

AW/PW/077

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Dear Kieran

GDPCR Cost Reporting Consultation

NGN welcomes the opportunity to respond to the Cost Reporting Consultation.

NGN agrees with the stated objectives of the cost reporting:

- to improve the data available for cross-GDN comparisons;
- to reduce the required workload at the next price review; and
- to be able to measure actual performance against current allowances.

However, in view of the considerable resource commitments experienced by DNOs in adopting this process, NGN strongly believes that a balance needs to be struck between the level of data required and the work needed to produce it. That is, there needs to be a demonstrable benefit of producing the data at a certain granularity and accuracy level. The process also needs to be practical and workable in terms of commercially sensitive data and relationships with unrelated third party suppliers.

As already discussed throughout the BPQ process, NGN's business model and resulting reporting structure is completely different to the structure of the draft RRP. As long as the service obligations and target costs are met, it is up to our operator whether to focus their resources, for example, on emergency operatives or HR reps. Complying with the cost reporting process will potentially involve substantial system changes, and hence costs, for to not NGN, but also our operator. Therefore, it is critical that all required data is going to be used in a productive manner.

NGN agrees with Ofgem that duplication of reported data between the revenue, cost and output reporting should be avoided whenever possible. I attach answers to your specific questions but our main concerns with the proposed process as it stands are:

- the scope and granularity of business sensitive data published in the public domain;
- the level of accuracy expected in the initial years;
- the proposal to divulge detailed costs of unrelated third parties;

- the likely increase in audit work and the associated cost implications;
- the likely cost of IT investment and resource that will be required to ensure efficient and accurate reporting; and
- whether the above incremental costs will be adequately reflected in the price review allowances.

These points are covered in detail in our attached response; appendix A provides initial comments on the draft tables in the reporting pack.

Please do not hesitate to contact me if you require clarification of any of the points that I make.

Yours sincerely

A handwritten signature in black ink that reads "Alex Wiseman". The signature is written in a cursive style with a long, sweeping underline.

Alex Wiseman
Regulation Director

Cost Reporting Outputs and Timetable

Question 1: Are the proposed contents of the annual report appropriate?

The content and level of detail in the annual report seem appropriate if the objective is to give an overview of the industry and to provide top level comparisons between operators. In NGN's view this represents a considerable step change from previously published reporting. Increasing the level of detail further however will bring diminishing returns as potential interpretation differences will have a larger impact. It will also create a false sense of accuracy especially in the initial years of the cost reporting process before definitions get clarified and initial differences in interpretation are uncovered and standardised.

One specific concern with the current proposed report is the publication of an indicative RAV. Published RAV figures will impact GDNs as the rating agencies use Debt/RAV as one indicator of credit rating and lenders may include Debt/RAV ratios in debt covenants. RAV is therefore highly sensitive data. If a RAV value is indeed going to be published, it is critical that it is put into context and clearly explained. The main points that are important to communicate are:

- that the published RAV is indicative;
- how the 5-year roller and IQI works in relation to the indicative RAV;
- what level of post adjustments Ofgem can make; and
- how revenue is impacted by the published RAV, both in the year in question and in future years.

If these components cannot be explained clearly, it would be prudent to exclude an indicative RAV in the published report.

It is also very important that the GDNs get a chance to sense check the values before they are published, akin to what has been done with the consultants' reports in the price review process. With this caveat, NGN supports the proposal to include a separate sheet in the Cost Reporting Pro Forma where all the to-be-published data is collected.

Question 2: Are there any reasons why, consistent with our desire to promote transparency, we would not publish RRP data?

Ofgem's desire for transparency is to be encouraged, however, there needs to be a balance between commercially sensitive information and providing useful data in the public domain. Publishing detailed data without context setting could easily be misinterpreted and, as discussed in Question 1, would create a false sense of accuracy. The areas which NGN deems especially commercially sensitive are:

- forecast costs of future specific capex and repex projects;
- tax information; especially capital allowance pools;
- debt information and financing plans;
- margins from third party providers, both related and unrelated third parties;
- any other data that makes commercial negotiations with external parties/suppliers more difficult and would hinder the ability to drive down prices through those negotiations.

Further, NGN believes that, especially in the initial years, the amount of allocation required to report at the activity level within the RRP will mean that a proper analysis at that level will be difficult to do and is likely to be misleading, even for parties with in-depth knowledge. A published report at the level of the DNO annual cost report is a more appropriate level.

However, NGN does see the benefits of more detailed data sharing among the GDNs themselves. It would be very helpful, both to be able to identify areas of inconsistency, and to drive competition on efficiency achievements.

Question 3: Do you have views on the annual timetable including deadlines for submission of information to Ofgem?

Overall, the timetable is reasonable; however we have a few concerns discussed below.

The timetable plans to have final definitions published by February / March. This means that potential late changes to definitions will not be reflected in the GDNs' accounting practices until the 12th month of the formula year or later. Ofgem's expectations of the level of accuracy and amount of estimation required therefore need to take this into account.

Based on the experience of the DNOs, we understand that the process will need a material amount of resource commitment from the GDNs. Conversely, we trust that Ofgem has used its own experience with previous cost reporting projects and have committed enough resources internally to ensure that there is no risk of delays in the timetable due to lack of resource within Ofgem.

There needs to be an established process, with a materiality threshold, for potential resubmissions after the audited regulatory accounts are finalised. NGN foresees primarily re-allocations between activities as definitions are clarified but there is always the possibility that small changes occur to the overall total as part of the review. At that point, there is a potential risk that the regulatory accounts auditors will deem the change immaterial, but the cost reporting will not and hence the two might diverge slightly. Ofgem's view on these situations needs to be clear from the outset.

Issues

Question 1: Is it realistic to seek to create benchmarking opportunities across sectors for generic cost types, such as indirect costs?

Our experience from the current price review shows that it is very difficult to ensure consistency in indirect activity definitions. This is often driven by differences in the organisational structure of the owners. For example, NGN's regulation department costs include gas shrinkage purchasing, UNC management, and pricing, which we believe are not included in other GDNs' definition of regulation. In the LECG report only shrinkage purchasing is adjusted for in the comparative analysis (and this has erroneously been removed from finance!). This type of example is not uncommon and therefore reduces the credibility of benchmarking specific indirect activities. Unless there is a high level of comfort in the comparability of data there should not be any benchmarking analysis at such a detailed level.

There is possibly potential to compare indirect costs in total. However, the boundary between indirect and direct needs to be comparable. Different business models may result in differences in the direct/indirect split, both within sectors and between sectors.

In addition, benchmarking against other sectors need to take into account the areas where costs are driven by specific regulatory requirements such as regulation, legal, and the impact of exit/interruption processes, which other sectors may not have. Also, different businesses, such as supply, will result in different head office structures and hence costs. Thus a vertically integrated business such as water may not be comparable to network businesses.

Currently, the GDNs' indirect/direct split is not even comparable to the DNOs. For example, certain project planning functions that are defined as Work Management functions for the GDNs are defined as indirect activities for the DNOs.

NGN is therefore not convinced that indirect cost benchmarking across sectors is going to be a useful exercise.

Question 2: How should we determine the criteria for requiring details of cost information from GDNs' service providers whether they are classified as related parties or not? What practical issues are there in requiring detailed third party cost information?

Criteria: The overall objective of cost reporting is to provide a robust, comparable data set for the next price review, and to be able to measure performance against allowance in the ongoing price control. Any new request for information must demonstrably achieve these objectives; otherwise the data serves no function.

In addition, the RPI-X and IQI regimes incentivise the GDNs to become as efficient overall as possible given the required service levels. How a GDN deploys its own workforce and contractors should be up to the GDN, as long as it meets the required targets on service, safety and efficiency.

In this context, cost data for related third parties, at a reasonable materiality level, has a logical purpose, as it aims to avoid double counting of margins when comparing costs. This fulfils the comparability objective and therefore helps to improve the accuracy of potential comparative efficiency analyses.

NGN endorses the collection of detailed cost data from its operator. However, NGN does not agree that detailed cost data should be requested from other unrelated third parties. NGN is not convinced that information from third parties will contribute to better benchmarking or a greater insight into comparative efficiency. On the contrary, there are quite a few obstacles, described below, that offset any potential benefit of cost sharing on an unrelated third party level.

Practical issues: Depending on the type of cost data required NGN sees commercial confidentiality as a critical obstacle. From a third party contractor's perspective, providing detailed cost data that potentially reveals its margins is a highly sensitive and unacceptable issue. If it is also to be published in the public domain, it will be an even greater obstacle. NGN foresees great difficulty in obtaining such data should it be required unless the provision of data is already built into the contract (as is the case with NGN and UUOL). It is not clear what powers the Authority has over unrelated third party providers to aid in obtaining the data. Therefore it is highly unlikely that data from unrelated third parties will actually be attainable.

In the longer term, this type of data requirement could result in a shrinking supplier pool. A strong contractor may actively choose not to continue to work with GDNs if other projects in other sectors do not require the same level of data disclosure. In a worst case scenario the GDNs would be left to choose from a pool of suppliers that are not efficient enough to be able to compete in other sectors, and therefore choose GDN work despite its data requirement. This is not a benefit to consumers.

Accuracy and Usefulness issues: If the data was indeed required and successfully acquired, the next obstacle is to ensure accuracy and comparability. How can the GDNs guarantee the accuracy of the data received? Who will audit the data? To enable useful comparisons, how can the GDNs and Ofgem ensure that all third parties have similar

methodologies to allocate costs to specific customers? How can Ofgem ensure that the contracts and their associated costs are accurately normalised for differences in mix of work, agreed service levels, contract length, and incentive structures? If you cannot control for these differences, NGN believes that any benchmarking at this level will be useless.

In summary, NGN believes that the practical obstacles surrounding asking for detailed cost data from unrelated third parties outweigh any benefits from the potential insights gleaned from the said data. NGN can however see the benefit of requiring related third party data disclosure at a reasonable level.

Question 3: Should we seek to collect detailed xoserve data directly from xoserve or via each GDN's RRP?

On balance, NGN's preference is for the data to be collected via each GDN's RRP. Although the main workload will still remain at xoserve, GDN submission will help ensure consistency across GDNs and xoserve's projections can be validated by GDNs.

An additional issue to consider is the appropriate level of data required from xoserve. The data will not enable the comparative efficiency objective as xoserve's charging mechanism across GDNs is pre-determined. Therefore, the data requests should be at a sensible high level of granularity.

Question 4: Should we look to commission external audit work on any aspect of the RRP or should we rely on our own review process? If so, should we engage auditors directly or rely on the GDNs' statutory auditors?

In principle, NGN prefers a solution that ensures lowest cost and avoids duplication of audits whilst continuing to ensure data integrity. The different options presented for the RRP need to be judged in conjunction with the audit options for the regulatory accounts.

NGN fully understands the need to continue with the regulatory accounts until Ofgem and the GDNs have confidence in the robustness and accuracy of the RRP submissions. In this transition period, the Agreed Upon Procedures (AUPs) covered in the RRP should be targeted to ensure that the results are useful, and to minimise any duplication with the regulatory accounts audit.

Since auditing will have timetable implications, it is critical that Ofgem provides clarity on the scope and process as soon as possible.

In considering the different options, we are assuming that the scope, process, and the stated focus on AUPs will be the same regardless of who is conducting the audit.

The decision whether to use internal Ofgem staff or external auditors is incumbent upon Ofgem's overall objectives of the audit. Using Ofgem's own team would increase the in-house knowledge of the GDNs' costs and structure, which will be very helpful in the next price review. Using external auditors would reduce the resource pressure on Ofgem but would leave Ofgem's team with a higher learning curve when entering the next price review process. We do not have enough information at this time to be able to discern which option would be cheaper. However, assuming no material cost differences, NGN believes that using Ofgem's own review process would benefit the price review process in the long term.

However, if external auditors became Ofgem's preferred approach, then it would be preferable to use the GDNs' own auditors as they understand the history of the business and the accounting systems and they can combine the audit with that of the statutory

accounts, which would keep costs down. However, the costs of their engagement would still be an incremental cost, which needs to be allowed in the 2008 - 2013 price review.

NGN has some ideas on how to optimise the auditing between regulatory accounts and the RRP. We would be happy to go through them with you in detail at the appropriate time.

Question 5: Do the regulatory accounts as they stand provide value to stakeholders?

The regulatory accounts do provide top line data on the financial performance in the regulatory year, divided by regulatory businesses. For those stakeholders that require that information they are obviously helpful. However, as Ofgem discusses in the consultation, there is limited usefulness to the stakeholders of those companies that are part of a larger regulatory entity (e.g. NGG).

Question 6: Under what circumstances, if any, should we consider relaxing the requirement to publish audited regulatory accounts?

The regulatory accounts requirement could be relaxed when Ofgem feels comfortable with the accuracy of the cost reporting data and have an established reconciliation procedure from statutory accounts. Potentially the RRP could be amended with any required notes, OFR or other items that are deemed to add value for stakeholders.

However, NGN is concerned about the proposal of only requiring the production of regulatory accounts based on certain criteria (e.g. a different year end or a material non-transportation business). The provision of regulatory accounts should either be required for every GDN or none.

Should Ofgem however decide to pursue this option, it needs to take the cost implications into account. That is, those companies that are required to produce regulatory accounts need to have the cost reflected in their allowances, and have those specific costs removed before any comparative benchmarking is conducted.

Question 7: Under what circumstances, if any, should we consider relaxing the requirement to submit a statement of allocation of costs and revenue and to have the application of that methodology audited?

There have already been discussions about the usefulness and relevance of licence condition E3, as it is thought that the audit does not add value, since a more in depth audit is done in the regulatory accounts. Therefore, regardless of whether the information is included in the RRP or not, we believe that there is little, if any, added value provided by condition E3 and it should be deleted.

If the RRP includes the information normally provided under licence condition E3, there is even less reasons for the condition to remain.

Appendix A

Initial Feedback on draft RRP Tables

General

- As already explained throughout the BPQ process, NGN's business model and subsequent reporting structure is completely different to the structure of the draft RRP. Complying with the cost reporting process will potentially involve substantial changes to not only our own, but also our operators' systems. Therefore, it is critical that all required data is going to be used in a productive manner.
- The suggested level of granularity will encounter the same materiality issues for NGN as the BPQ did. In particular the split of indirect activities moves NGN into the territory of partial FTEs and costs below £50k on certain cost lines. The RRP must consider materiality prior to establishing the level of granularity.
- NGN does not believe that the RRP needs to be aligned with the NTS RRP. Decisions should be made on the merits of each item and the benefit to GDN cost reporting. It is inappropriate to base cost reporting on the efficiency benefit of one network owner or on consistency with the NTS.
- The consultation states that the guidance for the RRP will be based on the guidance to the BPQ. Please note that there was an issue of internal inconsistency of the display of labour costs between the instructions for B3 and C6 in the last BPQ.
- Clear definitions are needed on throughput items, for instance whether it is actual, non weather adjusted and the like.
- Before definitions are finalised, thought should be put into the type of data already produced and for what time period (i.e. Calendar Year/Gas Year). For example, according to our Network Ops team, 'Day 46 Equivalent (Severe LDC) Firm plus Interruptibles', is not something that is currently measured. Unless there is a specific reason for requesting this particular scenario, it would make more sense to stay with the scenarios that are regularly produced.

Specific Tables

Table 1.6

- The inflation assumption is hard-coded. There is potential to forget to update should assumptions change or actual data be available.

Table 2.1

- The current split of activities results in too many columns, especially for indirect activities. As already mentioned above, certain cost lines, especially in indirect activities, fall below a reasonable materiality threshold (£0.1m) for NGN.
- Cost lines need to be seriously considered in terms of usefulness; a good test will be to see how many of these lines were actually used by the majority of GDNs in the BPQ.

Table 2.2

- This table needs careful explanation as it is a new table compared to the BPQ.
- NGN has concerns over whether the titles of cost centres will adequately explain what is included in each cost centre.

Table 2.3

- NGN understands the purpose of the table, but a reasonable materiality threshold needs to be applied.

Table 3.2

- There needs to be clarity of the purpose of the forecast.
- NGN needs to understand how reconciliations will work between each year's cost reporting versions.
- Clarity is needed on the level of accuracy expected for the later years.

Table 3.3

- Our current systems do not split costs between general reinforcement and specific reinforcement. We would like to understand the expected benefit of the proposed granularity so that the investment in updated systems can be justified.

Table 3.5

- Our current systems do not split costs between general reinforcement and specific reinforcement. We would like to understand the expected benefit of the proposed granularity so that the investment in updated systems can be justified.

Table 3.7

- It is critical that the definitions are clear.

Table 3.8

- This data was used in the BPQ for indicative splits between direct labour and contractors. On an annual, historic cost basis, is this still the main reason for collecting the data? If so, clarity is needed regarding the expected level of accuracy.

Table 3.10

- We are in the process of updating our systems to report costs by diameter bands for repex mains. However, it is possible that there will be an element of allocation involved in the early years as the new system beds in.

Table 3.11

- In our experience, the definitions of services from an operational perspective are not always consistent with regulatory definitions. Hence, the definitions for each type of service (including what is a non-domestic service) must be VERY clear and finalised as early as possible.

Table 3.15

- NGN does not collect 'Actioned Repairs' by diameter band.