

**Minutes of the Meeting of the Gas and Electricity Markets Authority**  
**Thursday, 17 September 2009 at 8.30 am**  
**Glasgow**

**Introductory remarks by the Chairman**

1. The Chairman welcomed to their first Authority meeting Stuart Cook, acting Senior Partner/Transmission and Governance in a new role, following the recent reorganisation of Ofgem; and Wilf Wilde, who had just been appointed to Ofgem as Director of Marketing and Public Affairs. Bob Hull was now acting MD Commercial in Ofgem E-Serve. The Chairman noted that Charles Gallagher, also in a new role, would be concentrating on all aspects of Scotland, Wales and the Regions and offered his thanks for all that had been achieved through his advice to the Board in recent years.
2. The Chairman noted that the opening of the new Ofgem Office in Glasgow, by the Scottish Government's Minister for Energy, Jim Mather MSP had gone well. The dinner the previous evening, which some eleven senior Scottish stakeholders had attended, had resulted in a very profitable series of exchanges on Scottish energy issues. Scottish and Southern Energy would be giving a short presentation to the Board, on energy pricing issues, at the end of the current meeting.
3. 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.
4. The Chairman and the Legal Adviser noted the proposal that all existing delegations approved by the Authority should have effect in to relation to the new posts or titles held by Ofgem staff after the reorganisation. This was agreed, as was the Chief Executive's role in setting the terms of reference and membership of the Tender Review Committee in respect of the Offshore Electricity Regime project.

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5. The draft minutes were approved.

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

6. In his report to the Authority, the Chief Executive concentrated on the following main issues:
  - The reorganisation of Ofgem, and its rationale, and the creation and tasks of Ofgem E-serve, plus the associated personnel changes and post designations; and some of the key messages emerging from the Chief Executive's consultation over the Summer months.
  - The next steps in setting up Ofgem E-Serve, including recruitment, and the planned reporting arrangements to the Authority.

- The immediate tasks ahead on Project Discovery, RPI-X@20, Project Mercury, DPCR5 and governance review matters.
- The current position on budgets and reserves - both satisfactory- and on staffing, notably the growth of staff numbers to deal with Ofgem E-Serve activities.
- A review of potential energy company mergers and acquisition activity and an assessment of how recessionary factors may be influencing this.
- The positions being taken by the main political parties on energy matters and regulation.
- Planned Ofgem announcements and seminars in September and October.
- The welcome delivery of a number of significant projects including work on Collective Licence Modifications, the follow up to the Probe and proposed licence conditions on retail remedies.

The Chairman noted that after discussions with the Committee's Chairman and others, and with the creation of the Sustainability Division, the Sustainable Development Committee would stand down. Sarah Harrison would be examining closely the means for improved delivery of sustainability themes across all of Ofgem's work. The Chairman, on behalf of the Authority, expressed thanks to the Committee Members and support staff for the achievements of the past years.

7. On the report on sustainable development, the Authority was briefed on the latest developments in the progress of a new Energy Bill, and noted a paper provided for information. The Bill, for the Fifth Session, was designed to deliver on a number of commitments made in the recent Low Carbon Transition Plan and elsewhere. These included measures on carbon capture and storage, and a proposed new levy to fund demonstration schemes; the setting up of a social tariff support scheme, as from 2011, when the current voluntary suppliers' schemes ended; and a number of proposed changes to further clarify Ofgem's duties. Also proposed were additional powers for Ofgem to tackle market abuse in the electricity wholesale market and improvements to Ofgem's financial penalty powers; and proposals to cover funding for the roll-out of smart meters. Ofgem would continue to track these proposed new measures – and their detailed drafting – updating the Authority as necessary. The Authority noted these proposals, the initial reactions of some industry stakeholders as well as the Parliamentary timing implications for the Bill's content and progress.
8. On other matters, the Authority noted the reviews under way on aspects of competition policy. There had been positive responses to the Ofgem/CAB Energy Best Deal campaign and a joint Ofgem/Consumer Focus report on vulnerable customer disconnections would soon be published.
9. On markets issues, the Authority received its regular update, noting that the wholesale/retail quarterly report was soon to issue on energy markets and where analysis indicated that margins were likely to come under pressure through the rising costs of environmental requirements, network investment and bad debt. Electricity demand remained muted due to recessionary factors and there were healthy generation surpluses with the planned commissioning of CCGT plants and improved nuclear power availability compared to the poorer outputs of 2008. System demand for gas was lower than normal in August and September. On the supply side, LNG capacity had increased and storage levels were currently at 99% of capacity, the market remaining confident that consumer demand could be met in all but exceptional circumstances.

10. There were some near-term weaknesses in electricity prices and divergence from some higher predicted power prices in continental Europe. Forward gas prices continued to show weakness compared to 2008 as the supply outlook improved.
11. On the follow-up action to the energy supply Probe, the Authority was briefed on licensee stakeholder responses to the package of retail measures on which a further consultation exercise had just closed, covering the proposed steps on assistance to SMEs, debt blocking, the provision of financial information to Ofgem, terms and conditions, marketing and billing and statements. The Authority noted an analysis of the responses, by issue and by company, and agreed that the proposed package should go ahead but with the revised dates recommended for the entry into force of the measures on small businesses, debt blocking and terms and conditions (to be set at 15 January 2010); and further agreed that 1 July 2010 should be the date for the introduction of the new billing and annual statements provisions.
12. In order to speed the introduction of these new licence requirements, and allow the maximum time for suppliers to start to implement them, it was agreed that the MD Markets should be given delegated authority to settle any remaining points of detail and arrange for publication of the decisions as soon as possible.
13. Finally, it was reported that a useful seminar had been held with interested parties on the current energy issues confronting the industrial and commercial sectors, covering a range of issues such as credit risks and their management, supply problems, and the trade credit insurance.
14. In the briefing on local grids and RPI-X@20 issues, the Authority was updated on the history and latest developments on the project to settle a common charging methodology for electricity distribution across GB, and its importance in terms of sustainable development and retail competition, through the introduction of cost-reflective charging. The proposal last looked at by the Authority had been blocked by two companies though a new way forward had been agreed offering DNOs the option of two competing methodologies on means of charging extra high voltage customers, with plans a later Authority decision between these options. This had been accepted, together with the necessary licence conditions. In September, DNOs had delivered a new and common methodology for charging high/low voltage customers, covering some 90% of their customers. This was on track for implementation in April 2010, as was a new charging methodology for independent operators and network companies wanting to use other DNOs' networks. The developing Ofgem open governance arrangements, and revised approaches to dealing with modifications, would allow these methodologies to evolve and adapt to meet future challenges.
15. The Authority was briefed on the first year performance, under the gas distribution price control, of the eight gas distribution businesses including the four formerly owned by National Grid but now in the hands of independent operators.
16. On transmission issues, the Authority noted the key developments on the electricity transmission access review. DECC had now published its consultation paper, a partial impact statement and its consultancy advice, all subject to a 12-week consultation period. Three variants of the "connect and manage" model had been proposed by the Department. These variants differed according to the way in which they handled constraint costs and in the extent to which they required

users to make a financial commitment to underpin their grid access needs. The Authority would be further consulted on the Ofgem response to these proposals. It was noted that the Department planned to implement enduring access measures in Summer 2010.

## **Project Discovery**

17. The Authority was provided with an update on Project Discovery. A consultation document was proposed for release in September, this concentrating on the scenarios under analysis for assessing the prospects for achieving sustainable security of energy supply in the next ten to fifteen years; and the steps which might be taken to secure this goal. The suggested timetable for development and delivery of the Project were set out.
18. The Authority debated the key messages reflected in the Summary, noting a number of points of relevance to these scenarios, including the role of demand side response, the future operation of markets, pricing structures, contrasts with other foresight studies and industry views on supply issues in the medium term, the prospects and likely impacts of changing policy frameworks, EU policy matters, and customers' willingness to meet the costs of securing sustainable future energy supplies. It was agreed that further reflections on the text of the Summary, the full the report as circulated, and the linkages between them should be offered by Members within a few days.

## **DPCR5**

19. The Authority considered a paper and presentation summarising the current state of play on the Initial Proposals for DPCR5, published for comment by Ofgem on 3 August 2009. The approval of the Authority was now sought on the next steps including the high level approach and process to be followed and the planned involvement of the Authority at key decision points; on the results of the outstanding areas of cost analysis and their treatment; on the content and scope of the individual letters to DNOs, with Ofgem's views on cost assessments and financial models; on the main issues for the approach to the treatment of pensions; and on processes for establishing the value of the weighted average cost of capital (WACC) and an appropriate range for the return on regulatory equity (RORE) under the settlement.
20. Stakeholders' reactions to the Initial Proposals were analysed and presented. The emerging picture suggested that consumer bodies and large industrial users were generally in agreement with the measures Ofgem had proposed, but were highlighting caution over measures that would entail further price increases and had emphasised the need to ensure there were strong incentives on DNOs to improve customer service. Suppliers welcomed a number of features, such as the focus on RORE, progress on the treatment of losses, the Ofgem line on unit costs and some were supportive of measures to amend the treatment of pension costs. But there were concerns over the price rises resulting from the settlement and suppliers were keen to ensure that the price control arrangements would not introduce further year-on-year volatility in distribution use of system charges. DNOs welcomed many aspects of the Initial Proposals and were in agreement with the objectives Ofgem had set out. However, in general they did not consider that Initial Proposals allowed them the level of costs required, to deliver the level of network replacement and reinforcement required or to make the changes required for the networks to enable the low carbon economy. Issues had also

been flagged on the treatment of losses; on tax methodology; the proportion of total costs that should be capitalised; and on some aspects of the RORE plans. Companies, unions and pension trustees were strongly opposed to any proposals to introduce greater incentivisation of pension costs.

21. The Authority discussed and agreed as follows:

- There were a number of specific areas of network cost and allowed revenue analysis which the team were revising to incorporate new information provided by the DNOs, to correct for errors and to address some unintended consequences of the work at Initial Proposal stage. The Authority agreed that further work should proceed with discrete changes and improvements, if these were warranted. There should, on the other hand, be no change to the high level approach or methodology.
- The Authority, in considering an analysis of each of the main elements on costs, the possible changes indicated and their materiality, agreed that DNOs should be contacted individually, with updated analyses, such that they could consider these before their next planned meetings with the DPCR5 Committee on 7 and 8 October. The Authority's DPCR5 Committee would review the updated cost and revenue allowances in late September ahead of these letters being issued.
- There would also be an open letter on 21 September, as an update, focussing on those areas of analysis highlighted at Initial Proposals as outstanding matters.
- On pensions, the Authority noted the responses from the latest consultation on pensions and points made at the 8 September workshop. The Authority again reviewed the different options for the treatment of pension costs. It was agreed that further analysis of the issues and the results of the consultation, plus options for pension cost treatment, should be examined in more detail in late September by the DPCR5 Committee. The Authority may then be able, on the advice of the Committee, and the meetings with DNOs, to take a "minded to" decision, at its October meeting, triggering for a further period of consultation.
- Having considered the advice from leading Counsel on the consultation process, the Authority agreed the plan to hold a four week consultation period on its minded to position on pensions. Authority asked the team and the executive to consider the detailed timetable between close of the pensions consultation and the Authority's decision on DPCR5 Final Proposals.
- On cost of capital, the Authority considered the team's proposal that the starting point in setting the WACC should be the approach taken in the recent Gas Distribution Price Control – and not the former DPCR4 - as being the most recent basis for assessment. Market evidence on the constituent elements of WACC were examined, including recent bond issues by network companies. Recent settlements reached by other regulators were also considered. It was agreed that Ofgem should be looking for an holistic settlement in which the range of RORE, and the detailed calibration of incentives, were also important factors in deciding on the appropriate cost of capital for. DNOs' suggestions were reviewed, several pointing to the impacts of the financial crisis on the costs of debt and of equity. The results of independent studies and methodologies were also explained. The team's initial thoughts on a suitable range for vanilla WACC were presented, together with their relationships to other elements of the settlement. The Authority concluded there should be a further debate on cost of capital at the DPCR5 Committee, then at the Authority at its October meeting.

- Final DPCR5 proposals on this, and other elements, would be further reviewed at the Committee's meeting on 5 November, with advice to the Authority for its November meeting.

### **Project Mercury**

22. The Authority considered a paper providing an update on the progress of this project for monitoring the financial health of network companies and the revised plans for responding should companies experience financial distress, building on the lessons from useful "War Game" exercise held earlier in the year. The role the Authority in any such event had been reviewed further, including the basis on which authority for action would be delegated, according to the circumstances, to the Chair or CEO. The note now reflected the recent reorganisation of Ofgem. The Authority agreed the proposals.
23. The Authority noted the revisions to the internal manual dealing with key decision makers and processes. A shorter and revised external manual and guidance document was explained, now taking in the comments from a recent consultation exercise which had yielded generally supportive comments. The Authority agreed that this should now be finalised, and that a draft decision document should be published, alongside the guidance document, summarising respondents' comments.
24. The Authority considered and noted further information on the development of the Project, in advance of a planned discussion in October, on a review of the financial ring-fence arrangements set out in network companies' licences; an assessment of the varying corporate structures of DNOs and any concerns these might raise should there need to be action to deal with financial distress; and continuing progress on the MoU with HMT and DECC on respective roles. A quarterly update on the financial health of network companies was provided and also noted.

### **Connection and Use of System Code (CUSC): CAP 170**

25. Under this item, the Authority considered a paper – following up an initial discussion in July 2009 – on NGET's proposal to amend the CUSC to introduce a new generator operational intertripping scheme, one of a number of measures to address the longstanding issue of rapidly rising constraint costs. The Authority was briefed on preliminary legal advice on the way forward; and agreed to consider matters further in the light of Counsel's advice at a later date.

### **Direct Debit arrangements**

26. The Authority noted, for information, a short paper explaining the current position on Ofgem's plans to introduce, in supply licences, obligations on direct debit arrangements and notably on customer communications aspects, in line with previous Authority discussions; and the background to and results of consultations on this topic over the Summer as part of the follow up to the Retail Probe. The proposals had been welcomed by consumer interests, though some concerns had been raised on implementation timescales and the details of what had been suggested. The proposal was now to publish a document with Ofgem's conclusions and start a statutory consultation on the underpinning licence modifications.

## **RPI-X@20**

27. A short information paper was presented describing emerging thinking and planning within Ofgem on the RPI-X@20 project since the Authority's last discussions at its Awayday in June, including the active engagement of four working groups and a second academic workshop. A number of working papers had been published on what networks might deliver – addressing the respective roles of key players in decision-taking on future network strategy and delivery, efficiency questions, innovation, consumer engagement and on how new frameworks might look. This work was welcomed and the Authority looked forward to further discussions on 14<sup>th</sup> October on the Project and its proposed timetable.

### **Other business and date of next meeting**

28. There was no other business. The Chairman outlined plans for forthcoming meetings and events as follows:

- An evening meeting at Ofgem at 6.30 pm on 14<sup>th</sup> October to discuss the RPI-X@20 project.
- The next Authority meeting at Ofgem on 15<sup>th</sup> October at 8.15 am.
- An Ofgem Parliamentary Reception on Wednesday, 28<sup>th</sup> October at 6.30 pm at the House of Lords.
- The following Authority meeting on Thursday, 19<sup>th</sup> November at 8.15 am at Ofgem.
- A special additional meeting on DPCR5 planned for at 2.30 pm on 24<sup>th</sup> November, also at Ofgem.

#### **Those present**

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

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

#### **Those attending**

David Ashbourne	(all items)
Wilf Wilde	( " )
Giles Stephens	(Discovery)
Kersti Berge	( " )
Rachel Fletcher	(DPCR5)
Chris Watts	(DPCR5)
Michael Brocklehurst	(Legal Adviser to the Authority) (all items)
Dr Tony Burne	(Secretary to the Authority) (all items)