities	0.10
Less: Ofgem FRS 17 adjustment	(0.04)
Adjusted costs	5.08

Source: NGGD. June 2007 update Table B2.2.

- A.11.4 In addition to the Ofgem FRS 17 adjustment, as discussed in paragraph 3.5, we have added back the £0.10m one off decrease in L&P costs due to a higher level of de minimis activities. Details of this adjustment are provided in paragraph 3.6.
- A.11.5 Our Phase 1 Report included a normalisation adjustment to reclassify storage costs from repex to L&P costs. Ofgem has accepted NGGD's classification of storage costs as repex¹⁴⁰. This adjustment is therefore not required in this report.

NGN

- A.11.6 The table below provides a breakdown of NGN's L&P costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

¹⁴⁰ Ofgem. "Review of Accounting Issues", August 2007.

Table 177: Total 2006/07 NGN L&P costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Day-to-day procurement of goods and services	0.20
Procurement of capital goods	0.00
Contract negotiation and monitoring	0.04
Setting procurement guidelines and monitor adherence to the guidelines by business units	0.02
Managing procurement related IT system	0.20
Total costs provided by NGN	0.45
Add: L&P costs incurred by NRG2	0.40
Add: Ofgem inflation adjustment	0.01
Adjusted costs	0.85

Source: NGN. June 2007 update Table B2.2. Note: * These costs were reported to be immaterial.

- A.11.7 In addition to the Ofgem inflation adjustment, we have made an adjustment to reclassify the L&P costs incurred by NRG2 from direct costs to L&P costs. The adjustment is consistent with the adjustment that we made in our Phase 1 Report, and the details of the adjustment were provided therein.
- A.11.8 Our Phase 1 Report also included an adjustment to reclassify the UUOL commercial team costs from direct costs to L&P costs. This adjustment is not required in this phase, as NGN has included the costs in the L&P costs figure that it submitted in June 2007¹⁴¹.

SGN

- A.11.9 The table below provides a breakdown of SGN's L&P costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

¹⁴¹ NGN. Response to question LE-NGN-091.

Table 178: Total 2006/07 SGN L&P costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Day-to-day procurement of goods and services	0.12
Procurement of capital goods	0.07
Contract negotiation and monitoring	0.03
Setting procurement guidelines and monitor adherence to the guidelines by business units	0.04
Managing procurement related IT system	0.03
Transportation	1.27
Warehousing	0.00
Fleet management	0.14
Inventory management (e.g. monitoring stock level and the making procurement decisions)	0.03
Total charge to repex/non regulated business	(0.40)
Total L&P costs as provided by SGN	1.40
Add: Ofgem inflation adjustment	0.01
Adjusted costs	1.42

Source: SGN. June 2007 update Table B2.2.

A.11.10 With the exception of Ofgem inflation adjustment, as discussed in paragraph 3.4, no further normalisation adjustments were required. Our Phase 1 Report included an adjustment to allocate some MSA umbrella charges from C&C costs to L&P costs. This adjustment is not required in this phase, as SGN has allocated the MSA umbrella charges to L&P costs in the cost figures that it submitted in June 2007.

WWU

A.11.11 The table below provides a breakdown of WWU's total L&P costs and summarises the normalisation adjustments required to ensure consistency across GDNs.

Table 179: Total 2006/07 WWU L&P costs and normalisation adjustments

Controllable operating costs in 2005/06 prices	2006/07 £m
Day-to-day procurement of goods and services	0.06
Supplier sourcing, contract negotiation and performance monitoring	0.16
Setting procurement guidelines and monitor adherence to the guidelines by business units	0.03
Managing procurement related IT system (e.g. setting up and maintaining vendor accounts within accounting system, and maintain e-procurement channels)	0.03
End user transactional support	0.03
Transportation Management	0.07
Technical Administrations	0.07
Management of third party logistics services providers	0.09
Inventory management (e.g. monitoring stock level and the making procurement decisions)	0.37
Payment to third party logistics services providers for performing the above activities	0.62
Total costs provided by WWU	1.54
Add: Ofgem inflation adjustment	0.02
Add: logistics costs incurred by Exel	0.20
Less: Ofgem FRS 17 adjustment	(0.02)
Adjusted costs	1.73

Source: WWU. June 2007 update Table B2.2.

A.11.12 In addition to the Ofgem inflation and FRS 17 adjustments, we have reclassified £0.20m logistics costs incurred by Exel from direct opex to L&P costs. WWU explained that in its June 2007 update, it has included the L&P costs relating to opex activities in direct costs. This treatment of L&P costs, however, is not consistent with its October 2006 submission and the other GDNs. We have therefore reclassified these costs from direct opex to L&P costs.¹⁴² We have not proposed further normalisation adjustments to WWU's L&P costs in this phase. This is consistent with our Phase 1 Report.

¹⁴² WWU. Response to question LE-WWU-135.