Introductory remarks by the Chairman

1. The Chairman noted that Miriam Greenwood had tendered her apologies, that David Fisk would be able to attend only the Thursday session, and that the Chief Executive was not able to be present at the meetings. On potential conflicts of interest, it was noted that the institute of one Member was in receipt of some research funding from energy companies. No other conflicts were recorded. The Chairman recalled that the Permanent Secretary DECC and the Director General/Energy had agreed to meet the Authority over lunch on Thursday. As regards the planned visit and meeting in Cardiff, the Chairman explained that the First Minister was unfortunately unable to join the Authority. Meetings had been rescheduled for London: new dates were being explored for a visit to Wales.

2. The Chairman noted the availability of the Ofgem Annual Report for 2009/10, and the Annual Resource Accounts for that year, adding his congratulations to the design team for their professional work on the Report. The key elements of Ofgem’s written communications project were noted, the Chairman’s close involvement, and the next steps in rolling out advice and training to colleagues. The Authority would take up in the Autumn the invitation to provide feedback on papers submitted. Finally, the Chairman sought expressions of interest from NEDs in the work of the proposed price control committee, likely to start its work in September, which would be addressing in parallel the next transmission price control review (TPCR5) and gas distribution price control (GDPCR2) reflecting the recommendations of the RPI-X@20 project.

Minutes of the Authority Meetings held on 21 May, 2009

3. Subject to one clarification, the minutes of the June 2010 Authority meeting were approved.
Reports from Senior Partners

4. On Local Grids and RPI-X@20, the Authority was briefed on the need to amend the current standards of service for electricity distribution, and to carry forward certain updating, as part of the final decisions reached in DPCR5. The Authority noted that this was a reserved matter and agreed that a Senior Partner should sign the required Statutory Instrument on behalf of the Authority, subject to there being no new or material issues arising during public consultation on the draft SI when the Authority should be further consulted. The Authority was briefed on the latest developments on the incident in Dartford in July 2009 when some 80,000 customers had lost electricity supplies for 36 hours or more, the determination reached by the Assessor about the event and the company’s reactions. Matters would be further reviewed and reported at a future meeting of the Authority.

5. The Low Carbon Networks Fund, valued at up to £500 million and established following the electricity distribution price control, was attracting strong and interesting proposals for funding, with a good mix of projects, whose value in aggregate considerably exceeded the planned first year funding. The offers of appointment to senior energy interests to join the assessment Panel, under the Chairmanship of Dr Robin Bidwell, were noted. Names would be announced shortly. Finally, the Authority was informed about the latest steps to roll out new and common charging arrangements for electricity distribution. Companies had until September to bring forward proposals. Also noted by the Authority, was a parallel consultation on charging for distributed generation connected pre-2005.

6. On markets, The Authority received its regular briefing on energy markets, noting in particular that gas prices had maintained their strength. This reflected, in the main, strong demand from Europe over the interconnector – given reduced Russian flows and increased end user and power station demand– and in meeting storage injection needs. Electricity prices had reached a 17-month high though were still below pre-recession levels, the UK forward power curve showing a typical seasonal profile, with UK prices being slightly higher than those in the rest of the main EU markets. The Authority noted these analyses, and further information on companies’ net supply margins, these showing further declines primarily due to recent reductions in prices. On power liquidity, the Authority noted that volumes on day-ahead prompt on the exchanges had risen sharply since May. Monitoring would continue.

7. On energy market reform measures, the Authority was briefed on the likely scope of measures proposed for the forthcoming Energy Bill and the plans for a consultation exercise was planned for the Autumn, on wider proposals for electricity market reform.
8. The report from Transmission and Governance Division returned to discussions at the May 2010 Authority meeting focusing on the case and plans for an holistic review of transmission charging and associated connection arrangements. It was proposed that this project should be either launched in July or September.

9. The Authority welcomed the early launch of this important review, and noted the plans for its scope and timing.

10. The report from Sustainable Development Division looked at a number of proposed legislative developments on energy policy matters. A briefing note for information was provided. Ministers had recently clarified the scope of a first Session Energy Bill in which the “Green Deal” would be the centrepiece. The Bill was expected to contain other measures on the reform of electricity markets; on improved information on customers’ bills; the offshore regime; suppliers of last resort, building on work initiated by Ofgem; and powers for the amendment of licences and codes in respect of smart metering.

11. A Public Bodies Reform Bill was being prepared to enable reforms of “quangos” – including transfers of functions and/or abolition of public bodies. The timing of the key stages of the Bill and the likely entry into force of its new, proposed powers in 2012 was noted. On regulatory reform, the Better Regulation Executive was developing a methodology for delivering the approach of “one in, one out”.

12. The Divisional brief also covered Ofgem’s planned report on Social Obligations, to be published shortly, this addressing energy suppliers’ performance on debt, disconnections, pre-payment meters and the provision of services to vulnerable customers during 2009. Key messages were that disconnections continued to decrease, generally; debt repayments were static in numerical terms, when 2009 was contrasted with 2008. But there were increases in the rates of debt repayment and in the size of those debts. There had been an increase in the installation of pre-payment meters, mainly to help debt recovery. A substantial increase in the number of customers now on Fuel Direct terms was noted, together with growth in the numbers of customers receiving advice on the Priority Services Register. The Authority noted the promotion of new Principles to improve suppliers’ practices in debt recovery and plans to review progress in this area. The Authority also noted the continuing monitoring on the impact of remedies pursued, after the findings of the Probe, into potential misselling through strengthened marketing licence obligations.

13. The Group Finance Director’s report first noted a numbers of reviews planned or in train involving an NAO performance review of Ofgem which would be considered by the Audit Committee in September; and a capability review on which the high record on deliverables and the
creation and role of E-Serve had been noted. NAO had also been reviewing the status of the smart meters programme and there would be further contacts with DECC on the findings. A further review of the energy landscape was in progress.

14. The financial overview for 2010-11 drew out the fact that first quarter costs were some 12% below target at present, the factors affecting this, and the projected spend by main categories. Staff in post numbers stood at 85% in relation to the Corporate Plan but some 16 new appointments were to be made shortly, including 5 new student placements. Permanent staff turnover was at a 5 year low, at about 8%.

15. On deliverables, the report outlined the main Divisional and Ofgem E-Serve projects and their Q1 achievement; and set out the corporate performance indicators, for 2010-11, across all key programmes. The Authority also noted the current Project Summary detailing progress against major Ofgem and Ofgem E-Serve projects to date, and their current status, with advice on when these issues would next be submitted for review by the Authority.

**Offshore regime**

16. A report was provided to the Authority from E-Serve on the current progress on tenders for the offshore regime. This noted that, in respect of the first transitional tender round, evaluations would shortly be forwarded to the Tender Review Committee for decisions on Preferred Bidders for each of the nine projects. For the second transitional tender round (TR2), requests from some six developers were under review. Ofgem and DECC were planning to consult on some specific changes to the enduring regime to allow generators the option of undertaking the construction of assets prior to their transfer to an Offshore Transmission Owner (OFTO) identified through competitive tender.

17. The Authority was briefed on two consultancy contracts covering legal and banking advisory support for the TR2 round for the period July 2010 to December 2012. These were agreed as proposed and prior to the start of the round, given the necessary preparatory work involved.

**Europe: Third Package and Ofgem**

18. The Authority received a paper providing an update on the main issues arising under the European Third Energy Package in respect of the powers and independence of Ofgem as the National Regulatory Authority, from March 2011, and the plans of DECC to consult shortly on implementation of the new measures in UK law. There had been a number of discussions with DECC in recent weeks since the Authority last considered these issues in March. DECC were now proposing to provide certain
strengthening of Ofgem’s powers to enable compliance with the Directives. The Authority welcomed this briefing, and noted that a number of issues would need to be pursued further with DECC as consultation proceeded.

**Europe: Third Package and unbundling**

19. On this agenda item, the Authority was briefed on the handling of the unbundling provisions for certain transmission system operators (TSOs), requiring them to separate network assets from their supply, generation or gas shipping interests, as provided under the provisions of the Third Energy Package; and the options and derogations available within these measures. Under the Third package, it would fall to the Authority to certify the compliance of TSOs (including interconnectors) with the unbundling provisions.

20. The Authority noted the legal position on these issues; the tests to be met for necessary independence before a derogation could be granted; and current thinking by the European Commission. The Authority agreed that, at this early stage, there should be an initial consultation which would help establish views and interpretations of these new measures, and so help the Authority with decisions to be taken by March 2011.

**Ofgem E-Serve: Quarterly Report to the Authority**

21. The Authority received and discussed the E-Serve First Quarter Report to the Authority. This focused on the key events and milestones since April with full reports on these. The Authority had noted the progress and had taken the decisions proposed on Offshore Transmission matters (as above). On smart meters, E-Serve was now finalising with DECC the consultation document on the scope of the project (the “Prospectus”) which was expected to be published in late July. This would employ an active consultation process with extensive engagement and collaboration with stakeholders. In turn this would require additional Ofgem inputs for Phase 1 – from August 2010 to January - 2011. The Authority agreed to this, subject to a settlement on satisfactory terms. Phase 2 was due to commence in February 2011, and the Authority noted that a decision on its potential role was needed in the Autumn.

22. On new scheme development, a report was offered on the progress in setting up the administrative procedures for the delivery of the DECC Feed-In Tariffs Scheme, now “live” and with substantial numbers of applications dealt with. Processes and systems had been designed an initiated for the DECC Renewable Heat Incentive and Carbon Capture and Storage Levy Schemes, with these expected to start shortly. Works on a
feasibility study for the design and potential delivery of a social price support initiative was being taken forward by E-Serve for DECC. It was anticipated that the work for DECC on the Renewables and CHP Registers, currently undergoing some modification, would be ready for launch in the Autumn. Activities and targets achieved for the CERT and CESP schemes were reported.

23. The Authority noted this work, its considerable scope and high demands, and the substantial results achieved. Over the planned lifetimes of all delivery schemes, E-Serve would be administering, for the Department, schemes with a total subsidy value of the order of £35 billion.

24. The Report to the Authority covered an information note on the relationships between the work of Ofgem E-Serve and Ofgem “Orange” and how these synergies were being identified and managed.

25. Finally, the Authority was briefed on the Government’s approach to the use of shared services, in current drives to secure efficiency savings in the delivery of public sector corporate services. All public bodies were expected to contribute. Ofgem E-Serve had identified three collaborative projects involving other economic regulators. The Authority agreed, in principle, on the basis of the analyses presented, that these offered worthwhile contributions to savings on “back office” shared services, suggesting that the proposals be worked up further over the Summer.

**RPI-X@20: Recommendations**

26. At this item, the Authority considered further advice and analysis on four of the recommendations it had examined at its Awayday in June. These were the inflation index for setting the price control; formal rights of appeal by third parties on price control decisions; providing a potentially greater role for third parties in the delivery of network services; and the move to financeability principles, particularly the decision to be made on economic depreciation. Work had also been suggested – and was now presented - on the impact of the changes on the regulatory framework. The Authority noted that, on the remaining eight elements of the proposals, it had been content, after several discussions, to agree the approaches advocated. It was hoped that the Authority could now take a “minded to decision” on all 12 recommendations, for consultation, with final decisions to be taken at the September meeting of the Authority in the light of further comment. In this way, attention could then focus on the planned TPCR5/GDPCR2 price control review, taking into consideration the final decisions on RPI-X@20 principles and the key elements of the package under development.
27. On indexation, noting the recent consultation, the Authority accepted that there may be a case for using the CPI for providing investors in network companies with means of protection against inflation which was beyond their control. However, the RPI had been used for current price controls; and was also the form of indexation for all current corporate and Government index-linked bonds. The Authority agreed that the next stage of consultation, over the Summer, should set out three options – retaining RPI, moving to the CPI, or hybrid approach with RPI for the RAV and CPI for other elements of the price control – but express a preference for the RPI approach, at this stage. Further testing of analyses would be taken forward over the Summer to inform a final decision in September.

28. As regards third party rights of appeal, the Authority recalled that it had discussed the publication of guidance on how Ofgem should respond to third party requests to make a price control licence modification reference to the Competition Commission. At present, there was no formal right of appeal by third parties. A new avenue would require primary legislation changes. The Authority, noting also the links to the implementation of the Third Package, agreed that the consultation should offer the guidance proposed, and make clear that the case for recommendations to Government on legislative change would be kept under review.

29. In a third proposal, it was recommended that the option to provide a greater role for third parties in delivery of network services should be included in the regulatory toolkit. The Authority was briefed on how this might work in practice, and the benefits seen in delivering long-term value for money for existing and future customers during a time of growth of the network companies and against high investment needs. In debate, the Authority noted that this approach, involving greater transparency, should encourage existing network companies to deliver major projects on time, with improved cost efficiency and – given the pressures for new low-carbon technologies – create greater potential for innovation. Current experience on the delivery of some major network projects and capacity expansions had raised questions about their timeliness and overall cost effectiveness.

30. A final proposal, debated further, concerned recommendations on the transition arrangements on financeability. Under these, it was proposed that a new set of principles be set out explaining how Ofgem would address the various components of financeability at forthcoming price control reviews. These would represent improvements to the present approach rather than a step-change. Each price control would determine how, in detail, the principles should apply. In discussion, the Authority noted the current principles, their design, and their application in balancing appropriately the interests of consumers and in providing transparency and predictability for companies and their investors. [These
covered regulatory commitment over the long term; the allocation of risks; notional gearing; using a real WACC and with the cost of debt assumed to be based on a long-term trailing average with annual updates; methods for determining the cost of equity; capitalisation policies and their alignment with opex and capex; asset life assumptions; the underpinning of decisions on financeability by the use of credit ratings metrics; and the application of return on regulated equity (RORE) analyses.

31. The Authority recognised both the importance and sensitivity of the proposed recommendations, agreeing that the proposed new transition arrangements on financeability should be subject to consultation in the set of Final Proposals, with further work on them – including the presentational aspects - being developed before final decisions planned to taken in the Autumn.

32. Finally, the Authority congratulated the Team for its sustained work, over a two year period, in developing these detailed and fundamental new provisions, involving much consultation, within and outside Ofgem.

Caythorpe

33. At this item, the Authority was briefed on a proposed procedure for the revocation of the exemption from the requirement to offer third party access which had been granted previously to the Caythorpe storage facility. The prospect of revocation had arisen following the purchase of Caythorpe Gas Storage Limited by Centrica from Warwick Energy in 2008. Ofgem’s assessment of Centrica’s position in the market, using the tests set out in its recent open letter on minor facility exemptions, was explained. Counsel’s views were noted, as well as the line being taken by the European Commission in its interpretive notes on the Third Package. In the light of these analyses, the Authority endorsed the approach on potential revocation, and agreed that DECC should be informed accordingly.

Liquidity

34. The Authority was provided with an update on the outcome of the recent Ofgem assessment of GB electricity wholesale market liquidity. This noted the background and the findings from the Energy Supply Probe that wholesale market liquidity may be acting as a barrier to entry and growth in the supply market, with implications for competition. Consultation documents had followed in June 2009 and February 2010, outlining some potential interventions should the preferred market solutions fail to deliver change. A draft consultation document planned for July was presented, summarising responses to the recent consultation, outlining a framework for assessing market liquidity, and the current Ofgem assessment.
35. The Authority noted that there was a mixed picture on market performance: there had been a growth in overall churn since 2006, and plans from N2EX to introduce new financial derivatives. However, liquidity for longer dated products appeared rather weak, and bid-offer spreads were tending to increase. There had been no major increases in either auction volumes or transparency. Problems reported by non-vertically integrated concerns, in meeting their power hedging needs, remained. It was proposed that Ofgem should keep possible regulatory actions under review, perhaps for integration with any wider package of energy reforms. The Authority was grateful for this update, and agreed that the consultation document should be published; and that other work should proceed as recommended, including continuing liaison with DECC.

Carbon capture and storage: potential asset disposal

36. The Authority reviewed a paper providing further details of NGG’s proposal to Ofgem, requiring the Authority’s consent, for the disposal of part of the National Transmission System for the transport of carbon dioxide from coal-fired power stations to permanent storage. The proposal would be part of a proposed consortium bid to DECC for funding under their Carbon Capture and Storage trial.

37. The Authority expressed the provisional view that this proposal conformed to the principles and conditions, as had been set out in the Authority paper. These points should be explored further with NGG and the parameters for any proposed disposal explained. The final decision on the proposed pipeline disposal would rest with the Authority, to be taken at a later date, should the consortium bid prove successful with a subsequent formal request to the Authority. DECC would be briefed on the background.

“Green Deal”

38. The Authority was briefed on the main emerging elements of the Government’s proposed “Green Deal”. A central theme, to encourage energy efficiency improvements, was the Green Deal Financial Initiative (GDFI). Under this, it was proposed that private sector interests could cover the upfront costs of installing efficiency improvements, to be repaid by charges collected by energy suppliers via energy bills, over time. The briefing considered the contribution to be made through these measures to sustainable development and to supply markets. Ofgem was working with DECC on aspects of the evolution of these plans, notably to maximise their benefit to consumers.

39. The Authority noted that the new arrangements would raise a number of issues for the potential role of Ofgem E-Serve on parts of this package, in respect of one or more operating functions of the scheme; and as regards
implementation, should DECC suggest the delivery of elements of the new schemes by Ofgem. The Authority agreed that Ofgem should continue to assist DECC on the Green Deal package and the GDFI – drawing on its expertise – concentrating on the impacts on sustainability and consumer benefit. A proposed feasibility study was supported under which Ofgem would examine the practical implications of supplier obligations and the implications for switching.

**RPI-X@20 and the TPCR5/GDPCR Price Control Reviews**

40. Under this item, the Authority considered and discussed an analysis of the approach to the next Transmission Price Control, (TPCR5) and the forthcoming Gas Distribution Price Control (GDPCR2), and the way in which the emerging recommendations of the RPI-X@20 project might be incorporated, once final decisions had been taken on them later in the year. The paper explained how, if the RPI-X@20 measures were agreed, the reviews would differ from earlier approaches; the proposed roles for the planned Committee of the Authority which would be taking forward the detailed work with recommendations; and the role of the Authority itself. The briefing highlighted the main issues for each review.

41. The Authority noted the briefing and agreed that it would be a valuable step to publish Open Letters soon, for each planned review, on both the topics to be covered and the high-level timetable; and to launch industry working groups to examine and help develop appropriate output measures. These would need to reflect the Authority’s "minded to" position on the RPI-X@20 measures on which final decisions were planned for September.

**Gas Distribution capacity outputs incentives**

42. The Authority received briefing on the proposed approach to the Gas Distribution Capacity Outputs Incentive for years 2013/14 and 2014/15, and on the background purpose of these in meeting peak customer demand. A change of approach was now advocated for these two years – as compared to the views developed during the discussion by the Authority in March. It was recommended that these allowances be not set at present but be further considered – including the case for them – in the context of GDPCR2. This would enable fuller consideration of the evidence provided by companies during the forthcoming price control review since they would need to set out their case for expenditure as an efficient response to meeting their capacity needs. The impacts of a later determination on the operation of the gas distribution businesses and customers were judged minimal. Contacts with companies had suggested no issues in opposition to this approach. Incentives would remain for the 2010 and 2011 auction processes and efficient contracting for interruptible capacity.
43. The Authority agreed the proposals. There should be a further consultation on these plans; and the Authority agreed that a Senior Partner be delegated to issue a Direction accordingly.

System Operator Review

44. An update note, for information, was provided on the System Operator incentives review, following the publication of the Phase I preliminary conclusions on 5 July. The focus of the Phase I study was a fundamental review of the current methodology for setting incentives (including NGET’s models and modelling approaches). Preliminary conclusions included the need for certain improvements to NGET modelling for forecasting SO costs, especially in dealing with the impacts of unpredictable external factors affecting cost bases. It was hoped that, subject to agreed changes, a new two-year SO scheme could start in April 2011. The Authority noted the current position.

Research Review

45. An information note was tabled and noted by the Authority. This set out the main findings and recommendations from a review assessing how Ofgem conducted and used research, initiated as part of the 2009 restructuring of Ofgem. Research capability had been interpreted quite broadly - to include identifying factors affecting the energy landscape as well as the capacity to undertake specific studies to underpin day-to-day policy decisions. Feedback from internal and external consultations indicated that Ofgem was good at research, particularly on regulatory economics. There was substantial and growing strength in strategic horizon scanning projects such as Discovery, LENS and RPI-X@20. A Research Unit was suggested, together with a number of proposals on good practice; continuing professional development; the importance of undertaking medium/long term analyses; and the identifying of technological and market-related developments.

Financial Health of Network Licensees

46. The Authority noted a quarterly report on the position of network licensees on the financial health “escalator”, following continuing monitoring activity by Ofgem. There were no changes since the last report to the Authority. One IDNO and one gas distribution company would continue to be kept under review.

Enforcement cases

47. The Authority reviewed and noted a schedule of current enforcement activity and the status of all cases under review.
Other business and date of the next meeting

48. There was no other business. The Chairman noted that the next meeting of the Authority would be held in Glasgow on 23 September, with a meeting and workshop of the Audit Committee, and then an Authority dinner with Scottish energy interests, on 22 September.

Those present

The Lord Mogg, KCMG (Chairman)
Sarah Harrison
David Harker
John Howard
Jim Keohane
Jayne Scott
Steve Smith
Andrew Wright
John Wybrew

Those attending

Stuart Cook (all items)
David Pimm
David Ashbourne
Martin Crouch (EU items)
Duncan Sinclair
Paul McIntyre (E-Serve) (Green Deal)
Bob Hull (E-Serve) (Offshore Regime)
Hannah Nixon (RPI-X20)
Clodah Jenkins
Scott Philips
Declan Tomany
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