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1st September 2015

Dear Mick,

This cover letter and attached note provides National Grid's formal response to Ofgem's consultation letter dated 31 July 2015 relating to costs associated with the TPCR4 enhanced physical site security upgrade programme and the RIIO-T1 and RIIO-GD1 enhanced physical site security uncertainty mechanisms.

Ofgem has proposed disallowances to our TPCR4, RIIO-T1 and RIIO-GD1 enhanced physical site security costs, with a particular emphasis on project management costs. In summary, we believe the proposed level of disallowances are disproportionate and do not properly take account of all the relevant circumstances or the extensive number of cost reviews that have been undertaken to date. The key points are summarised below and the attached note provides our response and our rationale in greater detail.

The context for the enhanced physical security upgrade programme during the TPCR4 period included specific challenges for National Grid, and this is recognised by Ofgem. Therefore we do not believe it is appropriate to use a benchmark based on operators that did not face the same challenges and which is based on a number of sites that are yet to be delivered. In addition, all the contemporaneous feedback over an 8 year period, including REDACTED VFM2 reports by DECC & Ofgem's value for money auditors, supports our view that our TPCR4 project management costs are reasonable. In particular, the auditor specifically complimented the performance of the project management team in many of the VFM2 reports e.g.:

- *"I must say I am very impressed with the negotiations with contractors and the level of savings made"*
- *"These challenges have consistently driven down the costs of the project and overall indicate a culture which strives to attain a level of expenditure which certainly can be judged to be value for money. This level of commitment should be applauded"*

The more detailed arguments presented in the attached note demonstrate that the proposed TPCR4 disallowances are not demonstrably inefficient, and therefore any final determination of disallowed costs should be treated like other TPCR4 costs and pass through the existing TPCR4 capex incentive mechanism.

The proposed disallowance for the RIIO-T1 and RIIO-GD1 project management costs does not recognise or give credit for the development of 'Operational Solutions' (which has resulted in a benefit

REDACTED

to the consumer of approximately REDACTED), or the protracted 18 month DECC site review, which created significant programme uncertainty and hence major project management challenges.

The proposed disallowance for the RIIO-T1 and RIIO-GD1 ‘general items and preliminaries’ costs is based in part on a reference cost for the National Grid costs which reflects our historic sites, and not the future RIIO sites, and in doing so calculates a disallowance value that is too high.

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We are happy to discuss any element of this response directly with Ofgem at a time of your convenience.

Yours sincerely,

SENT BY E-MAIL

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Response to Ofgem's Consultation Letter

As requested in Ofgem's consultation letter dated 31 July 2015, this note provides National Grid's response to Ofgem's minded-to position.

The response includes:

A. Responses to the 4 specific questions in the consultation letter.
B. Response to the proposed adjustments to the TPCR4 enhanced physical security costs for NGET and NGGT.
C. Response to the proposed adjustments to the RIIO-T1 enhanced physical security costs for NGET and NGGT.
D. Response to the proposed adjustments to the RIIO-GD1 enhanced physical security costs for NGGD's GDNs (East of England, London, North West networks).
E. Other items.

A. Responses to the 4 specific questions in the consultation letter

At the front of the consultation letter Ofgem asks for responses to 4 specific questions, which are provided below.

Question 1: Do you agree with our assessment and proposed adjustments associated with TPCR4 enhanced physical site security costs for the four Transmission Owners (TOs), NGET, NGGT, SHE Transmission and SPTL?
We do not agree with Ofgem's assessment and proposed adjustments associated with TPCR4 enhanced physical site security costs for NGET and NGGT. Our detailed response is provided in Section B of this note.

Question 2: Do you agree with our assessment and proposed adjustments associated with the RIIO-T1 enhanced physical security costs for the two TOs, NGET and NGGT?
We do not agree with Ofgem's assessment and proposed adjustments associated with the RIIO-T1 enhanced physical site security costs for NGET and NGGT. Our detailed response is provided in Section C of this note.

Question 3: Do you agree with our assessment and proposed adjustments associated with the RIIO-GD1 enhanced physical security costs for the five GDNs (NGGD's East of England, London, North West networks, and SGN's Scotland and Southern networks)?
We do not agree with Ofgem's assessment and proposed adjustments associated with the RIIO-GD1 enhanced physical site security costs for NGGD's three GDNs (East of England, London, North West networks). Our response is provided in Section D of this note.

Question 4: Do you agree with our proposal to introduce an output commitment in relation to enhanced physical security?
We agree with the proposal to introduce an output commitment in relation to enhanced physical security.

Please note that for simplicity and for consistency with our reopener submission, for the remainder of this note we use the "PSUP" acronym when referring to the programme (i.e. the Physical Security Upgrade Programme).

B. TPCR4

This section provides a response to the areas where Ofgem is proposing disallowances for the TPCR4 period, which are listed below and described in more detail in the subsequent sub-sections.

1. Project Management Costs
2. Initial Contractor
3. Site Specific Queries
4. Opex
5. Treatment of any Disallowed Costs

1. Project Management Costs

Summary of Ofgem's Position

- Ofgem states that our TPCR4 project management costs = 33% of total costs.
- Ofgem states that the average project management costs for other operators = 15% of total costs.
- Ofgem has applied the 'average for other operators' value to our TPCR4 costs to produce a proposed disallowed value.

Response

Our response to the assessment of the TPCR4 project management costs is summarised below and expanded upon in the sub-sections underneath:

- National Grid faced a challenging context when delivering the PSUP programme in TPCR4.
- This is acknowledged by Ofgem, and it is also recognised that this could lead to higher costs.
- We agree with Ofgem that the project management costs should fall in the future, but not during the TPCR4 period.
- REDACTED VFM2 reports produced by Ofgem & DECC's appointed consultants did not flag the project management costs as inefficient.
- A range of other reviews and audits support the view that our project management costs were reasonable, and not demonstrably inefficient.

National Grid faced a challenging context when delivering the PSUP programme in TPCR4

The PSUP programme in National Grid faced a number of unique challenges during the TPCR4 period:

- The scope of the PSUP programme was not fully developed at the start of the PSUP programme, and evolved throughout the TPCR4 period REDACTED.
- There were uncertain and changing site volumes throughout the period which ultimately resulted in a large net increase in the number of sites to be delivered.
- There was a deadline to complete a large number of the sites before the end of the TPCR4 period, including meeting specific Olympics requirements.

This context contributed to additional project management activities in a number of ways such as re-planning and re-programming projects and activities, managing the changing resource requirements, and accelerating works.

This is acknowledged by Ofgem, and it is also recognised that this could lead to higher costs

Ofgem's consultation letter acknowledges some of the specific challenges that were faced by National Grid:

- "The scope of the security work was not fully defined at the start of the programme".
- "National Grid was responsible for delivering more sites than other operators".
- "Olympics deadline to complete a specific number of sites".

Given this context, Ofgem states that they "understand project management costs may have been higher initially". Therefore, it seems inconsistent to accept that the costs could be higher then apply the 15% benchmark.

We agree with Ofgem that the project management costs should fall in the future, but not during the TPCR4 period

Ofgem states that they would expect to see the project management costs reduce as National Grid completes more sites and gains more experience.

We agree with this view, but we do not agree that this was realistic during the TPCR4 period:

- The challenging context described above was in place throughout the TPCR4 period.
- The large majority of sites started construction in a similar time period in the second half of the TPCR4 period.
- This batch of sites was delivered more or less concurrently during the remainder of the TPCR4 period.
- The change of programme context and the learning from experience would be built into the next wave of sites which would have been planned for the end of the TPCR4 / start of RIIO period.
- Therefore the improvement in project management costs would be expected through the RIIO period. The reduction in the project management costs forms a key part of our reopener submission and is acknowledged by Ofgem in the consultation letter.
- In the event, the beginning of the RIIO period coincided with the start of the major DECC site review, which created continued programme uncertainty and hence challenges for managing the project management cost, and also coincided with the development of operational solutions which added further project management workload (this is explained in more detail in Section C2 of this response).

REDACTED ***VFM2 reports produced by Ofgem & DECC's appointed consultants did not flag the project management costs as inefficient***

All sites undergo VFM2 audits at the end of the project, as required by the process set up by Ofgem and DECC. The results of the VFM audits are summarised below and do not suggest our project management costs are inefficient:

- To date, REDACTED VFM2 site audits have been completed, over an 8 year period.
- The auditor has referred some costs to Ofgem (which are addressed separately in Ofgem's consultation letter).
- The auditor has not challenged or referred the project management costs or challenged the level of the project management costs. This includes a VFM2 review that was completed as recently as 24 June 2015.
- Furthermore, the auditor specifically complimented the performance of the project management team in many of the VFM2 reports e.g.:
  - *"I must say I am very impressed with the negotiations with contractors and the level of savings made"*
  - *"These challenges have consistently driven down the costs of the project and overall indicate a culture which strives to attain a level of expenditure which certainly can be judged to be value for money. This level of commitment should be applauded"*

A range of other reviews and audits support the view that our project management costs were reasonable

Various reviews and audits have been undertaken on the TPCR4 costs which support the view that our TPCR4 project management costs were reasonable. The reviews are listed below and described in more detail underneath:

- Consultant's report (Harnser, July 2015).
- External efficiency review (Fraser Nash, summer 2014).
- EC Harris benchmark.
- Ofgem's comparison with other network operators.

Consultant's report (Harnser, July 2015)

The consultant's report reviewed project management costs for National Grid and other operators. Within the TPCR4 context, National Grid's project management costs are broadly consistent with the reference value that the consultant has quoted as 'value for money'.

- The consultant's report provides a reference value for project management costs of REDACTED, and states that this value "would represent value for money" (i.e. a value for money range of up to REDACTED).

- However, the other operators did not have the specific challenges faced by National Grid during the TPCR4 period, as described above, and the ‘other operators’ value includes many sites that are yet to be delivered.
- Therefore it is reasonable to assume that projects delivered within the challenging TPCR4 context faced by National Grid would have higher costs.
- The report refers to National Grid’s project management costs of REDACTED (which are based on TPCR4 projects).
- Therefore, given the TPCR4 context, the National Grid figure is reasonable at REDACTED than the ‘value for money’ range.

External efficiency review (Fraser Nash, summer 2014)
The TPCR4 project management costs were reviewed in summer 2014 as part of Ofgem’s efficiency review by their appointed consultants (Fraser Nash). The process included National Grid providing information, responding to questions and meeting with the consultants at Ofgem’s offices. On completion of the review, we did not receive any feedback that would contradict our position that our TPCR4 project management costs are reasonable.

EC Harris Benchmark
As referenced in Ofgem’s consultation letter, in December 2014 National Grid provided Ofgem with a project management benchmarking study. This report provided justification for our level of project management costs, and we stand by the validity and relevance of the report:

- The findings are based on a very large sample of projects (2,500 projects) across a range of industry sectors, including utilities (e.g. REDACTED) and infrastructure organisations (e.g. REDACTED).
- As well as supporting National Grid’s level of project management costs, the report also highlights the variation that exists in project management levels between projects and organisations.
- Therefore a large, broad based sample has relevance and should be considered alongside the comparison with other network operators, that is based on a much narrower sample and which includes sites that have yet to be delivered.

Ofgem’s comparison with other network operators
The project management costs are broadly consistent with the average for the other networks that is referenced in the consultation letter:

- From the VFM2 reports, the TPCR4 project management costs are REDACTED of total costs.
- Ofgem states that the average for the other network operators is 15% of total costs (though we are not able to source or test the assumptions behind this value).
- However, the other operators did not have the specific challenges faced by National Grid during the TPCR4 period, and the ‘other operators’ value includes many sites that are yet to be delivered.
- Therefore it is reasonable to assume that National Grid’s TPCR4 projects would have higher costs.
- Therefore, given the TPCR4 context, the National Grid project management costs of 19% of total costs are reasonable.

Conclusion
National Grid successfully delivered a large programme of work within a challenging TPCR4 environment, and this has been acknowledged by Ofgem. All the contemporaneous feedback over an 8 year period suggested that our project management costs were reasonable. We agree with Ofgem that project management costs should reduce and we have built this into our submission for the RIIO period. Overall, given the arguments laid out above we believe the proposed scale of disallowance is disproportionate. Furthermore any disallowance should not be considered as demonstrably inefficient, with Ofgem recognising in its consultation letter that the project management costs “were not flagged as inefficient in the VFM2 reports”. Therefore any disallowance should flow through the TPCR4 capex incentive mechanism.

2. Initial Contractor

Summary of Ofgem's Position
- Unsubstantiated costs (i.e. REDACTED) = £4.8M.
- Duplicate design costs = £1.1M.
- Site A = £4.7M.

Response
Our response includes the following elements, which are explained in more detail underneath:
- General response covering all elements of Ofgem's 'initial contractor' position.
- Specific response to the 'unsubstantiated costs'.

General response covering all elements of Ofgem's 'initial contractor' position
The initial contractor was appointed as the PSUP contractor in 2005. This appointment was an appropriate decision for the following reasons:
- A formal and proper OJEU process was followed to select the supplier.
- The initial contractor was the clear winner of this process.
- They were financially stable (profitable before, during and after their involvement with National Grid).
- They were of a suitable size to deliver PSUP work as envisaged at that time (and as big as or bigger than other companies that have subsequently delivered PSUP work for other operators).

From 2006 onwards they were awarded and successfully delivered the sites they were asked to complete, as demonstrated by successful completion of all technical audits, good VFM audit outcomes and favourable project outturn costs.

Therefore, in 2007 it was not unreasonable to realise the option of the 2 year extension in the original contract to deliver further sites, especially as more sites were being added to the PSUP list and pressure was starting to develop from government to accelerate delivery.

As the number of sites they were managing increased they then began to struggle to make progress on the delivery of the programme. It was at this stage that the decision was taken to move to new suppliers which provided the increased certainty of delivering the target site volumes.

All the decisions were taken with best intentions and balanced by the range of information available at the time. Therefore the costs should not be considered as demonstrably inefficient.

Unsubstantiated Costs
REDACTED.

3. Site Specific Queries

Summary of Ofgem's Position
- Ofgem has proposed disallowances at specific sites that equate to £8.2M in total.

Response
This section provides a response for the sites identified by Ofgem.

Site B
The PSUP works at Site B were not identified and scoped until 2011. This was long after the allowance for the Milford Haven project was set, which was before the start of the TPCR4 period.

As with all other PSUP work, the costs for Site B have been captured and accounted for as part of the PSUP programme, as we understood this was the appropriate approach to take (for example the PSUP costs have to be separated so that they can go through the VFM process as required by DECC and Ofgem).

The PSUP costs for Site B are not currently in the Milford Haven project. If Ofgem wants the costs to be included as part of the Milford Haven project we will need to transfer the costs in the accounts resulting in an increase in the Milford Haven project costs of £5.4M. The TPCR4 allowance for Milford Haven should also be increased by a corresponding amount as the original allowance did not take account of this new government driven obligation.

These costs have been assessed as efficient:

- The VFM2 report concluded that the costs for Site B were 'value for money'.
- The consultation letter states that the 'security upgrade costs have been reviewed as part of the Milford Haven review', and the consultant's report for Milford Haven concluded in relation to Site B that "there is no evidence to suggest that this work was not performed in an efficient manner".

Site C
Ofgem's challenge is that the asset in question should have been monitored prior to the project start to minimise the risk of asset deterioration impacting on the PSUP works.

The asset was monitored prior to the start of the PSUP works. It was an unfortunate coincidence that the need for a risk management hazard zone around the asset materialised soon after the start of the project.

The physical security upgrade was not put on hold but rather mitigations were put in place to proceed with work as efficiently as possible within the constraints of the risk management hazard zone, that had to be placed around the asset for health and safety reasons. This allowed the work to proceed and construction to be completed within the target TPCR4 window.

Therefore we do not consider that these costs are demonstrably inefficient.

Site D
Ofgem's challenge is that National Grid failed to order sufficient fence posts which led to delays while waiting for them to be delivered.

The situation was not created by a failure to order sufficient fence posts, but rather a problem in the supply chain that could not be circumvented because of the constraints imposed by the approved PSUP supplier list:

- The ramp up in the PSUP programme created challenges in the supply chain, as the PSUP programme can only use suppliers that have had their fencing systems tested and approved by CPNI / CAST.
- In the case of strainer posts, sufficient strainer posts had been ordered but the approved supply chain had some quality issues and was unable to match the increased demand, and because of the supplier restrictions it was not possible to source the posts from an alternative supplier in time.
- This led to the delays and consequential costs referenced in the VFM2 report, which had been mitigated as much as possible by re-sequencing other activities.
- The auditor recognised some of the mitigation actions taken by the National Grid team: "*It should be noted that the technology contractor mitigated considerable potential delays caused by this issue by undertaking advanced commissioning with additional manpower earlier than anticipated*".

Given this context we do not believe these costs are demonstrably inefficient.

4. Opex

Summary of Ofgem's Position
Ofgem's view is that the opex costs for 2012/13 were funded as part of the TPCR4 rollover price control allowance.

Response
As part of our discussions with Ofgem in December 2014 we explained how the PSUP opex costs for 2012/13 were not funded as part of the TPCR4 rollover price control allowance.

REDACTED

The rollover opex allowances were based on the latest available outturn figures at the time i.e. those submitted in July 2011 which reflect the 2010/11 financial year (as defined in the rollover final proposals paragraph 2.12).

The 2010/11 opex allowance did not include PSUP opex costs. Therefore by showing below that the rollover opex allowance is the same as the 2010/11 opex allowance we are also demonstrating that the rollover opex allowance did not include PSUP costs.

REDACTED

5. Treatment of any Disallowed Costs

In the previous sections we have demonstrated that the proposed disallowances are not demonstrably inefficient. Therefore any final determination of disallowed costs should be treated like other TPCR4 costs and pass through the existing TPCR4 capex incentive mechanism.

C. RIIO-T1

This section provides a response to the areas where Ofgem is proposing disallowances for the RIIO-T1 period, which are listed below and described in more detail underneath.

1. General Items and Preliminaries
2. Project Management Costs

1. General Items and Preliminaries

Summary of Ofgem's Position

- Harnser's report states that National Grid's general items and preliminaries costs are approximately REDACTED.
- Harnser's report states that the average for other network operators is REDACTED.
- Ofgem has used these values to calculate a 52% disallowance for National Grid's general items and preliminaries costs, equating to £52.8M (for NGET and NGGT combined).

Response

We challenge the use of the reference values in the Harnser report for assessing our RIIO-T1 values, and present 4 alternative calculation methods that produce proposed disallowances between REDACTED.

Method 1: Challenge to the use of the REDACTED ***for the National Grid value***

The REDACTED value is based on a very small sample of historic sites and does not reflect the REDACTED efficiency that is built into the reopener submission.

Adjusting for the full historic portfolio of National Grid sites produces a value of REDACTED.

Further adjusting the National Grid value to reflect the efficiencies built into the reopener submission gives a reference value of REDACTED.

This gives a revised disallowance factor of REDACTED.

This reduces the proposed RIIO-T1 disallowance in the consultation letter from £52.8M to REDACTED

Method 2: Same as Method 1, plus an adjustment to reflect National Grid's portfolio of sites

The average for other operators of REDACTED is based on REDACTED sites that on average are likely to be smaller and less complex than the National Grid portfolio of sites. Therefore it is reasonable that the relevant benchmark for National Grid would be higher than the REDACTED – we suggest a REDACTED increase would be reasonable.

Therefore, the proposed relevant benchmark value is REDACTED.

This gives a revised disallowance factor of REDACTED.

This reduces the proposed RIIO-T1 disallowance in the consultation letter from £52.8M REDACTED.

Method 3: Bottom up calculation based on the cost per site per week benchmark value

This method calculates an adjustment to the proposed disallowance based on a calculation of the allowed cost derived from the benchmark cost per site per week benchmark value.

Using the REDACTED value, we calculate that the allowed cost for the RIIO-T1 period for NGET and NGGT would be REDACTED:

- Harnser's proposed benchmark value is REDACTED.
- The average duration of our RIIO projects is REDACTED.
- The number of NGGT + NGET sites = REDACTED.
- This produces an allowance value of REDACTED.

Ofgem's proposed allowance is REDACTED, which is derived from the proposed disallowance value in the consultation letter:

- The proposed disallowance value from the consultation letter is £52.8M (i.e. £35.3M + £17.5M).
- This is based on a disallowance factor of 52%.
- Therefore the starting value is REDACTED
- Therefore the proposed allowed cost in the consultation letter is REDACTED.

Therefore, the allowance value implied by the consultation letter is under-estimated REDACTED.

Therefore, this reduces the proposed RIIO-T1 disallowance in the consultation letter from £52.8M to REDACTED.

Method 4: Same as Method 3, plus an adjustment to reflect National Grid's portfolio of sites

The average for other operators of REDACTED is based on REDACTED sites that on average are likely to be smaller and less complex than the National Grid portfolio of sites. Therefore, as with Method 2, it is reasonable that the relevant benchmark for National Grid would be higher than the REDACTED average – we suggest a REDACTED increase would be reasonable.

Therefore, the proposed relevant benchmark value is REDACTED.

Using the REDACTED benchmark value, we calculate that the allowed cost for the RIIO-T1 period for NGET and NGGT would be REDACTED:

- The proposed relevant reference value is REDACTED.
- The average duration of our RIIO projects is REDACTED.
- The number of NGGT + NGET sites = REDACTED.
- This produces an allowance value of REDACTED.

As described in Method 3, Ofgem's proposed allowance is REDACTED, which is derived from the proposed disallowance value in the consultation letter:

Therefore, the allowance value implied by the consultation letter is under-estimated by REDACTED.

Therefore this reduces the proposed RIIO-T1 disallowance in the consultation letter from £52.8M to REDACTED

2. Project Management Costs

Summary of Ofgem's Position

- Ofgem states that our RIIO-T1 project management costs = 25% of total costs.
- Ofgem states that the average project management costs for other network operators = 15% of total costs.
- Ofgem has applied the 'other operators' value to our RIIO-T1 costs to produce a proposed disallowed value of £46.1M (for NGET and NGGT combined).

Response

Our response to the assessment of the RIIO-T1 project management costs is summarised below and expanded on in the sub-sections underneath:

- Our RIIO-T1 project management activities include areas that are not comparable with other operators, including activities that have delivered approximately REDACTED of consumer benefit.
- These activities led to additional project management costs, which would not be incurred by others.
- Our RIIO project management costs are reasonable when compared to other references i.e. other networks, the Harnser report, and the EC Harris report.
- In conclusion, a disallowance of between REDACTED would seem more proportionate.

Our RIIO-T1 project management activities include areas that are not comparable with other operators, including activities that have delivered approximately REDACTED of consumer benefit

At the start of the RIIO-T1 period there were two areas that were not comparable to other networks, namely the development of Operational and Hybrid Solutions and the impact of the extended DECC site review on a very large, active PSUP programme.

Through its own initiative, National Grid introduced the concept of ‘operational solutions’ (which avoids the need for a physical build at some of the PSUP sites), and ‘hybrid solutions’ (which results in a reduced build at some other sites). An extensive process was followed over a 12 month period between April 2014 and April 2015 which identified a significant number of operational and hybrid solutions and resulted in a benefit to the consumer of approximately REDACTED through avoided build costs.

The start of the RIIO period coincided with a new DECC site review which extended over an 18 month period and lasted far longer than was originally anticipated. This created significant planning and programming uncertainties especially as National Grid was at the peak delivery point of its PSUP programme when the site review started. This inevitably increased the proportion of project management activities and created resourcing uncertainties, which were mitigated as much as possible for example through managing down resources as projects works were put on hold (in agreement with DECC) and as it became clear that certain sites would be removed from the PSUP list.

The activities described above led to additional project management costs, which would not be incurred by others

The context described above impacted the project management costs in three ways:

- Costs associated with sites that were removed from the PSUP list either because they were identified as operational solutions or because they no longer met the new DECC criteria. These sites were in various stages of development and therefore their incurred costs were mostly project management costs. Our submission report shows that the cost associated with these stopped sites was REDACTED. Six of these stopped sites have completed a VFM2 audit and have been assessed as value for money.
- Costs associated with developing the operational solutions. This process involved reviewing over REDACTED sites on the DECC list over a period of 12 months. All these activities are captured as project management costs, and therefore distort the project management percentage.
- Costs associated with having to manage the uncertainty created by the DECC review. This is specific to National Grid as we had a full PSUP programme running at the time, with a fully resourced project management team. Managing down these costs within the context of an uncertain and ultimately declining future workload necessarily leads to costs that would not have been incurred if there had been certainty of scope, site volumes and timescales.

These costs would not be incurred by the other network operators, and therefore any disallowance based on comparisons with other operators should take account of the context described above. We estimate these costs would be in the region of REDACTED.

Our RIIO project management costs are reasonable when compared to other references

Comparison of our project management costs with four other references suggests they are reasonable. The comparisons are listed below and described in more detail underneath.

- Consultant’s report (Harnser, July 2015) – Item 1.
- Consultant’s report (Harnser, July 2015) – Item 2.
- EC Harris benchmark.
- Ofgem’s comparison to other networks.

Harnser report (July 2015) – Item 1

In Section 3 of the consultant’s report Harnser reviewed project management costs for National Grid and other operators. National Grid’s RIIO project management costs are consistent with the value that the consultant has quoted as ‘value for money’:

- The consultant’s report provides a reference value for project management costs of REDACTED, and states that this value “would represent value for money” (i.e. a value for money range of up to REDACTED).

- The report quotes National Grid's project management costs as REDACTED, which is REDACTED than the 'value for money' range.
- However, the calculation of the National Grid value is based on historic sites that have completed a VFM2 audit.
- Our future sites have lower project management costs which are REDACTED lower than our historic sites.
- Therefore a reduction to the Harnser calculation for National grid costs by REDACTED produces a revised value of REDACTED, which is marginally below the mid-point figure deemed as 'value for money' by Harnser.

Harnser report (July 2015) – Item 2
In Section 7.1.2 of the consultant's report, Harnser calculates a proposed combined disallowance value for NGET & NGGT of REDACTED. The disallowance value of £46.1M proposed by Ofgem in the consultation letter is more than twice the value proposed by their consultants.

EC Harris Benchmark
As referenced in Ofgem's consultation letter, National Grid provided Ofgem with a project management benchmarking study in December 2014. This report provided justification for our level of project management costs, and we stand by the validity and relevance of the report:

- The findings are based on a very large sample (2,500 projects) across a range of industry sectors, including utilities (e.g. REDACTED) and infrastructure companies (e.g. REDACTED).
- As well as supporting National Grid's level of project management costs, the report also highlights the variation that exists in project management levels between projects and organisations.
- Therefore a large, broad based sample has relevance and should be considered alongside the comparison with other network operators which is based on a much narrower sample and includes sites that have yet to be delivered.

Ofgem's comparison with other network operators
The project management costs are in line with those of the other network operators:

- The future sites in our RIIO submission have an average project management cost equal to 15% of total costs.
- This is the same as the value for the other network operators referenced in the consultation letter.

In conclusion, a disallowance of between REDACTED and REDACTED would seem more proportionate
The impact on project management costs caused by the extremely successful operational solutions initiative and the impact of the extended DECC site review, alongside the comparisons with other reference values suggests the National Grid project management costs are reasonable, and that the proposed level of disallowance is disproportionate, and more than twice the disallowance proposed by their consultants.

We suggest a more proportionate disallowance would be in the range REDACTED to REDACTED. The higher disallowance value of REDACTED reflects an estimated REDACTED recognition for the context created by the delivery of the Operational Solutions and the DECC site review. The lower disallowance value is that proposed by Ofgem's consultants in their July 2015 report.

D. RIIO-GD1

This section provides a response to Ofgem's proposed disallowances in relation to NGGD's RIIO-GD1 reopener costs.

Summary of Ofgem's Position

- For general items and preliminaries costs, Ofgem applies the same approach to National Grid's three GDNs as described for the NGET and NGGT RIIO-T1 costs.
- For project management costs, Ofgem applies the same approach to National Grid's three GDNs as described for the NGET and NGGT RIIO-T1 costs.

Response

As Ofgem has applied the same approach to NGGD as it has applied to NGET and NGGT, we request Ofgem considers the responses described in our RIIO-T1 responses (contained in Section C of this letter) in relation to any proposed NGGD disallowances.

E. Other Items

2018 Reopener
The consultation letter states that for the 2018 reopener Ofgem would only expect submissions for shared sites and Site J.

In accordance with the licenses we would expect to be able to submit costs that meet the definition for Enhanced Physical Site Security Costs as described below:

NGET License:
"Costs incurred, or expected to be incurred, by the licensee for the purposes of implementing any formal recommendation of the Secretary of State to enhance the physical security of any of the sites within the licensee's Transmission System."

NGGT License:
"Costs incurred, or expected to be incurred, by the licensee for the purposes of implementing any formal recommendation of the Secretary of State to enhance the physical security of any of the sites used in connection with the pipeline system to which this licence relates."

NGGD License:
"Costs incurred, or expected to be incurred, by the Licensee in respect of the relevant Distribution Network for the purposes of: (a) implementing any formal recommendation or requirement of the Secretary of State to enhance the physical security of any of the sites within the Licensee's Distribution Network; or (b) complying with any requirement arising under sections 85 to 90 of the Counter-Terrorism Act 2008 to make payments to the Secretary of State for costs incurred by him in respect of the provision of extra policing services in or around a gas facility, as may be further clarified in the RIGs."

Confidentiality
As with all our PSUP communications we have marked this document as 'Confidential' and 'Official Sensitive' in line with guidance from our corporate security colleagues. We will submit separately a redacted version of this consultation response.