

Minutes of the Meeting of the Gas and Electricity Markets Authority

Thursday, 21 May, 2009 at 8.15 am

Ofgem, 9 Millbank, London SW1 3GE

Introductory remarks by the Chairman

1. There were apologies for absence from Judith Hanratty, David Harker and Charles Gallacher. The interest of a non-Executive Member in a company mentioned in one paper, which was carrying out research on social issues in energy for Government, was noted. No other conflicts of interest were declared. The Chairman announced that the Secretary of State DECC had offered a further term of three years to John Wybrew as a Member of the Authority, adding his warm congratulations. Miriam Greenwood had represented the Authority at the formal opening of the South Hook/Milford Haven LNG terminal and was thanked by the Authority. The Chairman noted that Jonathan Amos, one of Ofgem's graduate trainees, would be joining the meeting for some agenda items, as an observer.

Minutes of the Authority Meeting held on 23 April, 2009

2. The minutes were approved.

Reports from the Chief Executive and Managing Directors

3. The Chief Executive drew attention to the following key issues and developments:
 - The phasing and interrelationships of the main forward Ofgem policy workstreams including the follow-up activities on the retail price probe, Project Discovery, RPI-X@20, the Offshore Transmission regime, the Transmission Access Review, the Distribution Price Control and Project Mercury which was looking at Ofgem's systems, policies and process in the event of network companies' financial distress.
 - The related work and deliverables on the industry modifications governance review and corporate communications.
 - Retail price factors including recent and welcome cuts in energy and gas tariffs but the likely countervailing pressures on costs ahead from schemes such as ROCs; transmission charges; and the feed through from DPCR5, CESP and EEC.
 - An analysis of current market trading and credit issues and their impacts for energy companies, for investment banks and their clients and for the finance and credit required for infrastructure investment.
 - The importance of appreciating the international – and particularly European – context of capital markets and capital flow issues, given the structure of foreign ownership of many of the major GB energy companies, and differing continental European energy policies and investment needs.
4. The briefing for the Authority on corporate affairs covered the latest steps on the British Energy/Centrica deal, following the merger of EdF and BE, and aspects of the merger clearance and Ofgem's potential role, and its timing, in providing formal advice to the OFT following the expected notification. The Authority would continue to be briefed on developments. The Authority were briefed on and noted DECC's plans for its summer strategy and BERR plans on further consumer measures. The Authority welcomed these reports and Ofgem's plans for monitoring developments and feeding in as appropriate.

5. The Authority noted that current networks issues were, in the main, covered fully in the range of Authority papers for the meeting.
6. On energy markets matters, the Authority was presented with an analysis of current energy market developments including trends in dual fuel direct debit prices and the price spreads between companies' offerings, now averaging £42 on typical annual bills. The analysis covered trends in customer bills for gas and electricity, and for dual fuel tariffs, since January 2003 and the relationship to companies' wholesale energy and other input costs. Forward price curves for electricity showed no significant divergence among European prices in major markets. For gas, Summer prices were steady but indicated some strengthening into early 2010, given a projected rally in oil prices. Again, GB and continental European prices were showing similar forward trends. The Authority noted that the next wholesale/retail report was soon to be published by Ofgem.
7. On security of gas supply, the Authority noted Ofgem's work in contributing to DECC analyses covering supplies, including LNG, and steps taken to improve resilience. A consultation exercise had recently closed on proposals to introduce a market power licence condition: views from the generators were mixed, and work on the measures was proceeding in consultation with DECC.

SP losses case

8. The Authority recalled the representations by Scottish Power Energy Networks (SP) claiming higher allowed loss percentages (ALPs) in its current price control for its two electricity distribution companies; and was briefed on the key developments since it last discussed this matter, including the completion of an impact assessment, and a consultation exercise on SP's request, and legal analyses on the issues arising. The Authority recalled that the MD Networks had informed the company that Ofgem was not minded to not to increase SP's ALPs in December 2007. It had been accepted at that time however, that some adjustment might be made in respect of losses on EHV units. The Authority was provided with the latest key documents, including responses to the consultation and an exchange of correspondence with SP. The Authority noted that SP had indicated that they would seek judicial review of any decision by the Authority to reject their application for revised ALPs. The Authority discussed a number of the features of the SP claim, the agreement reached previously with SP on losses and their assessment at that time, and the views of respondents during the consultation. It was agreed that a final decision should await further advice from Scottish Counsel, given the possibility that any judicial review might be heard in the Scottish Courts.

DPCR5: defined benefit pension costs

9. Following its discussions on the main elements of the DPCR5 at its last meeting, the Authority turned again to the issue of pensions treatment for the forthcoming price control period. Defined benefit pensions schemes were a significant part of DNOs' costs and, on recent analysis by the companies, could amount to 13% of forecast costs for the 2010-2015 period, covering ongoing contributions and deficit repair. The Authority noted its agreed 2003 pension principles, and how they compared to the treatment adopted by other regulators. The Authority noted the assessment of information provided to Ofgem by the network companies and by the Government Actuaries Department and discussed, at a high level, the key options for pensions treatment in DPCR5. These options ranged from keeping the current arrangements, introducing some form of additional incentive on DNO's and shareholders to manage pension costs and risks, or allowing DNOs to choose between these options as part of the price

control settlement, with adjustments to the cost of capital reflecting the relative risk, depending on the chosen approach.

10. The Authority agreed that the matter was important and complex. The high level options should be worked up for further discussion by the Authority in July ahead of a possible consultation on these options and retaining the approach adopted as part of the last Distribution Price Control also in July. There would need to be further consultation of the Authority's initial proposals on this matter in the Autumn.

Transmission Access Review

11. The Authority was brought up to date on the latest developments on reform of the transmission access arrangements since it last considered the issues in March 2009. At the end of March the Secretary of State DECC had been advised that the Authority saw no need for the use of his powers under the Energy Act 2008. These would enable him to modify licences and associated documents; to facilitate access to a transmission system; or require the efficient use of a transmission system, in Great Britain or offshore waters. In March, the Authority had expected a further ("fourth") access model to be raised by National Grid. However, two CUSC amendment proposals – representing the "fourth" model – had been blocked from consideration in the CUSC Panel. This now raised concerns about the ability of industry processes to deliver the necessary reforms successfully, to an acceptable timescale. The Authority also noted recent analyses and forecasts by National Grid on use of system and constraint costs for thermal plants, new wind farms, and on the impact that different access models would have on charges and on the costs borne by consumers.
12. In the light of these developments, the links to the industry codes governance review and briefing on the latest contacts with DECC, the Authority considered options for the way forward and their timing. It was recognised that transmission access reform was critical to the achievement of HMG's targets for renewables and carbon emission reduction, yet continuing reliance on industry processes carried the risk of further delay and possibly failure. The Authority concluded that the team should make one final effort to see if a solution could be found using the existing industry processes and that DECC should continue to be closely informed. In the light of these actions, the Authority would aim to reach a final decision on the way forward at its June meeting.

Dealing with network companies in financial distress

13. The Authority received a briefing note setting out the proposed work plan for taking forward the main issues highlighted in the recent "War Game" exercise to test Ofgem's responses and resilience in the event of financial distress of a network company. These included engaging with DECC and HM Treasury on respective roles; and a review of the effectiveness of the existing financial ring fence licence conditions. Further information had been drawn together from the monitoring of the financial health of network companies. An update was provided on the development of the Ofgem procedural manual for responding to network financial distress.
14. In discussion, the Authority agreed that HMT and DECC should be approached with a view to agreeing a Memorandum of Understanding covering roles and responsibilities, areas of policy lead, timings for action, and communications matters, with appropriate agreements by the Autumn. The Authority also agreed the proposed timetable for the completion of the review of the financial ring fence arrangements, noting that modifications to the present conditions would require

statutory consultation. On monitoring, the Authority was briefed on the increased effort by Ofgem teams, including analysis of the submissions of data submitted by companies on their resources and projected cash flow, and the resultant picture on companies' financial health.

15. The Authority discussed the appropriate procedures for dealing with a network company in financial distress. The Authority agreed that it was important to ensure that the procedures enabled a timely response and saw merit in delegating responsibility to the CEO in consultation with the Chair. The Authority asked for further consideration as to how this might work in practice.

Probe: decisions on consultation

16. The Authority was given a brief update on the latest consultation and its conclusion, taken in March 2009, that it was minded to introduce two new licence conditions designed to address retail price differentials which failed to reflect underlying costs. The consultation had closed on 13 May and, to date, the majority of companies appeared to be willing to support the approach currently favoured by the Authority but with some reservations. Consumer groups were generally supportive, a number suggesting further regulatory steps, while academic respondents had raised the possibility of creating risks to competition and potential consumer detriment.
17. No decisions were sought at this stage and the Authority welcomed the offer of a full presentation at its June meeting with recommendations on the way forward, including advice on statutory consultation.

Social Tariffs

18. The Authority considered a paper updating it on social tariffs and Government's plans for a fuel poverty review. The Authority recalled its long-held view that the more progressive way of providing assistance would be through the tax and benefits system, so as to prevent poor redistributive effects, market distortions and other unintended consequences. However, the Authority noted the pressures which current economic circumstances were likely to exert on further assistance via tax and benefits. The Authority noted suppliers' social measures under which some £150m a year would be spent by 2010 and the complex questions concerning eligibility, matters principally for Government. The Authority debated and discussed further analysis and issues raised. No action points were sought at this stage, but the Authority agreed that it be kept updated as matters developed.

Heat and Energy Saving Strategy

19. The Authority considered a paper outlining the Government's Heat and Energy Saving strategy proposals which had been published in February 2009, alongside consultations on the new Community Energy Saving Programme (CESP) and proposed modifications to its Carbon Emissions Reduction Target (CERT), all of which would inform its final Heat and Energy Savings Strategy to be completed later in the year. The high level proposals included offering a "whole house" energy saving refurbishment to 7 million homes by 2020 and to all homes by 2030; plans to reduce household carbon dioxide emissions by 30% by 2020; consumer information on energy savings; and new delivery and financial support methods for heat and energy saving policies.
20. The Authority agreed that the consultation provided a good opportunity for Ofgem to contribute to long term strategies for improving domestic energy efficiency,

fully in line with its principal objective of protecting the interests of present and future customers, and in delivering its contribution to achieving sustainable development in the energy sector. Through these means, there was an opportunity to achieve results in a relatively cost-effective way. Demand reduction would have benefits for long-term security of supply, and in meeting the cost of complying with carbon reduction and renewables targets. The Authority agreed that, in its responses, it should be should make clear its welcome for the focus on energy saving, and the needed and ambitious scale of the proposals. The Authority looked forward to further reports on these proposals and their development.

Industry Codes Governance Review: Initial Proposals

21. Under this item, the Authority debated a paper seeking agreement to a set of initial proposals for reform following the review of the industry governance codes. The key issues among these were the need to find a way forward for introducing a proposal on a major policy review (MPR) framework for the delivery of strategic reforms under the code arrangements; and a new self-governance framework for those code modifications entailing limited consumer or competition impacts. The paper noted that the MPR process should enable customer benefits to be delivered at an earlier stage, from a more transparent and coordinated approach to key strategic reforms. The proposed MPR process was being designed to be highly consultative, with parties having full rights of appeal on the merits of the proposed modifications. The Authority recognised some of the concerns identified from the initial consultation and considered the arguments in response to these and further proposals to improve the arrangements and mitigate these.
22. The paper also noted proposals to improve the administration of the industry codes with the chief aim of creating better incentives to increase engagement from small participants (small suppliers and renewable generators) and consumers. The Authority agreed the measures together with those designed to improve the quality of analysis on code change proposals. The Authority accordingly endorsed the package of industry code governance reforms for consultation in Initial Proposals scheduled for issue in late June or early July.

Smart Meters

23. The Authority received an update on the DECC's planned programme, announced on 11 May, to introduce smart meters by 2020; and was briefed on the preparatory work to date by the department for the rollout plan. DECC had expressed a preference in these proposals for a central communications model, such that meters would be under supplier control but communications arranged centrally, with the functions and governance arrangements for this still to be decided. Further thought was being given to the networks' involvement; and Ministers had made it clear that that were not minded to provide compensation for the early removal of existing meters. The roll out programme would itself be a very major piece of work with significant impacts on existing industry systems and processes. It was an issue of considerable media and public interest. The Authority noted that many detailed matters would have to be to be resolved on issues such as finalising smart meter functionality and interoperability, detailed market design, communications requirements, the functions of central systems for communication, and consumer engagement. DECC were suggesting that completion of the preparatory work could take up to two years. An Ofgem role had been suggested for the management of the programme roll-out, and a number of individual workstreams and responsibilities provisionally identified.

24. The Authority noted that no decisions were needed at this point, and that the DECC consultation exercise would end in early August. The draft response from Ofgem would be developed for and discussed at the June Authority meeting. The Authority noted however that the Ofgem's involvement in a project of this size, complexity and importance would require clarity on a number of issues. These included agreements on funding and resources; objectives and duties for the individual workstreams; the degree of independent control over detailed aspects of the project, its design and its outcomes; and the associated risks. The Authority agreed that it would be valuable to explore a number of these matters further with DECC in advance of further debate.

Offshore Electricity Transmission: final policy proposals and the approach to transitional project cost assessments

25. The Authority had agreed the overall approach for the offshore regulatory regime in April 2008, and had approved the remaining policy issues leading to the DECC/Ofgem consultation in March 2009. Consultations were complete and the Authority now turned to a paper proposing detailed policy positions for the structure of the regulatory regime for offshore electricity transmission, and the associated tender processes, both designed to encourage competition for new capital investment and new entrants to the industry. It also examined an update on the projects considered likely to qualify for the transitional regime and the first round of tenders with an updated cost assessment process for these transitional projects. The issues had been carefully examined by the Authority's Offshore Transmission Committee, as confirmed by the Committee's Chair, Miriam Greenwood; and the work had benefitted from inputs from Ofgem's external advisers.
26. The Authority noted that the proposed design of the regulatory regime was broadly as developed earlier; and that the model now presented had taken into account points raised by commentators in relation to strategic network developments, performance incentives, aspects of the OFTO revenue stream, and the compliance link to the Third EU Package. The proposed design was approved by the Authority. On the standard framework documentation, the Authority agreed the implementation plan for the completion of changes and their proposed timings, as raised in the latest consultation round. These could be put to the Secretary of State for approval and implementation under the powers granted under the Energy Act 2004. The Authority agreed the overall design of the competitive tender process for the transitional regime, noting that further advice would come forward on the decision-making mechanisms for the start-up of the tender process. A Member of the Authority was given authority to authenticate the application of the seal to the regulations prior to their submission to the Secretary of State. Finally, the Authority delegated to the Executive team the finalisation of the necessary modifications to NGET's special licence conditions in recognition of their costs for development and in respect of their future role as an offshore system operator.

Communications Strategy

27. Under this item, the Authority reviewed and agreed a paper setting out Ofgem's proposed communications strategy to the end of 2009, against the context of public policy and political developments, continuing pressures on issues such as fuel poverty, debt and disconnections, and retail energy prices, and in relation to the major forward looking projects (e.g. Project Discovery and RPI@20) on which Ofgem was working during the year.

Olympics 2012

28. The Authority was briefed on the issues arising following requests from companies owning and operating the electricity distribution network in London and other SE venues where Olympic events were to be held. Ofgem had been asked that relevant costs - in the absence of indicated funding so far from the Olympics Delivery Authority - should be dealt with in the context of DPCR5. Certain derogations from licence conditions were considered necessary by EDF energy given operational restrictions imposed by the ODA. It was noted that the London Organising Committee of the Olympic Games (LOCOG) may also commission additional electricity network services for the sites. The Authority considered that appropriate costs should be funded by ODA or LOCOG, as appropriate, rather than be met by all relevant licensees' customers. Contacts and further discussion with the companies, Olympic site planning bodies and other regulators such as Ofwat and Ofcom should continue, with consultations on proposals following once policies had been further explored.

Audit Committee: Annual Report

29. The Authority received a report from the Audit Committee, presented by Jayne Scott, its Chair, summarising its work for the past year and highlighting the some of the key issues to be addressed in 2009/10. A note on the main issues discussed at the Audit Committee meeting on 22 April was also provided. Activities in 2008/9 had covered financial reporting, risk, financial updates, the management of environmental programmes, the offshore electricity transmission project and IT security. In all areas, the Committee was able to report positive assurances in relation to the Authority's governance, management of risk, reputation and control environment, this enabling the Accounting Officer to sign a satisfactory Statement on Internal Control for the year. The Authority welcomed these reports, and expressed its grateful thanks to the Committee and its members.

Other business and date of next meeting

30. The Chairman outlined the plans for the Authority Awayday on Wednesday 17 June at a London venue, starting at 9.30 am, and noted some of the key issues to be addressed at the next Authority meeting which would be held at Ofgem on 18th June at 8.15 am. There would be an open session of the Authority on the afternoon of 18th June starting at 2.00 pm. There were no other items of business.

Those present

The Lord Mogg, KCMG	(Chairman)
Alistair Buchanan	(Chief Executive)
Dr Robin Bidwell	
Miriam Greenwood	
Judith Hanratty	
Sarah Harrison	
Jim Keohane	
Jayne Scott	
Steve Smith	
Andrew Wright	

Those attending

Charles Gallagher	(all items)
David Ashbourne	(")
Rachel Fletcher	(SP losses/DPCR5- pensions)
Stuart Cook	(Transmission Access)
Hannah Nixon	(Project Mercury)(Olympics)
Emma Kelso	(Probe)(social issues)(smart meters)
Neil Barnes	(")
Duncan Sinclair	(")(smart meters)
Colleen Hanley	(")
Maxine Frerk	(social issues)
Martin Crouch	(" ")
Angela Bourke	(" ")
Mark Feather	(industry codes governance)
Andy MacFaul	(" " ")
Irene Hurrell	(" " ")
Louise van Rensburg	(smart meters)
Nigel Nash	(" ")
Bob Hull	(offshore regime)
Edward Ntephe	(" ")
Trevor Loveday	(communications)
Rachel Hatfield	(")
Alex Lyon	(")
Michael Brocklehurst	(Legal Adviser to the Authority)
Dr Tony Burne	(Secretary to the Authority)