

Minutes of the Meeting of the Gas and Electricity Markets Authority

Thursday, 23 April, 2009 at 8.15 am

Ofgem, 9 Millbank, London SW1P 3GE

Introductory remarks by the Chairman

1. The Chairman informed the Authority, with regret, that Prof George Yarrow had recently tendered his resignation, and that this had been accepted by the Secretary of State. Prof Yarrow had made a substantial contribution to the Authority's work, across a wide number of topics, and he would be missed. There were no other absences, nor had conflicts of interest been registered in relation to any of the items on the agenda. Tim Collins, one of the participants in Ofgem's graduate entry scheme, would be joining part of the meeting as an observer.

Presentation

2. The Authority welcomed Lorna Shearin, Managing Director of the Royal Bank of Canada's Capital Markets Division, London, who provided a presentation on aspects of the investment characteristics of the proposed Offshore Transmission regime being developed by Ofgem, based on a recent City briefing from Ofgem and its advisers. This started with a consideration of the transmission assets to be owned by the Offshore Transmission Operators (OFTOs) and their roles and responsibilities; and the transitional projects likely to be developed to 2011.
3. As regards investment opportunities, the analysis suggested that the transitional process offered strong opportunities for new entrants, given the political and regulatory support for UK offshore transmission, with robust and transparent competitive processes, which should provide valuable experience to those now participating for the longer-term, enduring regime now being developed. In the longer term, there would be a 20 year regulated revenue stream from the GB system operator which was independent of transmission capacity utilisation or wind farm performance, with low asset and operation and maintenance risks, and opportunities for increased capacity and for unregulated services. The presentation considered the allocation of risks as between the main stakeholders – the generators, transmission operators and consumers – and potential returns to new OFTOs. Debt providers were viewed as taking a positive view of the transitional regime for investment. Finally, the Authority was briefed on the tender processes and their timing, and the implications for investors in the regime and the steps to be taken to meet these during the registration and qualification stages.

Minutes of the Authority Meetings held on 5 and 19 March, 2009

4. The minutes of the 19 March meeting were approved; and the Chairman sought final comments on the record of the 5 March session by 28 April.

Reports from the Chief Executive and Managing Directors

5. The Chief Executive had circulated a short update report for Authority Members. This noted the key financial issues arising from the Resource Accounts for 2009/10, now approved by NAO, and soon to be presented to Parliament. It also noted some of the financial and organisational challenges for Ofgem for 2010/11; and the linkages between a number of significant and forward-looking projects on

which Ofgem was embarked and their resource demands. The Chief Operating Officer provided further information on the variance (£81k) as against a budget of some £42m for 2008/9, and the main elements in the fourth year of Ofgem's RPI-X cost control regime - including staffing, contractor costs and accommodation. Overall, 29 out of the 32 delivery targets had been met, despite the pressures of the past year. The Chief Executive paid tribute to the consistently high professionalism of his Divisions and their high delivery, the Authority adding its own thanks to all Ofgem staff for another year of exceptional performance and support.

6. On networks issues, the Authority was briefed on the latest developments on the Transmission Access Review. National Grid had tried, and failed, to introduce a new proposal reinforcing the Authority's existing concerns about the ability of existing governance arrangements to deal effectively with complex reform. A briefing was provided on issues raised by the London 2012 Olympics. The Authority noted in relation to the National Grid Gas transmission system exit capacity, and the treatment of the Irish interconnector, that a proposal to delay implementation of new exit capacity had been rejected but that further discussions with the Irish regulators were planned. The concerns raised by a number of independent electricity networks about the impact on their businesses of current charging arrangements were explained and Ofgem's existing and proposed actions were noted. There had been generally positive feedback on Authority decisions on the structure of electricity distribution charges for both low and extra high voltage systems.
7. The briefing on corporate affairs first provided a progress report on a range of consumer and social affairs matters, including the planned review of debt and disconnection practices, as foreshadowed in the Corporate Plan and joint work with Consumer Focus on vulnerable customer disconnections. A report would be made to the July Authority meeting. BERR were understood to be working on a consumer White Paper to modernise consumer protection law. The social and environmental guidance to Ofgem was still under review by Ministers. The annual report on modifications showed high levels of performance in 2008/9, with 92% of modification decisions completed within 5 weeks as against a target of 70%. The year ahead would be challenging given the additional need to consider, for example, new code modifications on transmission access and for the offshore regime as well as proposals to reform industry codes governance. The Authority was briefed on and noted the main energy-related issues announced in the Budget, including proposed new spending on carbon capture and sequestration demonstration projects, additional support via the RO for Offshore wind developments, further funding for energy efficiency measures, and capital allowances and tax changes designed to encourage investment and gas storage projects.
8. In a presentation on markets issues, the Authority noted the report on gas and electricity price developments, showing further falls in prices in near term energy markets. National Grid had now published their Summer outlook which indicated capacity margins in electricity were materially better than in Summer 2008, due to increased availability and lower projected demand. On gas, an expected further decline in UKCS supplies had been offset by increased availability of storage capacity and increased LNG import capacity. Oil prices were currently around \$50/bbl though were stronger in forward markets with oil for delivery in mid 2011 trading at about \$67/bbl. Ofgem had now published the "Spring Document" of measures to take forward a range of proposals for dealing with retail issues emerging from the Probe's findings. Initial verbal responses from stakeholders were noted; and the next step would be discussions. Ofgem had also published for consultation its final proposals for addressing price discrimination in retail

energy markets, including draft guidelines and a further development of the associated impact assessment. The Authority welcomed these actions, and looked forward to considering the responses to these consultations at the May meeting, after which the Authority would consider the final form of the statutory consultation that would be expected to follow.

9. On European matters, the Third Package proposals had been agreed on 24 March, and had now been adopted by the European Parliament, with some changes to the consumer aspects and with additional responsibilities for the new body, ACER, and on the generation of codes.
10. DECC were expected to publish shortly their proposals for taking forward the mandated roll-out of smart meters. These matters would be considered further at the May Authority meeting, including the potential role of Ofgem.

Security of Energy Supply: Project Discovery

11. The Authority was briefed on progress on the workstreams of a new project it had agreed in December 2008 to consider the ability of the current gas and electricity markets to deliver adequate security of energy supply in the medium term. The project was still at an early analytical phase and further work would be presented at the Authority's planned Awayday in June. The Authority noted the importance of risk and uncertainty; the importance of the range of assumptions and forecasts, and their sensitivity. The potential obstacles to the operation of efficient markets in electricity and gas were noted. Initial data was presented from Ofgem's analysis of supply and demand forecasts, for both gas and electricity, the prospect for future investment in new capacity, and information on investment needs and associated risks, and the emerging views of the investment community on the cost and availability of finance.
12. The Authority welcomed the results from this important and forward-looking project, noting the emerging themes for mid-term energy supply and the investment consequences. It agreed that the ideas and analyses should be further worked up, with appropriate testing of the base case and options, for discussion in June.

DPCR5

13. In this further briefing on the progress to date and overview of the distribution price control review, the Authority was provided with a paper and presentation, setting out the plans for conducting the next round of consultations in early May. This round would seek to establish a way forward on the policy for quality of service; and gather views on Ofgem's cost assessment methodologies. The Authority was accordingly invited to decide on the consultative proposals outlined for the two aspects of quality of service, dealing with worst served customers and the unplanned element of the interruptions incentive scheme (IIS); and, at high level, proposals on cost assessment methodology.
14. The Authority was also asked for views on the options for consulting on pensions, and where final decisions would be taken later in the DPCR5 process. The Authority recalled that it had introduced a set of "pension principles" in 2003 for all price controlled network companies. Given predicted rises in pension costs, Ofgem had consulted all relevant network companies seeking information on efficiencies, and had examined responses with the help of the Government Actuaries Department. This study had looked at pension schemes' benefits, investment strategies, ongoing contributions, funding levels and assumptions. The Authority noted the findings of the study. The Authority recognised the cost

impacts of defined benefit pension scheme; the roles of pension trustees; the relationship between potential efficiency savings and setting of the cost of capital; and considered information on the treatment of pensions by other regulators in the setting of their price controls. The Authority noted that there was a range of options for the treatment of pensions. The Authority asked for further information and in particular detailed information on other regulators' approaches to pension costs and agreed to consider the issue again in May.

15. Proposals on quality of service, with options covering specific areas, had been developed in the December policy paper. These included a "use it or lose it" allowance for DNOs to fund improvements in service for those customers experiencing the worst supply interruptions, and where a 25% improvement would need to be demonstrated to secure funding. The Authority approved the approach and mechanism, and the proposed maximum level of funding at £42m for the 5 year price control period. DPCR4 included an interruptions incentive scheme for the DNOs based on benchmarking and a target setting methodology including the numbers of customer interruptions and the minutes of supply time lost. The Authority was briefed on the continuing work to review similar targets for DPCR5 including customers' willingness to pay for improvements in interruptions performance by the DNOs. The Authority agreed that, in the light of performance data expected soon from the DNOs for 2008/9, suitable targets should be developed, together with further amendments to the IIS for consultation in the May document.
16. The Authority discussed a presentation which considered cost assessment methodology – covering network investment and cost benchmarking – as the background to the setting of allowances. In aggregate, DNOs were forecasting a 62% increase in network investment from £4.8bn (DPCR4) to £7.8bn (DPCR5), with a 13% increase in network operating costs and indirect costs, from £7.4bn to £8.4bn. These were substantial increases, and modelling work was continuing to review these figures. The Authority noted the progress in setting common approaches for output measures for asset replacement and enforcement. The Authority was briefed on the initial results of comparative analysis as between DNOs on the major forecast costs for their networks, noting that further work would be necessary in considering the development of initial proposals.
17. The Authority also noted the latest figuring on DNO receipts arising from under-forecasts of connections income, agreeing that materiality considerations did not point to the need for recovery for the DPCR4 period, and welcoming proposed revisions to the forthcoming price control to deal with this issue.
18. On IQI and RAV, the Authority noted the approaches recommended. Once assessments had been completed for each cost category, and for each DNO, these would need to be translated into revenue allowances through the IQI mechanism, where a similar approach to DPCR4 and GDPCR was suggested for DPCR5 and which would determine the power of incentives.
19. Finally, the Authority approved revised terms of reference for the DPCR5 Committee including delegated powers to approve for publication the Methodology and Initial Results document, reflecting the guidance offered by the Authority during its recent discussions and decisions.

Network companies and financial distress

20. The Authority was provided with a paper and presentation which considered the main issues arising from the recent "War Game" designed to test Ofgem's arrangements for dealing with financial distress of a network company, and the

policy issues arising. This exercise had followed from an Ofgem position paper published in December 2008, together with a commitment to produce an internal procedural manual, with a high level version for external publication in the Spring. The War Game was judged a success, and the procedural manual had been valuable. The Authority noted that decisions were not sought at this stage, and that work was now being undertaken on aspects of coordination with other Government departments; the potential implications of network companies' corporate structures; and the working of the financial ring fence. Monitoring of the financial health of companies would continue with regular reports to senior management and the Authority's Audit Committee. A paper would come to the Authority in May reporting further on all these issues. Meanwhile, the text of the draft high level manual was approved for consultation.

Industry Codes Governance Review

21. The Authority considered a paper reviewing progress on the Industry Codes Governance Review and the five main work-strands on this project which had been subject to initial consultations. The Authority recalled that the current ten industry codes were each the subject of different code change and administration arrangements. The review proposed major reforms for code governance, for both gas and electricity, given the deficiencies now evident in these arrangements, notably in delivering the major policy reforms required in respect of sustainable development and security of supply, and in ensuring pro-competitive approaches for the benefit of energy consumers.
22. The Authority considered views emerging from the consultation exercises to date, including the arrangements for greater industry self-governance on more routine modification matters; the approach advocated on the Major Policy Review process under which Ofgem would consult on and then initiate changes; the need for improved transparency of process; the question of appropriate checks and balances, including the routes of appeal; and the steps being suggested to help improve the quality of service and accountability of code administrators. The Authority also noted the key relationship between work on this project and the development of EU cross-border codes. There were also strong cross-links to other projects being taken forward by Ofgem.
23. In discussion, the Authority agreed to delegate to the MD Corporate Affairs, in consultation with Executive, decisions on those governance review work-strands dealing with charging methodologies reform; on increasing the prominence to be given to environmental matters in code modifications; and on those measures designed to reduce fragmentation and complexity in the codes' arrangements. No other decisions were sought at this stage, the Authority noting that proposals regarding the MPR and self governance processes would be brought to the May meeting for decision ahead of the initial proposals consultation.

Other business and date of next meeting

24. There was no other business. The next Authority meeting would be held at Ofgem on **21 May at 8.15 am.**

Those present

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

Those attending

Charles Gallagher	(all items)
David Ashbourne	(")
Roy Field	(reports)
Bob Hull	(offshore presentation)
Ian Marlee	(security of energy supply)
Kersti Berge	(" " ")
Duncan R Sinclair (consultant)	(" " ")
Andrew Pester	(" " ")
Ben Woodside	(" " ")
Rachel Fletcher	(DPCR5)
Kieran Donoghue	(")
Chris Watts	(")
Mark Cox	(")
Nicola Cocks	(")
Hannah Nixon	(network financial distress)
Mark Feather	(industry codes governance review)
Andy MacFaul	(" " " ")
Irene Hurrell	(" " " ")
Michael Brocklehurst	(Legal Adviser to the Authority)
Dr Tony Burne	(Secretary to the Authority)