

Minutes of the Meeting of the Gas and Electricity Markets Authority

Thursday, 15 October 2009 at 8.15 am

Ofgem, London SW1P 3GE

Introductory remarks by the Chairman

1. The Chairman thanked those Members who had been able to attend the previous evening's dinner and presentation on aspects of the RPI-X@20 project. This had been valuable in setting the scene on the main issues and further work in the coming months. On conflicts of interest, the Chairman noted that one Member of the Authority declared that the organisation with which he was associated, and with a major interest in social and consumer issues, continued to comment on aspects on Ofgem's measures in respect of the retail market. Another Member noted that his institution was in receipt of support for work under the Innovation Fund. The Chairman also noted that three Members of the Authority were in receipt of occupational pensions from their former employers in the energy sector. This would be reflected in the Annual Resource Accounts. There were no other declarations of potential conflicts of interest. Finally, the Chairman noted that the Chief Executive of National Grid would be offering a short presentation to the Authority at lunchtime.

Minutes of the Authority Meeting held on 17th September 2009

2. The minutes were approved, subject to one clarification in respect of the Sustainable Development Committee of the Authority.

Reports from the Chief Executive and Senior Partners

3. In his report to the Authority, the Chief Executive drew attention to the following main issues:
 - The reorganisation of Ofgem's work, and the creation of E-Serve, which had been well received by a number of commentators within and outside Government, and on which further information on revised budgets for 2010/11 and senior appointments would be presented to the Authority in due course. A number of areas of Divisional activity were under further examination. It was gratifying that these substantial organisational changes had been carried through by Ofgem colleagues without disruption to an already heavy project and work schedule. The Authority, welcoming these important developments, added its own warm congratulations to all involved. Aspects of the new structures might usefully be reviewed at the next Authority Awayday.

- A review of the phasing of the work of the main policy streams to June 2010 – including the follow up work on the Probe, Project Discovery, RPI-X@20, the Offshore Transmission regime, the Transmission Access Review, DPCR5 and Project Mercury – and an assessment of the strategic importance and interrelationships of each.
 - External reactions to the launch of Project Discovery from Government and Parliament and other key stakeholders, and the value of maintaining a strong profile and proactivity for this work, with continuing close engagement.
 - Views on the quarterly Ofgem reports dealing with retail/wholesale prices in the sector and where prices and comparisons remained a topic of high interest.
 - Some suggestions for key initiatives in coming months across, especially Probe, Mercury and discovery, and their promotion with outside interests.
4. In the report on markets, the Authority noted the main indicators on the movements and projections of energy prices. Gas markets remained delinked from oil due to oversupply and, as a result, near term prices tended to be driven by LNG prices at Henry Hub in the US. Ofgem had hosted a successful Winter Outlook conference on the previous day; and the third joint annual DECC/Ofgem report on the energy market outlook was due to be published before the end of the year. The Authority went on to discuss the underlying trends to be reflected in its forthcoming (and third) Quarterly Review of wholesale and retail prices, including costs and margins, the potential impact of DPCR5, and actions which might be open to the Authority. Ofgem were working through the 3rd EU energy package and the implications for Ofgem. A note would come to the Authority shortly.
5. The report on Transmission and Governance noted the current stage of consultation by DECC on the Transmission Access review. It was agreed that the proposed Ofgem input would be worked up and discussed within the Executive and agreed with the Chairman. The Authority noted that the current Transmission Price Control review (TPCR4) would expire on March 2012, and that work would start very soon on proposals for a successor regime, TPCR5. This raised the question of how TPCR5 should be developed and handled, given the ongoing review of the regulatory framework being conducted through the RPI-X@20 project. The RPI-X@20 review is not due to be completed until late 2010. The options for the timing of TPCR5 would be set out in an early consultation paper.
6. DECC were holding a competition to demonstrate commercial-scale carbon capture and storage (CCS) facilities, and National Grid had approached Ofgem to discuss the disposal of part of the gas network for transporting

carbon dioxide to permanent storage. The proposed disposal would require Ofgem's approval. A consultation on this proposal had indicated broad support, subject to certain further information, now being pursued in an NGG-commissioned independent study. The Authority noted these developments and looked forward to further advice to underpin its final decisions.

7. On smart grids, the Authority was briefed on the steps being taken by the European Commission, and others, to develop thinking on smart grid issues. The Energy Network Strategy Group (ENSG), chaired jointly by DECC and Ofgem, was drawing up analyses setting out views on how GB networks could also benefit from smart grid technologies.
8. Finally, the Authority was further briefed on the latest steps on National Grid's proposed modification to the CUSC on administered price intertrips (CAP 170), on industry reactions, and on associated legal issues. It was noted that a further consultation on the competition aspects of CAP 170 would be undertaken. The Authority would be further briefed, with recommendations, in the New Year.
9. The Sustainable Development Division's report first covered the present stage of drafting and development of a proposed new Energy Bill - on which a separate paper had been tabled for information and which was noted - and the issues arising for Ofgem. The Authority was updated on smart meters including progress with DECC's conclusions from its consultation and Ofgem plans to organise and mobilise in readiness to undertake Phase I work. The Authority was briefed on Ofgem's response to the Government proposals for renewable financial incentives to help deliver the increase in renewable electricity generation, as a share of total generation, from 5.5% in 2008 to more than 30% by 2020. Proposals included changes to the renewables obligation regime; a new revenue stabilisation mechanism which took on board proposals made previously by Ofgem. Plans for new feed-in tariffs for both domestic and small-scale generation were explained and the Ofgem line explained and noted.
10. On Local Networks and RPI-X@20, the Authority agreed that the key issues from the Divisional report would be covered in discussion of the main papers before the Authority.

DPCR5

11. The Authority considered a further paper and presentation concentrating on the approach to be adopted on the treatment of pension costs for DPCR5 and for future price control reviews in transmission and gas distribution. Final decisions were not sought at this stage - though the

Authority was invited to agree a “minded to” view on its approach for a third consultation to be published later in the month. A special session of the Authority had been arranged for late November at which responses to the further consultation on the Authority’s emerging views on pensions and DPCR5 could be assessed and presented for a final decision in late 2009. The DPCR5 Committee of the Authority had considered the issues fully, and the recommendations now put forward had been agreed by the Executive. The Authority had the further benefit of internal and external legal advice on a number of procedural and consultative matters arising from this element of the DPCR5 package.

12. The Authority noted the key background to this issue on which Ofgem had been consulting since August 2008, reviewing the responses and the results of a seminar for interested stakeholders where a range of options had been set out for treating pension costs in future price control regimes. These involved retention of the current approach – that of setting revenue allowances in line with network operators’ forecast pension costs, with subsequent adjustment in the light of reported outturns; and new approaches on incentives for different categories of pension cost; (i.e. liabilities for past pension provision and the ongoing costs of servicing a defined benefit and defined contribution schemes). It had been proposed that incentives of varying strengths be introduced to reflect the different levels of influence and control that network operators’ management and shareholders had over these different cost categories.
13. The latest views of stakeholders on the pensions options were summarised and presented. Some consultees had argued that incentivisation of network companies was necessary in order to bear down on pension scheme costs, while others were opposed to changes to the current approach. Employees’ representative bodies had concerns about the potential for diminution of benefits, though Ofgem had no powers to reform or set pension rights. The Authority noted also the fact that fundamental changes were being made to both private and public sector pension schemes, and those for other organisations, which were likely to gather pace in the next few years; and it recalled that pension costs – at some £2 billion or some 15% of total distribution costs - were expected to be a significant element of the price changes flowing from the final DPCR settlement and with resultant consumer price impacts.
14. On ongoing costs, having examined the data and arguments in the paper and presentation, the Authority concluded that it was minded to apply benchmarking of total employment costs (including pensions) along with total costs to set revenue allowances for all future price controls. Under this approach, it was envisaged that NWOs would be free to choose their own pension arrangements; but the setting of funding would involve

benchmarking of their total costs against other NWOs and comparable private sector companies. However, at this stage of the DPCR5 process, it would not be practical to include ongoing pension costs in the benchmarking exercise. Hence, and for DPCR5 alone, the Authority took the view that NWOs should be allowed, in their settlements, their forecast ongoing pension costs. An incentive mechanism was considered appropriate where NWOs could share the benefit or cost of any movements from the forecast to actual levels of pension cost.

15. On the funding of pension deficits, the Authority concluded its debate, having reviewed the analyses and views presented in consultation, by agreeing a “minded to” decision to set a longer notional period for funding deficits for all schemes of 15 years whilst maintaining the commitment to fund these deficits so long as the schemes continued to be managed efficiently. The Authority also concluded that Ofgem might provide further guidance on the application of the existing Ofgem principles of allowing only economic and efficient pension costs when assessing any deficits at subsequent price controls. The Authority was minded to conclude that the Pension Protection Fund 7800 Index should be used to assess whether a more detailed *ex post* efficiency review should be carried out, this requiring companies to demonstrate that costs had been managed efficiently and in line with other schemes’ deficits, with funding decisions on allowable costs being made appropriately. The Authority noted, finally, that it would have to be satisfied that these approaches were consistent with the rules established by the Pensions Regulator; and it authorised Ofgem to issue a third consultation paper, setting out its proposed approaches.
16. The Authority also considered a presentation setting out how the different elements of the DPCR5 package would be brought together in the run up to Final Proposals. In particular, the Authority was briefed on how the team would be using forecast of Return on Regulatory Equity (RORE) to assess and calibrate the risk/return balance in the settlement. This, along with financeability tests, would form part of the information the team would present to the Authority as it makes its recommendations on cost of capital and other elements of the settlement.

Project Mercury

17. The Authority considered a paper summarising the work carried out by Ofgem in the review of the financial ring fence conditions in network licences for gas and electricity transmission and distribution, with proposed options for amending and strengthening these which could be put to consultation. The review had followed from the issues trailed in an earlier paper on the topic and reviewed by the Authority in September

2009. The six licence conditions covered disposal of assets; availability of resources; restriction of activity and financial ring-fencing; credit ratings; restriction of indebtedness and transfer of funds; and ultimate controller undertaking. The Authority was briefed also on legal matters on aspects of entry into administration.

18. The Authority noted the paper. It agreed that the key focus should be on protecting consumers from the impact of financial distress of a network company while creating a stable framework for network operations. The Authority also agreed that responsibility for identifying and managing financial and operating risks should remain firmly with the licensee company's management, together with the responsibility for notifying Ofgem should there be potential concerns.
19. The Authority agreed to consult on the options as proposed, and noted the intention to carry out an impact assessment

Transmission investment incentives

20. The Authority considered a paper and presentation providing updates on the development of funding arrangements for major infrastructure transmission projects identified by transmission operators (TOs) and which were designed to support the Government's 2020 renewable energy and carbon emissions targets, representing some £4.5 billion in total investments and seen as necessary to meet these targets. The Authority had already reached the view, in July, when last considering this substantial proposed programme of infrastructure investments, that it was appropriate for some projects to proceed on a non-competitive basis, particularly where the projects needed to start before a competitive approach could be implemented, if such an approach were agreed by the Authority. A consultative paper on proposed funding approaches, and the timing considerations, had been issued by Ofgem in September, and the latest views of interested parties were summarised and presented.
21. The Authority noted that while, ordinarily, investment plans would be considered as part of Ofgem's transmission price control processes, the need for a significant proportion of the plans was not foreseen at the time of the last price control review. The Authority recalled the work in progress to assess TOs' plans and to prioritise critical investments. It recognised also the important links to fundamental work, running in parallel, to review regulatory frameworks under the RPI-X@20 project.
22. The Authority noted that there were two broad options for achieving these objectives:

Option 1 : to put in place funding and incentive arrangements for each project over a 20 year period which would create funding certainty but potentially cut across the results of the RPI-X@20 review.

Option 2 : to agree to interim funding between now and the start of the next transmission price control (TPCR5).

23. The Authority saw merit in developing the second approach but with engineering and financial scrutiny of the case for each investment resulting in a list of "projects approved for funding purposes". Companies would be able to recover agreed costs and an appropriate return on capital for approved projects incurred up to the next price control. The Authority concluded that proposals should be developed on these lines; and that, with the Chairman's approval, refined proposals would be circulated to Authority Members, soon after the meeting, for comment. If agreed by the Authority, this would form the basis of the Initial Proposals document on TO investment incentives.

Corporate Strategy and Plan

24. The Authority discussed a note providing an outline of the main themes and opportunities for the Corporate Strategy and Plan for 2010-2015, offering also options for its structure and the timetable to the proposed publication date of 31 March 2010. The results of an initial consultation on the potential contents of the Plan were presented. Issues raised included the need for greater emphasis on sustainable development and the move to a lower carbon energy sector; maintaining security of supply; the challenges of the competitive market; the need for stable regulatory frameworks so as to encourage much-needed investment; and Ofgem's European role in promoting open and competitive markets.
25. The Authority debated its overall orientation on the structure of the Plan. While the key themes of the present plan were sound and enduring in capturing the main priorities for Ofgem's work ahead, it was important that these be set in the wider context of the changes and the underlying uncertainties. These should include the drive towards lower carbon and greater sustainability and issues on security of supply; potentially changing duties and guidance for Ofgem; new regulatory approaches (such as the results of the RPI-x@20 Project); and the impacts of European developments. The Plan should keep a clear focus on consumer interests and concerns. In terms of drafting, the new Plan might also be a shorter and more sharply focussed document. And it should reflect, separately and distinctly, Ofgem's regulatory policy roles and the work of its delivery arm, E-Serve. The Authority approved the consultative timetable and looked forward to considering further drafts.

Financial reporting

26. The Authority considered representations made by RWE Npower plc on the decision taken in September, following up the Probe, to proceed with a new licence condition and accompanying guidelines in respect of financial reporting. The Authority had before it the company's letters objecting to this modification, the company arguing *inter alia* that the increased transparency sought would be detrimental to them in comparative and, more generally, in competitive terms. The Authority had also relevant Ofgem legal advice, noting the possibility, raised by the company, that legal challenge could follow the imposition of the new licence conditions.
27. The Authority considered carefully the representations made, and the balance of arguments, concluding that the risks to competition did not outweigh the wider benefits seen of increasing transparency from the provision of data by companies on WACOG/WACOE. Accordingly, the proposed licence condition should stand.

Audit Committee Workshop

28. The Authority noted and approved the proposals made in a short paper reporting on the Audit Committee's workshop, held on 16 September. This had reviewed the successor to the current RPI-X cost control regime for Ofgem, proposing that the figure for "x" should remain at 3% and reviewed alongside the development of the Corporate Strategy and Plan. The end-year carry over figure to 2010/11 should be increased, given the significant levels of funding required for the new environmental schemes for Government. A formal MoU setting out the relationship between Ofgem E-Serve and DECC had been suggested to cover funding of the new schemes. Finally, the Audit Committee had recommended that risk assessment processes be reviewed and benchmarked against examples of other organisations' good practice.

Locational BSUoS charging methodology

29. A paper, providing an update for information on the progress of a proposal from NGET to modify charges in the locational Balancing Services Use of System charges, was noted. Further analyses were due from NGET. The Authority recalled the importance of dealing effectively with increasing levels of constraint costs and its concerns about their impacts on consumers. The Authority would be consulted further, early in 2010, it being envisaged that an impact assessment would be prepared as part of further consultations on NGET's latest approach.

Other business and date of next meeting

30. There was no other business. The Authority's Parliamentary Reception would be held in the House of Lords on Wednesday, 28th October. The next Authority meeting would be on **Thursday, 19th November at Ofgem at 8.15 am**. There would be a **special additional meeting of the Authority to consider the latest proposals on DPCR5 at 2.30 pm on Tuesday, 24th November**, and a planned and **further session on the same topic, arranged by conference call, for Monday, 30th November at 12.00 noon**. A planned visit to Wales, originally set for 25th November, had been postponed but would be arranged for 2010.

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

David Ashbourne (all items)
Wilf Wilde (")
Rachel Fletcher (DPCR5)
Peter Trafford (") (Project Mercury)
Chris Watts (")
Hannah Nixon (Project Mercury)
Min Zhu (Transmission investment incentives)
Konrad Keyserlingt (" " ")
Maxine Frerk (Corporate Strategy and Plan)
Andy MacFaul (" " ")
Kersti Berge (Financial licence condition)
Duncan Sinclair (" " ")

Michael Brocklehurst (Legal Adviser to the Authority) (all items)
Dr Tony Burne (Secretary to the Authority) (all items)