

Meeting of the Gas and Electricity Markets Authority
Thursday, 19 November 2009 at 8.15 am
Ofgem, 9 Millbank, SW1P 3GE

Introductory remarks by the Chairman

1. The Chairman noted apologies for absence from Judith Hanratty, offering her best wishes for a speedy recovery from a recent accident. On conflicts of interest, one Member declared that the organisation with which he was associated, and with a major interest in social and consumer affairs, continued to comment on aspects of Ofgem's measures in respect of the retail market. Another Member noted his institution's receipt of support under the Innovation Fund. The occupational pension arrangements of three Members were again noted for the record. There were no other declarations of potential conflicts of interest.
2. The Chairman noted the current classification and prioritisation of agenda items and the implications for discussions and decisions at the Authority.

Minutes of the Authority Meeting held on 17th September 2009

3. Subject to a small amendment, to record formal Authority approval of the proposed actions in the Audit Committee's report, the minutes were agreed.

Reports from the Chief Executive and Senior Partners

4. The Chief Executive concentrated on the following key issues in his report to the Authority:
 - On the roll-out of E-Serve, encouraging news on the planned appointments of a new Group Financial Director, a Commercial Managing Director and a Legal Director; the establishment of clear reporting lines from E-Serve and the proposed involvement of the Authority; and the development of a draft MoU covering the Services being provided to DECC. Overall, and despite the high activity required in the creation of E-Serve, current business had not suffered, this being a considerable tribute to staff commitment.
 - Staffing issues, including health and safety, staffing levels – now with a low turnover – and evidence of high interest in the new posts being created; training and development; and Ofgem's "green record".
 - Ofgem's current budgetary position and the implications for projects and capital works plans.
 - A continuing strong record on deliverables, all being met on time and with some substantially exceeding targets.
 - Ofgem's relationships with the media and others, Parliamentary parties, and with Government; and the work programmes designed to foster and maintain good contacts.
 - The value of the Discovery Project in establishing Ofgem's credentials, and other platforms ahead on the Price Control announcements, Ofgem's role in smart metering, offshore and the Quarterly Review of retail/wholesale prices.

- An analysis of the timing of delivery of key Ofgem projects, and their interrelationships, and the current views of key players on their content.
5. On Divisional reports, the Authority was briefed about the current issues on Sustainable Development, including the possible content, timing and prospects for enactment of a 5th Session Energy Bill; and the issues arising for Ofgem on potential new powers to deal with market abuse and financial penalties. There were also powers for the Government to require companies to introduce social price support mechanisms and where Ofgem's role might be to monitor compliance. On sustainable development themes, the Division was building good contacts with the main stakeholders who had welcomed these approaches. A review embedding sustainable development across Ofgem's work was in progress, with reports planned for early in 2010. The Authority noted the forthcoming planned announcements by DECC on smart metering and smart grids policies, and the issues to be addressed by Ofgem in Phase I of the project. Finally, the Authority was briefed on the current position and interest in a case opened against a company in respect of tariff setting, a decision having been taken earlier in the year not to proceed with the investigation given advice on *vires* in relation to penalties for past actions, matters which were now being addressed in the Energy Bill.
 6. The report from the Transmission and Governance Division focussed on the Ofgem response to the DECC consultation on transmission access reform, and associated legal advice. A short paper would be presented to the Authority on either 24th or 30th November Special Sessions. The Authority recalled that it had considered at its last meeting funding regimes for major infrastructure transmission topics, the Authority favouring a variant which would enable interim funding up to the point of the next transmission price control. This would involve engineering and financial scrutiny so as to develop a list of "approved projects", and would provide for recovery of efficient costs up to the next price control for "approved projects". There were links to the proposed innovation funding initiative and the setting of an appropriate cost of capital. The Authority noted this, with approval, and looked forward to further analysis and proposals at its December meeting.
 7. On markets, the Authority received its regular update on energy market developments. This covered projected oil market trends and the comparative volatilities in the price evolution of energy feedstocks and carbon. UK gas prices were displaying their expected seasonality with price forecasts of prices showing broad comparability with European figures in the longer term but with some significant nearer divergence given continental availability of nuclear and wind generation. Spark and dark spreads for coal generation were noted, with peak demand predicted to be rather lower than in 2008. Gas demand was much as for the 2008 profile, while European storage levels were showing no significant draw-down, despite the onset of winter.
 8. The Authority went on to consider energy prices for customers in the light of the Probe, and its follow up action, comparing standards and on-line tariffs and their evolution over recent years, and by company, noting the

analyses and the relative volatility of margins on domestic supply/generation since 2005. The Authority also discussed a range of options for taking forward further work in the light of the forthcoming publication of the QR on wholesale/retail pricing, and some of the timing issues. It looked forward to further advice and analyses.

DPCR5

9. The Chairman first drew attention to recent representations from one DNO company: copies of correspondence had been circulated to the Authority. The company was seeking the reconvening of the Authority's DPCR5 Committee - or further bilateral discussions - such that additional information could be presented and discussed on a range of points. The Authority considered the case made out, concluding that the company, like all others involved closely in the DPCR5 processes, had been given full opportunities over past months to present their case, and concluded that the request be turned down. The Chairman also thanked the DPCR5 Committee of the Authority for the very considerable work carried out in meeting companies and in assessing the Executive's proposals.
10. The Authority considered a paper and presentation seeking views on the main elements of the DPCR5 package. These were cost allowances; incentives and obligations; the weighted average cost of capital (WACC) and the risk/reward balance in the emerging Final proposals; dealing with some company specific issues which had been raised; and communications. The Chairman noted that further meeting of the Authority was planned for 24 November to address pensions, final allowed revenue figures and the approach to revenue profiling and any outstanding points. A final decision would be sought on the treatment of pensions in the Final Proposals at an additional session of the Authority on 30 November.
11. The Authority noted the key background issues. Total network cost allowances were of the order of £14bn over the five years of DPCR5, a 16% rise over company spending in the 2005-10 period of price control, with some £41bn going towards new or reinforced assets. Customer bills currently reflect total costs of electricity distribution of some £3.6bn annually, with domestic customers paying around £67 p.a. and non-domestic customers facing a range of bills. The key issues for the settlement were agreeing the behaviours the price control should be seeking to encourage; deciding on the needed revenues to meet these objectives; and striking the appropriate balance between risk and reward in the settlement.
12. On the various elements of the DPCR5 proposals, the Authority considered and decided as follows:
 - i. On cost allowances, DNOs had requested a 48% increase in network investment to £7.8 bn from DPCR4 to DPCR5 and a request for a 16% increase in network opex to £7.5bn. A 7% reduction in DNO forecast was agreed on average across all DNOs. Two of the more efficient DNOs would be granted their forecast figures. On

overall total expenditure forecasts, the Authority agreed a narrowing of the gap with a proposed total £3.6bn increase, given better data and the correction of some errors. The Authority also concluded that Ofgem's analyses were both fair and robust, and had taken full account of DNOs' views.

- ii. On capex for asset replacement costs, the Authority agreed some adjustments for two companies given calculations on baseline unit costs.
- iii. New information on one company's network operating costs had revealed errors in business plan submissions. The Authority agreed that reopening the baselines for all would be inappropriate; concluding that while an adjustment should be made for the DNO concerned, only a proportion of the calculated impact to baselines for this company should be reflected.
- iv. A proposed further change to another company's baseline network investment for outputs was reviewed, the Authority agreeing that some deferral of work and adjusted outputs merited a cut in the baselines.
- v. On Real Price Effects (RPEs) and their impact, and at the Initial Proposals stage, Ofgem had applied CEPA's April 2009 forecasts. New work by CEPA to update these, as of November 2009, had now suggested a reduction to some £460m in total for DNOs compared to the earlier aggregate figure of £496m. The Authority considered the DNOs' proposals on actual wage deals struck and where lower rates were expected over the DPCR5 period; and the case for any specialist labour market premia which CEPA did not support. The Authority agreed to apply some adjustment for specialist labour, and concluded that RPE allowances should be reduced in line with the latest CEPA forecasts as proposed.
- vi. The Authority examined a schedule of changes in cost allowances for each of the DNOs, and their evolution since early October, based on DNOs' changed forecasts. A number of corrections had been proposed following further analysis and these were agreed.
- vii. Recalling the key objectives of DPCR5 in respect of incentives, the Authority agreed that DNOs should be encouraged to play a responsible and innovative role in tackling climate change; that they should be customer-centred; and that DNOs should be suitably incentivised to invest efficiently, considering also how customers' needs were to evolve in the future. The Authority noted that, at the Initial Proposals phase, a number of new incentives had been well received. These included the £500m Low Carbon Networks Fund which envisaged start-up funding, collaboration with other parties and dissemination. The details would be worked out early in 2010, the Authority agreeing the approach and the further work proposed.
- viii. On losses, a key contributor to DNOs' carbon footprints, the Authority agreed that incentives were needed to encourage DNOs to control losses. This and the matter of suitable targets had been a contentious issue. However, the Authority agreed with the proposals that these should be as far as possible in the form of an output-based incentive.
- ix. The Authority considered a package of measures on connections, designed to encourage both competition and improved service in

connections to customers, involving guaranteed standards of performance, regulated margins, and improved recording and submission of data. A proposed cap recommended at 100 bps was proposed and agreed as part of the package.

- x. On outputs, the Authority considered the work carried out on agreed outputs, for each DNO, covering asset condition and loading, with a qualitative assessment suggested at the end of the DPCR5 period where the failure to meet agreed outputs should result in suitable adjustments to allowed revenues. This approach was agreed.
 - xi. The Authority noted two specific DNO requests, one relating to future supply at Shetland with a DNO cross-subsidy to pass through variable costs associated with generation on the Island. The Authority had accepted this specific case under the DPCR4 arrangements and concluded that they be taken forward for DPCR5, with a re-opener to be triggered in April 2013, until a new power station was in place.
 - xii. One company was a main sponsor for the Olympic site in London and had sought both prior funding, and a reopener as needed, to cover those costs not recoverable from the relevant Olympic authorities. The Authority noted that most of the costs should be recoverable by the company as a service provider. The case for any unrecovered and efficient costs to be recovered from customers and other matters relating to the Olympics could be examined in consultation as appropriate, in the New Year.
13. The Authority turned to a presentation on possible values for WACC and the proposals for Return on Regulated Equity (RoRE). The Authority reviewed four main input areas on WACC: market data analyses and consultancies' inputs and the views of stakeholders; likely returns on RoRE based on a number of WACC figures; financeability analysis; and the relationship of WACC to risk/reward factors in the proposed incentive schemes in the DPCR5 proposals. Regulatory precedents were also presented and described, as were the previous approaches of Ofgem to WACC covering the cost of debt, cost of equity and gearing. The Authority concluded, having considered the evidence, that it would be appropriate to consider a preferred range of WACC to be set at 4.7 – 4.9%. The Authority also reviewed and approved proposals for the calibration of incentives so to generate an appropriate risk/reward balance for ranges of WACC, expressed in basis points terms, together with proposed caps and collars.
14. Finally, the Authority considered a DPCR5 RoRE analysis which examined estimates of plausible performance of DNOs against a range of settlement figures using RoRE as the measure to help inform decisions about the final cost of capital within the ranges under consideration. The views of the DNOs on potential risks were explained and Ofgem's views on them. On financeability obligations, the legal duty of the Authority, in exercising its principal objective, was also to have regard to the need to enable companies to finance their regulated activities, such that efficient companies would be able to finance their functions. The work on a number of tests – on interest cover, retained cash flow/debt and

regulatory gearing, and their application to each DNO - were explained and noted by the Authority.

RPI-X@20

15. The Authority discussed a presentation and paper providing an update on the work of this project, since the October meeting, noting the key messages proposed for a planned consultation paper in early 2010. The main themes were as follows:
 - i. the case for fundamental change to the current regulatory regime, - acknowledging the benefits achieved for consumers from the current RPI-X approach - especially to deal with the push to sustainability in the energy sector, low carbon economies, and issues on security of supply; and where application of an *ex ante* framework was seen still to have value.
 - ii. the case for continuing incentives, translated into outcome measures wherever possible, delivering value for money for present and future consumers.
 - iii. the need to encourage long-term planning and investment, treating companies on the basis of their delivery performance.
 - iv. the importance of innovation stimuli.
 - v. the need for effective consumer engagement by networks under a new regime and its implementation.
 - vi. the case for certain third party rights of appeal.
 - vii. the part that might be played by tendering, as part of the regulatory toolkit, as a means of stimulating efficiency gains.
 - viii. on financeability, working and developing a range of factors from current price control approaches.
 - ix. encouraging competition in energy services.
16. The Authority welcomed and supported these emerging themes, agreeing that a number would need further analysis and consideration as the final package of proposals for the new regulatory regime was developed.

Network company merger policy

17. The paper for the Authority on this topic provided an overview of existing Ofgem policy for dealing with mergers of network companies suggesting that this now be reviewed and form the basis of a consultation for updated proposals for 2010. The Authority noted the main issues arising - including developments in the sector in distribution and transmission, and the role of IDNOs - since the policy first came into effect in 2002, and the current provisions for the merger "tax" on earnings in price controls. It agreed to give some aspects further consideration at its next meeting.

Project Discovery

18. The Authority considered a paper and presentation on the key messages arising on the second stage of Project Discovery, carrying forward the first stage analysis of the challenges and risk(s) facing the GB, wider European and global energy markets of the next two decades. The first stage on

energy market scenarios had been put to consultation in October after review by the Authority; the second stage now considered current market arrangements; and it was proposed that potential policy packages, in response to analysis and the scenarios arising, should be developed for further Authority debate and then consultation in Spring 2010. The paper set out the main conclusions of a range of commissioned research papers supporting the appraisal of the market arrangements from the technical standpoint.

19. The Authority noted the key themes arising from the second stage. These included interlinked issues on costs and availability of finance; market structure; future carbon values; costs to consumers; investment signals for generation and infrastructure; current market rules and governance issues; demand side response; risk management practices; the interaction of interconnected markets and networks; and non-financial barriers. Markets had worked well in the past – in delivering competition and so benefiting consumers, in encouraging new generation and import capacity, and in helping to maintain security of supply. But market conditions would need to adapt further and flexibly to deal with a range of uncertainties, notably the future value of carbon and related governmental incentive policies; the scale and timing of needed investment; and the relative inadequacy of short term price signals and the required strengths of responses to them.
20. The Chairman offered his thanks, on behalf of the Authority to both the Team and those of its Members who had contributed to this significant and thoroughly researched Project. The thrust of the work and its analysis and present conclusions were discussed and supported by the Authority and where it was felt that all the key scoping issues had been addressed. The plans for the development of policy packages were agreed as were the proposed points for further consultation and engagement by the Authority. The Authority stressed the importance of full and continuing engagement with stakeholders at all levels in taking this central work forward and in developing robust models and options for consideration; the linkages to other projects on which Ofgem was leading; and the wider context and significance of responses to emerging governmental policies, national and international.

Implementation of the EU Third Package

21. The Authority noted a paper highlighting the main issues arising on the implementation of the EU Third Package in Great Britain, by March 2011, in the main; and by March 2012 for those aspects of EU policy requiring the unbundling of transmission systems from other energy-related activities. There were potential implications for GEMA/Ofgem given proposals in the Third Package measures, and their evolving interpretation, for the role and relationship to Government of the National Regulatory Authorities under the Directive. The Authority, noting that a consultation exercise was suggested, agreed to return to some of the issues raised in the paper at a further and early meeting.

Licence application regulations

22. The Authority reviewed a paper setting out proposals to amend the Current Application Regulations to reflect changes to implement the EU Services Directive in UK law through the Draft Services Regulations 2009. Implementation would be through new Statutory Instruments, approval for whose making was a reserved matter for the Authority.
23. The Authority agreed the content of the proposed changes, concluding that, subject to there being no material changes, the SIs be made by an Executive Member of the Authority on its behalf. Further, any minor or consequential amendments required before these new regulations were made should be approved by an Executive Member of the Authority, the Authority being notified accordingly of these.

Authority capital works programmes

24. Under the reserved matters procedures governing approval required by the Authority for certain contract expenditure proposals, the Authority agreed an Ofgem plan to proceed with a lift refurbishment contract covering the next 4 years.

Electricity interconnector policy

25. The Authority noted a paper setting out the latest developments relating to current and future electricity interconnectors, notably the need to respond to European developments on capacity allocation; and to consider approaches to regulating new investment. GB had current interconnectors with France and Northern Ireland, and other developments were planned. The Authority looked forward to further advice, following a planned consultation on the next steps in December.

Gas entry capacity substitution

26. The Authority noted an information paper providing the current position on implementation of the gas entry capacity substitution obligation as part of NGG's licence following the TPCR4 settlement. NGG's proposed methodology was currently under consideration, together with an impact assessment, and would apply, if approved, to the planned March 2010 Quarterly System Entry Capacity (QSEC) auction. The Authority welcomed the update, noting industry views; and it recalled that final decisions had already been delegated to a Member of the Executive.

Other business and date of the next meeting

27. There was no other business. The Chairman reminded the Authority that special sessions of the Authority had been agreed for 24 November at 2.30 pm and 30 November at noon, both to be held at Ofgem, and planned mainly to consider remaining issues on the DPCR5, and any outstanding points from the current meeting.

28. The next full Authority meeting would be held at Ofgem on Thursday 17 December, 2009 at 8.15 pm.

Those present

The Lord Mogg, KCMG (Chairman)
Alistair Buchanan (Chief Executive)
Dr Robin Bidwell
Prof David Fisk
Miriam Greenwood
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 (")
Chris Watts (")
Nicola Cocks (")
Hannah Nixon (RPI-X@20) (Network company merger policy)
Ian Marlee (Discovery)
Kersti Berge (")
Giles Stevens (")
Ben Woodside (")
Duncan R Sinclair (")
Martin Crouch (Europe)
Pamela Taylor (")

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