

## **Minutes of the Meeting of the Gas and Electricity Markets Authority**

**Thursday, 16 July, 2009 at 8.15 am**

**9 Millbank, London SW1P 3GE**

### **Introductory remarks by the Chairman**

1. The Chairman welcomed to their first meeting two, new Non-Executives who had recently been appointed to the Authority by the Secretary of State, Professor David Fisk and John Howard. Each gave an outline of their backgrounds and interests in energy matters. Charles Gallacher had offered his apologies for absence: aspects of communications would be covered by Alex Lyon and Rachel Hatfield. The Chairman noted with regret that members of the Conservative Front bench team would not be able to meet the Authority over lunch, given the pressures of Parliamentary business that day.
2. One Member of the Authority declared that the organisation with which he was associated, and with a major interest in social and consumer issues, was commenting on aspects on Ofgem's proposed way forward on measures in respect of the retail market. Another Member noted that his institution was in receipt of support for work under the Innovation Fund. There were no other declarations of potential conflicts of interest.
3. As a follow up to discussions at the Authority's recent Awayday, it had been proposed that Authority Papers should be prioritised with appropriate classifications, as now reflected in the Agenda. This was agreed. On Committees of the Authority, the Chairman noted that the arrival of two, new Non-Executives had given him the opportunity to begin reflecting on Committee membership matters and the particular areas of interest which NEDs might like to follow across Ofgem's work. The Secretary would be putting his proposals to Non-Executive Members after the Summer. The Chairman drew attention to the need for details all Members' business expenses to be collated and published quarterly, and information on any hospitality offered or received in their GEMA roles, noting that early submission of claims would assist these processes.
4. The Chairman, on behalf of the Authority, offered his warmest wishes to Mark Feather and Jo Witters who were leaving Ofgem and returning to Australia after many years of highly valued service on a range of Ofgem assignments.

### **Minutes of the Authority Meeting held on 17<sup>th</sup> June, 2009**

5. The minutes were approved.

### **Reports from the Chief Executive and Managing Directors**

6. In his report to the Authority, the Chief Executive drew out the following main issues :
  - The central importance of Project Discovery and future security of supply matters which continued to generate considerable interest within Government, Parliamentary, academic and advisory circles.
  - The Government's plans for capability reviews and the pressure for reviews of the numbers, costs and effectiveness of "quangos".

- A review of the main Ofgem projects, their interrelationships, and the issues ahead for stakeholders and their interests.
  - Some of the key issues for Ofgem's plans and proposals in the Scottish context.
  - Potential M&A activity in the energy sector and competition cases.
  - The possibility of further legislation on energy matters, and the potential implications for Ofgem.
  - Welcome progress on a number of delivery achievements including on Ofgem's work for HMG on environmental schemes, on IT, the launch of the offshore regulatory regime, progress on the pay negotiations, and on spending at lower than budget for Q1.
7. On corporate affairs issues, the Authority was briefed on the Government's plans for new measures on consumer advocacy and consumer empowerment and on reform of financial services regulation. On the review of NDPBs ("quangos") both the Government and the Opposition had announced the terms of their proposed reviews, with varying emphasis on the numbers of such bodies, the possible repatriation of their functions to central Government, and approaches involving judging quangos' functions against technical needs, impartiality and transparency. The Authority was updated on key legal risks; plans for the publication of the Ofgem Annual Report; a forthcoming Parliamentary newsletter, and a factsheet on retail energy prices on (copies of which were circulated). A Parliamentary Reception had been planned for the evening of 28 October. The Authority noted that the Competition Appeals Tribunal had dismissed the appeal by National Grid against its finding and penalty following the Authority's decision to find National Grid in breach of the Competition Act in respect of its Metering Services Agreements.
  8. Finally, the Authority was provided with a digest of the main elements in DECC's UK Low Carbon Transition Plan, setting out the factual background, targets, measures for the power sector, and those matters relating to consumers' interests. The Authority was briefed on plans to clarify Ofgem's duties and the interests of present and future consumers in respect of climate change and security of supply, changes concerning the promotion of competition and regulation, and on new powers for Ofgem for example to tackle market abuse in the power generation sector.
  9. On networks, the Authority was briefed on the background and current progress on the transmission access review, and some emerging issues and concerns, agreeing that these should be highlighted to DECC prior to the issue of a joint DECC/Ofgem consultation document. Further progress would be reported at the September Authority meeting. On Project Mercury - Ofgem's review of whether existing policies and procedures were sufficiently robust to deal with the financial distress or failure of one or more network companies - the Authority noted good progress on the MoU with HMG, on analysing energy networks' corporate structures and their implications for action in a crisis, and on the financial ring-fence arrangements. The Authority also approved the proposed steps for communication of events; and for its own involvement, at varying levels of escalation of concern, and the respective roles of the Chair and Executive Members should such circumstances arise.
  10. The Authority was briefed on recent awards under the discretionary reward schemes: gas awards had been made to National Grid and Scotia Gas for work on carbon monoxide awareness and network extension initiatives. For electricity, awards had been granted to SSE on corporate social responsibility matters; WPD, in respect of priority customer care initiatives; and sums for EDF, WPD and E.On for their work in assisting vulnerable and disabled customers.

11. The markets briefing covered the present National Grid view on the winter Outlook which appeared broadly comfortable, in the absence of significant political shocks and market disturbance, such as had been seen during the Russia/eastern bloc states' disputes. The Authority received its regular briefing on market factors, covering electricity demand forecasts to mid March 2010, compared to historic data and information on the key generation and supply indicators; and, for gas, data on demand forecasts. Forward price curves for gas and electricity, and comparative figures for key continental markets were presented. UK gas storage levels were higher than at the equivalent period for 2008. Data were noted on trends in gas and electricity margins. Oil price rises had moderated.
12. The latest progress on smart metering was reported, the Authority noting a separate paper provided and the line proposed for responding to the current DECC consultation exercise (see paragraph 28 et seq).
13. The Authority noted that, as described in a separate paper, workshops on the proposed retail measures following the Probe had been satisfactory, with some suggested changes to the remedies proposed (see paragraph 23 et seq).
14. The Authority was briefed on some issues arising in the I & C energy market, with reported concerns from customers about supplier behaviour, for example on security deposits. Further work was being undertaken. Finally, the European Commission had issued infringement letters against some 25 Member States, noting some features of the UK market; and Ofgem had submitted its views to DECC who would respond.

### **SP losses**

15. The Authority considered a paper providing an update on Scottish Power's (SP) representations in respect of the performance of the two electricity distribution network operators in the SP Group, SP Manweb plc (SPM) and SP Distribution Ltd (SPD), under the DPCR4 distribution losses incentive (the main issue). The Authority also considered SP's representation on settlement data relating to SPD and a discrete issue involving EHV lines under the same incentive (the EHV issue).
16. On the main issue, the Authority considered all material developments since its 'minded to' decision to reject SP's representation of December 2007, including SP's subsequent representations, Ofgem's impact assessment and consultation and consultation responses, and work carried out with Elexon and SP in respect of SP settlement data. The Authority having carefully considered the issues and the associated documents, including the powers open to it to reopen this aspect of the DPCR4 settlement, confirmed that SP's allowed loss percentages under the scheme would remain unchanged; and, as such, the Authority did not accede to SP's request on the main issue. In reaching its decision to reject SP's application, the Authority had considered all the material before it. The Authority considered that the resetting of SP's allowed loss percentage following an investigation into SP in 2005 was and remained objectively justified following consideration of SP's representations. The Authority considered that the regulatory certainty was important, under which price control and enforcement decisions should not be reopened save where there were clear evidence based reasons for doing so. The Authority did not believe that the case presented by SP amounted to a material change, noting the work Ofgem carried out with SP and Elexon had supported the view that the data used to re-set SP's ALP in 2006 was the best available. The Authority acknowledged that SP had been subject to significant penalty

adjustments under the losses incentive scheme under DPCR4 and was mindful of SP's representation with regard to the financing of its distribution activities. But did not consider it would be appropriate in the circumstances to increase SP's ALP merely to allow particular credit rating criteria to be met. The Authority also considered the wider impacts that an adjustment in SP's favour would have on suppliers and consumers which were judged to be significant and adverse. In light of its decision not to direct a change to SP's ALP on the main issue, the Authority agreed it appropriate for the losses roller to remain in place.

17. On the EHV issue, the Authority agreed that for SPD alone, that there had been particular factors affecting the quality of the relevant losses data, and that SP's representations in this regard should be accepted. The Authority agreed to backdate fully SP's request, consistent with Ofgem's approach in similar cases. The Authority also agreed that an appropriate adjustment be made to the losses roller for SPD only so that the effect of backdating the increase on the EHV issue was not defeated.
18. The MD Networks agreed to write to SP explaining the reasons for the Authority's decision on the main issue and on the EHV issue. [The letter was sent on 31 July 2009 as at the following link:  
[http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR4/Documents1/Decision%20Letter\\_SP%20ALPs\\_31%20Jul%2009.pdf](http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR4/Documents1/Decision%20Letter_SP%20ALPs_31%20Jul%2009.pdf).]

### **DPCR5 - Initial Proposals**

19. The Authority considered a paper and presentation setting out, in full, draft Initial Proposals for the revenue allowances for the 14 electricity distribution network operators for the period 2010 to 2015. These had been developed in the light of the Authority's discussions and determinations on DPCR5 in June which had focussed on the behaviours Ofgem was seeking to encourage from DNOs ; the revenues needed by DNOs to meet these objectives; and returns from the overall settlement. The Authority noted the suggested "road map", with planned publication of the Initial Proposals, as agreed, in early August, then decisions on Final Proposals in November.
20. In debate, the Authority considered each of the main elements of the Initial Proposals as follows:
  - i. On the proposed network cost allowances, DNOs had, in aggregate, sought a 56% increase in network investment from £5.1 bn to £8.0 bn in DPCR5 as compared to DPCR4, with a 13% increase in network operating and indirect costs to £8.3 bn. The Authority concluded that a tough but fair approach to these proposed increases was needed, and that a reduction of some £2.4 bn should be proposed. A bench-marking approach to operating costs was agreed, setting the bench-mark at the upper quartile where the quality of data and statistical results allowed, and with no glide path for those companies with costs above the benchmark. Benchmarking of network investment unit costs – which seemed high in some DNOs' estimates – would be appropriate. The proposals from some DNOs for very large investment projects, in total ca £0.5 bn, needed closer investigation, the Authority agreeing that the Initial Proposals should set out a number of options for treating costs incurred in the period. The suggested approach for ongoing operational efficiencies (at a proposed 1% rate) was supported, as was the assumption that input prices would move in line 0.9% above inflation for opex. Similarly, the Authority supported the proposal that, for capital expenditure costs, it should work on the assumption that real price effects and ongoing efficiency would cancel each other out. It was agreed

that the team would monitor economic developments and reconsider the matter of real price effects ahead of Final Proposals. On regional factors, the approach should again be to normalise DNOs' costs for specific technical and geographic network differences and to look at independent data on labour and contractor rates so as to normalise for differences in regional costs. It was agreed that no adjustment should be made to DPCR5 ex ante allowances to account for EDF's involvement in the London Olympics; and that there was a case for continuing the Shetland Islands' supply cross-subsidy arrangements, but examining options, in the price control, for the most efficient future supply of electricity to the Islands.

- ii. The Authority agreed, given that there may be small further changes to the proposals from ongoing analyses of DNO data, that approval for the final form of the Initial Proposals should be delegated to the Executive, but with consultation with the Chairman, acting on behalf of the Authority, should there be any material movements in cost allowances.
- iii. On weighted average cost of capital (WACC), the Authority noted the work commissioned by Ofgem which had been presented to the Energy Networks Association and Centrica at a recent workshop; and the views of some individual DNOs on preferred WACC values. The Authority debated the options for the treatment of WACC, concluding that, at this stage of the DPCR5 process, it would be preferable to publish PwC's range for WACC in the Initial Proposals document in order to inform the consultation exercise, as per the approach adopted for previous price reviews. The Initial Proposals should also indicate that Ofgem would stick to its previous approach to setting the cost of capital, deciding on the appropriate level of WACC at Final Proposals, taking into account the balance of risk and reward in the rest of the package. This approach would involve examining a wide range of evidence, giving greater weight to longer term factors, as well as taking account of the current market circumstances for the raising of finance.
- iv. The Authority, noting recent volatility in capital markets, considered a range of possible new instruments, identified by PwC, which could be introduced to address uncertainty in the cost of debt. These ranged from changes to the licence to expand on the circumstances and process by which the control would be disappplied through to a mechanistic cost of debt trigger. The Authority agreed to consult on each of the instruments, noting that it had a preference for no new instrument at this stage; and that, of the new instruments on the table, it did not consider it appropriate to introduce a cost of debt trigger mechanism for DPCR5. The Authority noted that incentive mechanisms in price controls, and uncertainty over the movements of costs, may mean that DNOs' returns could vary from the baseline return-on-equity factored into WACC at the outset of the period, and considered the results of preliminary scenario analysis in this regard. It was agreed that the Initial Proposals document should explain the factors that would influence Ofgem's final decision on the scope the settlement should provide for over- and under-performance on Return on Regulatory Equity (RORE), inviting views in the consultation on the appropriate balance between RORE and the WACC.
- v. The Authority agreed that ahead of Final Proposals decisions would be needed on the ranges of basis points available, the symmetry of the ranges and the number of basis points available for each incentive scheme.
- vi. The Authority considered that the DPCR5 settlement should signal further and significant steps to address, through the incentive mechanisms, the

challenges in achieving climate change targets, so encouraging DNOs to play their part actively. It welcomed the proposals for a low carbon networks fund which would allow DNOs to trial new technologies and commercial arrangements, noting the fund's requirements and some illustrative projects. It was agreed that the proposed fund might be of the order of £100m pa – or £0.5 bn over the period – having considered the impact of this fund on distribution charges. In addition, proposals for retaining the present undergrounding incentive, proposed changes to improve the losses incentive and new reporting and information requirements were agreed.

- vii. On handling uncertainty on price, volume and other factors, the Authority agreed the removal of the volume driver and its replacement with a trigger for general reinforcement and a driver associated with the number of connections. The proposal to increase the category of costs which might be subject to the Information Quality Incentive was agreed, as was the introduction of a tax trigger. The retention, from DPCR4, of the possibility of re-opening of settlements to meet the costs of new legislation in respect of traffic management and electrical safety and other features was agreed. The Authority accepted that, in principle, some of these features could be bundled together, for the purpose of triggering any re-opening of allowed revenues.
  - viii. The Authority examined the three main financeability tests applicable for DPCR4 – dealing with debt: RAV ratios, funding from operations/interest and retained cash flow: debt ratios - and was briefed on current modelling of these factors. It was agreed that each test should feature in the Initial Proposals.
  - ix. The Authority was briefed on the main elements determining networks' pension costs – liabilities for past pension provision, ongoing costs, and the costs of servicing defined contribution schemes - and the estimated aggregate costs faced by DNOs. The Authority recalled the "pension principles" which had been adopted earlier in respect of the recovery of economic and efficient costs, and agreed that the team should set out – in a separate consultation document - ideas for more explicit and stronger incentives than at present with the objective of encouraging DNOs to manage pension costs more effectively. The Authority agreed the option of retaining the current treatment of pension costs once this consultation had closed. Given the possibility of the sale of several of the DNOs, with action perhaps ahead of the Final Proposals for DPCR5, the Authority confirmed that the present policy on network mergers should be maintained but kept under review.
  - x. Finally, aspects of the DPCR5 Communications Plan were noted.
21. The Chairman and Members thanked the DPCR5 Team for the considerable amount of work completed and progress made.

### **Funding arrangements for major transmission infrastructure**

22. The Authority considered a paper on the approaches to be taken for the planned £4.7 bn in new transmission infrastructure needed to meet HMG's 2020 renewable energy and carbon emissions targets, including, for example, the proposed two high voltage DC cables offshore and the Shetland link. The analysis followed consultations, discussions and decisions at the Authority on competitive approaches and new incentive regimes for anticipatory investment as part of the

Transmission Access Review. The Authority noted that the projects identified by the 2020 Transmission Study, undertaken by transmission operators and overseen by the Electricity Networks Strategy Group, could be divided into two phases. Phase I projects needed to commence before competitive approaches could be developed and implemented; and Phase II projects which did not need to commence immediately, potentially allowing sufficient time for new competitive arrangements to implement a more competitive approach to be developed and implemented. The Authority noted each of the main projects and the current views of the transmission companies on their proposed costings and timings. The Authority also noted advice on the legal issues surrounding competitive approaches to transmission. There were also links to the policy issues to be addressed and the findings of the RPI-X@20 Review and the continuing work for the next transmission price control period, TPCR5.

23. The Authority confirmed its view that the introduction of competition, where appropriate, could carry benefits for customers, including the management costs of delivering lower financing costs and with a better balance of risk and reward. Competition should potentially encourage new transmission operator interest. Against this, the time needed for the development of competitive approaches could delay the delivery of needed investment, which should be seen in the context of the Authority's sustainability duties.
24. The Authority agreed that, on balance and in principle, it was appropriate to allow Phase I projects to proceed on a non-competitive basis, given the critical investment needs and timing considerations. Phase II projects expected to start sufficiently far in the future could be candidates for consideration under competitive processes, yet to be developed in detail. Further preliminary work should be carried out and reported, with a view to another consultation paper.

### **Energy Supply Probe: retail market remedies**

25. The package of proposals to address concerns identified in the Energy Supply Probe had received broad support during the most recent consultation exercise. The Authority noted the further work which had been carried out on the detail of the proposals, with alternatives, to address concerns on the automatic roll-over of small business consumer contracts, and the ability of indebted domestic consumers to switch supplier. Two further issues had also been the subject of additional analysis by Ofgem, and discussions with interested stakeholders, namely extending the new high-level objective in the marketing licence condition to apply to suppliers' telesales activities as well as to face-to-face marketing activities; and the requirement that annual statements should be provided for customers but not necessarily at each time when there had been a price increase. The Authority agreed that these desirable changes to the amended package of remedies should now be put forward for statutory consultation, other non-statutory measures from the April consultation being part of the overall package but not needing formal consultation. The Authority had discussed previously the detailed financial information required from the "Big 6", and confirmed that the proposals should require publication, on an annual basis, of data on profits, underlying costs and revenues separately for their supply and generation businesses, for gas and electricity consumers, both domestic and non-domestic.
26. On timing, it was agreed that there should be a phased approach to implementation of the proposed package of retail measures. Under this, supplier objections at the level of individual licence conditions could be made (rather than to the entire proposed package). The right of the Authority to decide not to proceed with any element, or the entire package, should be reserved such that the need for a market investigation reference could be considered, as necessary,

in the light of the results of the consultation. The Authority also delegated authority to the Executive for final sign off of the consultation documents, planned for publication in early August.

### **Vulnerable customer disconnections review**

27. The Authority reviewed a note providing an update on the key findings from a joint review with Consumer Focus - and proposed actions - to improve protection for vulnerable customers from disconnection. The review had highlighted inadequacies in some suppliers' post disconnection procedures; the need for further assistance for those customers who could not have a PPM meter installed; the arrangements for reconnection of any vulnerable customers who were inadvertently disconnected; and some points on policy in respect of disconnection for multiple occupancy premises.
28. A range of remedies was proposed, which were focussed on improving existing self-regulatory steps, (i.e. the ERA Safety Net arrangements), and on promoting best practice. The ERA has agreed to take forward a number of changes to the Safety Net arrangements to address the issues identified. A report on this study would be published in September.
29. Some potential inadequacies had been revealed in the individual cases passed to us by Consumer Focus. The Authority agreed that, while these did not warrant enforcement action, there was a case for clarifying the licence conditions in this area. Cases of alleged meter-tampering and energy theft, involving vulnerable customers, had been investigated as part of the study, and the Authority agreed that action should continue to protect the interests of innocent parties.

### **Smart metering**

30. The Authority was further updated on the progress being made with DECC on the Ofgem role in the programme for the introduction of smart meters. It was agreed that Ofgem should take a leading role in Phase I of this project, the key issue being establishing the design and delivery of a central communications provider, and ensuring that this would support any future requirements associated with smart grids or networks. The Authority also confirmed that it was essential that appropriate funding be provided to meet all associated costs for Ofgem in this substantial project; and that subsequent work and the potential Ofgem involvement would depend both on available resources and there being no conflict with Ofgem's statutory duties or independence.
31. Finally, the Authority noted a number of policy matters which it was proposed be communicated to DECC, as part of their current consultation, on matters such as the central communications model and consumer benefits; the need for suitable customer protection arrangements prior to roll-out; and the full engagement of all interests in deciding the minimum functionality needed for smart meters.

### **NGET's proposals for amendment to the Connection and Use of System Code CAP 170**

32. The Authority noted , for information, a trailer paper which set out the context of this proposal from NGET to amend the generator intertripping scheme so as to reduce the costs of managing constraints by extending existing administered prices for intertrip services, in certain circumstances. Consultation on an impact assessment had closed in early July, and the results were summarised. These and the matter of cost savings would need to be explored further in preparation for a final decision by the Authority at a later date.

## Regulatory Services

33. The Authority noted a paper which set out the Government's proposals for additional low carbon incentive schemes and related initiatives, and the potential role of Ofgem in administering them. These were the Community Energy Saving programme (CESP) dealing with improving the efficiency of low income homes; and the Feed in Tariffs (FIT) scheme and the Renewable Heat Incentive (RHI), aimed at increasing the uptake of renewable energy sources. These would be in addition to Ofgem's work on the administration of the Renewables Obligation and the Carbon Emissions Reduction Target schemes, taken on in 2002, plus the current work associated with establishing a regulatory framework for an offshore regime; and the proposed Ofgem role in smart metering. The paper noted the importance of ensuring full funding for any Ofgem involvement and set out how this work might be implemented and the key timing and cost considerations.

## Other business and date of next meeting

34. There was no other business. The next Authority meeting would be held in Glasgow, on the morning of Thursday 17<sup>th</sup> September with a dinner for senior Scottish energy contacts during the evening before. There would be a formal opening of the new Glasgow office of Ofgem on 16<sup>th</sup> September by the Scottish Energy Minister. Attendance by Authority Members would be welcome. Looking further ahead, the Chairman noted that there was a possible need for a meeting of the Authority to consider a number of DPCR5 issues. A provisional date of Tuesday 24<sup>th</sup> November, at 2.30 pm, at Ofgem, had been set. A dinner and discussion would be held on the RPI-x@20 project on the evening of Wednesday 14<sup>th</sup> October, also at Ofgem.

## Those present

The Lord Mogg, KCMG (Chairman)  
Alistair Buchanan (Chief Executive)

Dr Robin Bidwell  
Prof David Fisk  
Miriam Greenwood  
Judith Hanratty  
Sarah Harrison  
David Harker  
John Howard  
Jim Keohane  
Jayne Scott  
Steve Smith  
Andrew Wright  
John Wybrew

## Those attending

Aidan O'Neill QC of the Ampersand Stable (Edinburgh) (SP losses)  
James Maurici of Landmark Chambers (London) ( " " )

David Ashbourne (all items)  
Rachel Hatfield (covering all items from SP losses)  
Alex Lyon ( " " " )  
Rachel Fletcher (SP losses) (DPCR5)  
Declan Tomany ( " )  
Paul Darby ( " )

Hannah Nixon	(DPCR5) (Funding/transmission infrastructure)
Chris Watts	( " )
Kieran Donoghue	( " )
Mark Cox	( " )
Nicola Cocks	( " )
Nick Russ	( " )
Peter Rice	( " )
Stuart Cook	(Funding/transmission infrastructure)
Min Zhu	( " " " )
David Hunt	( " " " )
Maxine Frerk	(Probe) (Vulnerable customers)
Michael Brocklehurst	(Legal Adviser to the Authority) (all items)
Dr Tony Burne	(Secretary to the Authority) (all items)