

Business, Energy and Industrial Strategy Committee

Oral evidence: RIIIO 2: Energy network price controls, HC 983

Thursday 12 November 2020

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Members present: Darren Jones (Chair); Alan Brown; Judith Cummins; Richard Fuller; Ms Nusrat Ghani; Paul Howell; Mark Pawsey; Alexander Stafford; Zarah Sultana.

Questions 1 - 55

Witnesses

I: Jonathan Brearley, Chief Executive, Ofgem; Nicola Shaw, Executive Director UK, National Grid; Stew Horne, Principal Policy Manager, Energy Networks and Systems, Citizens Advice.

Examination of witnesses

Witnesses: Jonathan Brearley, Nicola Shaw and Stew Horne.

Q1 Chair: Welcome to this morning's session of the Business, Energy and Industrial Strategy Committee. We are considering two issues today: we are first looking at the RIIO 2 draft determinations, which we will get into in detail with our experts in a second; and then, in the second half, we have Kwasi Kwarteng, the Energy Minister, looking at the emissions trading system and some other energy-related issues post Brexit.

Before we begin the session today, I ought to declare my interests in this session. My wife is the head of external affairs at the Association for Decentralised Energy. Many moons ago now, I used to be a lawyer in house at npower, so I thought I ought to put that on the record. I do not think there are any other declarations of interest from colleagues at this stage. If members of the Committee have them, maybe they can say them at the start of their questions.

In the first session this morning, we are delighted to be joined by Jonathan Brearley, the CEO of Ofgem, the energy regulator; Nicola Shaw, the executive director in the UK for National Grid; and Stew Horne, the principal policy manager for energy networks and systems at Citizens Advice. Welcome to all three of you this morning.

Jonathan, I wonder if you could set out for us what lessons have been learned from the RIIO 1 process, in terms of both its limitations and its successes, and how that has influenced the decisions at Ofgem about RIIO 2 design.

Jonathan Brearley: I would like to start by talking about our aims. What are we trying to do with these price controls? Really, it is fairly simple. We are absolutely foursquare behind our climate change targets, so getting to net zero. Of course, we want to maintain security of supply and a good service to customers, but that should be at a cost that is fair and reasonable to customers involved.

When I look at the history of price controls overall, it has been a big success. We have seen £70 billion of investment, we have seen costs come down and we have seen services improve over the last 25 to 30 years. For example, power cuts have halved. When I look at RIIO 1 as part of that history, we have had what I would describe as a partial success. Service levels absolutely have improved. We have had some big successes in companies really focusing on what their stakeholders want and need. As I am sure my colleagues from Citizens Advice and, indeed, in the NAO have pointed out, that came at a cost that was too high for customers.

When I now look at RIIO 2, as a regulator, we have to get that balance right. Yes, we need to make sure that we deliver the rates of return and the revenues needed to get the investment to get to net zero and support security of supply, but to do that in a way that is fair for customers. We



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all agree on the strategic direction that that implies, and that is really three things: returns need to come down from where they were in RIIO 1; companies need to be run as efficiently as possible; and that creates the room we all agree we need for the additional investment to get to net zero.

If I could just say one thing about the process, when we got to draft determinations, we were faced with what we thought was quite thin evidence from some companies about what they needed. I am really pleased to say that, since then, we have worked very hard with them, and I would like to thank all of them and, indeed, all of our stakeholders for their co-operation. We have a much firmer base on which to make that balance at the end of the year.

Q2 Chair: Thank you for that. We will get into more of the detail of RIIO 2 with colleagues on the Committee in due course. Nicola from National Grid, we understand that, as a company, you did not spend all that you were allowed to under the previous price control. Was there a reason for that?

Nicola Shaw: Thank you for asking me to be here. I represent National Grid's transmission businesses in electricity in England and Wales, and gas for the whole of Great Britain, so your questions are very pertinent. I agree with much of what Jonathan has said. The key thing to remember, though, is the incentive to innovate. The principal reason why we spent less over the last eight years than was in the original proposal was that we found new ways of doing things.

One this year is a really good example of that. We are putting in new technology that allows us to control the electricity network in a much more effective way than it would have been if we had used an old technology. That new technology is a lot cheaper but it has taken the eight years of the price control to develop, so we have innovated. That saving is then shared with consumers immediately. About 50% of the saving over the last control period has been shared with consumers, so there has been benefit to both of us. That is really important as we go forward because finding new ways to do things more cheaply is really important for that overall balance that Jonathan has been talking about.

Chair: Thank you for that. Again, we will probably come back to you with some more detailed questions on spending and capacity for flexibility on spending in the next period.

Q3 Alan Brown: Can I start with a couple of questions on process? Jonathan, we have billions of pounds of investment at stake here looking forward. It feels to me that this is really going down to the wire. We are looking at a final determination sometime in December, yet the investment period starts in April. Has that been the planned cycle all along or has there been any slippage? Have all stakeholders bought into this as an acceptable timeframe?



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Jonathan Brearley: That is the timeframe we laid out when we laid out the process for RIIO 1, and it is pretty similar to previous price controls. It allows us sufficient time to react to things as they change and to make sure we have all the evidence we need following the consultation. Equally, we have time to make the changes to the licence conditions for companies to put their investment plans in place. I would emphasise that, for us as an organisation, it has clearly been a challenge running a process like this in the conditions that we have all been working in, but we have stuck so far to the timetable that we laid out right at the start of this process. Of course, given that the impact of coronavirus is unknown, we have thought about contingencies but, right now, we are on track for where we want to be.

Q4 **Alan Brown:** Nicola, have National Grid and other operators always been happy with this timeframe?

Nicola Shaw: It has been a long process. The good news about that is that we have been able to consult with our stakeholders and our customers through it. For us, the big feedback from them was the importance of the resilience being protected through the period and making sure that we got the bill and the balance right. Following the pandemic, we have checked back with customers and they still saying the same things about the importance of getting that balance right. The longer we go and the more potential there is for challenge after the decisions are made in December, it just leads to a bit more challenge for all of us, but we have to find a way through.

Q5 **Alan Brown:** Jonathan, in its written submission, SSE said that some mistakes were made by Ofgem in the draft determination. It quoted £361 million-worth of errors and excess efficiency assumptions. Is that right? Were there errors of that magnitude? If so, how did that come about and how will that be rectified and fed back to the operators before final determination?

Jonathan Brearley: We are concerned where people were worried about errors made in the original calculations. These are very complex calculations and, in many price controls, there are data errors and things that appear at this stage. However, when we unpicked a lot of the drivers behind what were described as errors, they were just differences in view. You mentioned efficiency, for example. We are pushing very hard on our efficiency assumptions because we believe that companies need to run as efficiently as they can. Therefore, when we unpick it, some of those numbers are driven by a difference in view rather than what we would accept as an error. What we have done, though, is benchmark RIIO 2 versus previous price controls and we are roughly in the same place.

Q6 **Alan Brown:** SSE talked about £250 million of errors, so you would dispute that those were errors. It is all just a difference of opinion.

Jonathan Brearley: It is three things: there are some data errors, absolutely; there is some difference of view on the assumptions that we



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put in the modelling; and there is a difference of view on the methodology that we apply to some of this.

Q7 Alan Brown: Can you quantify what the value of errors was at this late stage?

Jonathan Brearley: Yes. Looking at the draft determinations, they were about 2% of the overall allowed revenues within the control, which benchmarks very closely to the same stage in RIIO 1.

Q8 Alan Brown: All stakeholders, including National Energy Action as well as the operators and Citizens Advice—I will come to Stew on this—say the process is not transparent enough. How do you respond to that?

Jonathan Brearley: We have built a huge amount of consultation within this process. In the last few weeks running up to this Committee, we have run open hearings, where we have had very public discussions about our draft determinations and where concerns were raised. I would emphasise that we are also listening to people right now and adapting where our draft determinations might go. National Energy Action and, indeed, many of the user groups that have formed around the price control to get stakeholder views have asked us to look again at how much we are doing for vulnerability. That is absolutely something that we will do as part of this process.

Q9 Alan Brown: We are going to come to vulnerability later on. On the user groups, is it true that some have expressed concern that their views have not been taken into account? If so, how are their views going to be factored into the final determination?

Jonathan Brearley: We take the views of the user groups very seriously. We want to hear what different stakeholders would like out of the network and the pattern that they would like to see, but we do have other evidence and other voices. Really, the hard technical analysis still remains within the Ofgem organisation. I should also point out that we had a challenge group that saw all the price controls, which sometimes came to different views as well.

However, having said that, there are two things we could do better when we get to the final determination: the first is to be clear with the feedback that we have taken on board, and perhaps that was not clear enough in June; and secondly, there are areas where the user groups, collectively, have asked us to highlight and to have a look again. I mentioned vulnerability as one of those and we absolutely will do.

Stew Horne: At Citizens Advice, we are the statutory energy advocate as well as being a charity that provided advice to over a million people for energy concerns last year, so that gives us a really rich insight into the sorts of issues that people have with energy supply. Energy networks typically take up about a quarter of the bill, so this is a really important area for consumers. We have experience of these price control processes. We really welcomed the amount of work that Ofgem asked networks to



do in speaking to their customers and stakeholders, gathering a lot of evidence about what was needed in these price controls, including the needs that people have at a practical level, especially with the distribution companies, but also their views on some of these big infrastructure questions. That was really impressive.

What we have found really difficult is that, in the draft determinations, we did not think it was clear enough how this information had been taken onboard, and we are looking for Ofgem to make that much clearer and more transparent when it gets to the final determination. This is really vital because we have asked consumers and stakeholders what they need. The companies have responded to this, and now Ofgem really needs to show its hand and say, "This is what we have done with this information and this is how we have weighted it along with all the other evidence".

Q10 Alan Brown: Jonathan, you are nodding your head, so that will all become clear in the final determination and there will be a lot more information on that.

Jonathan Brearley: We accept some of that and want to make sure that it is clear what we have taken on board, and, equally, what we did not and why we did not.

Q11 Alan Brown: Looking at net zero, Jonathan, the National Infrastructure Commission found that the frameworks are not designed to meet net zero and the current networks are more about driving down cost, yet net zero is a legally binding Government commitment. In your opening remarks, you stated Ofgem's commitment to net zero and climate change. Do the draft determination and, possibly, the final determination properly address net zero or should net zero be better enshrined in the frameworks, given that it is legally binding for the UK Government?

Jonathan Brearley: Addressing the question about our statutory goals and how our job is set up, we are very open to the idea that they would be amended, but what I would emphasise is not just in the price controls but across the board. I, as CEO, and the board are fully behind trying to deliver net zero. Indeed, on my first day in this job, I issued a decarbonisation action plan, which really was a set of actions to try to get there but also to make that statement clear publicly.

In these price controls, coming back to the draft determinations, there are two elements. First of all, we accepted 90% of net-zero-related funding, around £3 billion, but we also said that the energy economy is going to change quickly as we get to net zero, so we absolutely accept that there will be more investment coming through. One thing we have tried to do and worked hard with the companies to do is to design a way in which these regulations can adapt to make sure we get more investment, if it is needed. We think that that would add another £10 billion of investment over the five years, potentially.



- Q12 Alan Brown:** Nicola, from the network operators' point of view, what would you see as the challenges to the networks in meeting the net zero target? Jonathan mentioned the possible addition of £10 billion there, which is an uncertainty mechanism. What are the risks of putting so much into an uncertainty mechanism?

Nicola Shaw: There is a lot to be done over the next period, but I see that as an opportunity. The work you have been doing as a Committee is helping to raise the profile of that and make sure that we keep going. The challenges are in the scale of investment needed. Your point about uncertainty mechanisms is something that we continue to be worried about. We have supported the use of uncertainty mechanisms and think it is a good idea, but the balance here between predictability and investment is important.

As you say, there is a lot in the space—maybe twice the amount that is in the baseline—so talking about the baseline is rather misleading in relation to the net zero developments. Ofgem is proposing changes from its draft determinations in three broad ways: first, in allowing us to invest properly for connections to the network; secondly, in allowing us to invest in the ongoing development of projects that have already been determined as needed; thirdly, in the process for dealing with large-scale investments. All of those things are good, useful and important to give us more security as part of the final determinations.

There are two things that I still continue to be nervous about. The first is making sure that, wherever possible, we can give certainty on what we will be required to do and what others might be required to do. The first big project required is a link from Scotland to England on the eastern side of the country, where we need to be building in about 18 months' time and yet do not have certainty about whether we will be required to do that project in conjunction with our colleagues in Scotland. The second is getting this balance right, so that investors continue to want to put their money into energy projects in the UK. That is something that I am sure we will come on to.

- Q13 Alan Brown:** Jonathan, coming back to you on that, Nicola gave the example there of the additional upgrade needed between Scotland and England. How do you allow for grid reinforcement to facilitate additional generation in Scotland? ScottishPower has highlighted Branxton substation, which was needed for an offshore wind farm, which was disallowed. How do you also account for devolution and the fact that the Scottish Government have a net zero date of 2045? ScottishPower has suggested that it has agreed projects that the Scottish Government and Transport Scotland, for example, think are important for rail electrification, yet these projects have been stripped out. How do you take account of the different governance and different aspirations, perhaps, in terms of devolution?

Jonathan Brearley: We fully support all devolved Administrations' statutory goals, including the Scottish goal to get to net zero. That forms



the frame of what we do. In terms of the specific projects, we are still having an ongoing discussion about the evidence that was presented, so there is a conversation about what might go into the baseline and what might go into an uncertainty mechanism. One area where we have worked incredibly well with the industry is in shaping how this uncertainty mechanism would work. I acknowledge that what came out in draft determinations was probably too slow and not fit for purpose. The three changes that Nicola has highlighted are the sorts of things we are exploring now to make sure that project development can continue and these investments come through.

We have two jobs here. We absolutely want to get the investment in but we do need to make sure that that is robust and in consumers' interests. Getting that balance right is the important job that we need to do, not just this December but over the next five years.

Q14 Alan Brown: You already said that the uncertainty mechanism is £10 billion. Is that a £10 billion ceiling? You are saying that some projects might still go to baseline and some might go towards the uncertainty mechanism, so are you still capping the allowable investment or is there scope for moving that in the final determination?

Jonathan Brearley: That is not a cap. That is a rough estimate of where we might be, and we are not limiting the scope of the uncertainty mechanism. If more investment is needed, we will provide the process to get that through. Just to point out the scale of change that might happen, we have seen some huge ambitions announced by the Government on offshore wind very recently. We are going to see, I am sure, big changes over the next five years, and that is why we need to be ready to make sure that we can get the investment through to support that.

Q15 Alan Brown: How do you take account of that announcement where the offshore wind target has gone from 30 gigawatts to 40 gigawatts? How does that feed into this investment programme, which is going to have to facilitate future connections for that?

Jonathan Brearley: We rely on the system operator, so another part of National Grid, which thinks about the future of the network, what is needed and, therefore, what investments might come through. Some of the uncertainty that Nicola has described really has been about that process as much as the regulatory process, to make sure we get robust investments in place. Then we are designing a process through which investment cases can be put to us and we can do our job properly, which is to protect customers' bills because, ultimately, we all pay for this, but to do so in a way that gets us towards net zero.

Nicola Shaw: That is all absolutely right. I just do not want the Committee to think that delivery is easy and can be squashed into the last bit of the timetable. We really have to push hard now for clarity for these projects. On the east coast, for example, we have proposed a project that would allow lots of the windfarms to connect offshore rather



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than all to connect onshore. That project is sitting in a very complex discussion with Government and Ofgem. They are all important discussions.

What I am worried about is that the discussions will continue for too long and then we will be told to build it really quickly. We cannot do that kind of thing. These are complex, difficult projects to deliver that need us to have time to think about it. Making sure that we look out, over the next 10 and 15 years, and think about how long we have to deliberate and then how long we have to deliver is really important.

- Q16 **Alan Brown:** Following up on that, Jonathan, how do you allow for that lead-in time for these projects, and for the investment, the planning and the process? That also has to align with the lead in for the new offshore developments. You almost need to look backwards from when the generation is required to when these projects are given the go-ahead for the grid upgrades.

Jonathan Brearley: In a sense, I support what Nicola said. She is right and we should be looking at when we need this and working backwards. I would point out, though, that these big projects, equally, do not just appear one day. They take time to develop. You have to go through planning and environmental assessments. Surely, between us, we should be able to design an economic process that runs alongside that and does not hold that up. We are very keen to make sure we have a process that does that but, of course, we have to ask questions on behalf of customers about what is right and, indeed, whether the amount of money being approved is in customers' interests. I believe we can do that alongside that process without holding that process up.

- Q17 **Alan Brown:** Moving on to energy security, to what extent, Jonathan, do you take into account energy security, reliability and resilience of the network as a whole? In its submission, RenewableUK stated that, in some cases, there has been a focus on refurbishment as a cheaper option to replacement of assets, but that this ignores whole-system costs. When you are looking at asset replacement versus refurbishment, do you take into account whole-system costs? Do you look at long-term potential costs for the consumer versus perhaps the costs and bills over the next five years? Do you look at best long-term value for money?

Jonathan Brearley: Absolutely, we do. We look at whole-system costs and we look at making sure that the system remains resilient. Fundamental to network regulation are some strict requirements on companies to maintain very high levels of security of supply. When we make that trade-off, we go through all the evidence that we have and make sure it is in customers' interests. Customers' interests are not about customers today; they are about customers over the next five, 10 and 20 years, and that is part of our statutory duty.

- Q18 **Alan Brown:** Stew, from your point of view, do you have any concerns about the risk, reliability and resilience of the network under the current



RIIO 2 proposals?

Stew Horne: We do not see any compelling evidence presented to us that there is an issue with reliability caused by Ofgem's proposals. We have heard from companies that they have their own concerns, and sometimes those sit around some of the projects and the funding.

We would say that companies have had a long time to prepare their business cases. They have done a lot of engagement with stakeholders. We are a little disappointed that they did not provide the best evidence that they could have and as early as they could have in the process, so we are now, quite late in the day, hearing of the reliability problems that companies have concerns about. We know from the open hearings that Ofgem has run that evidence has been provided and things have been talked about, and we are reassured that some of those things are being addressed. From a customer's point of view, we would have preferred to see these conversations happen much earlier in the process.

This links back into the conversations about how we release money for net zero. We know that consumers really value net zero. Our research earlier in the year indicated that 82% of consumers support action taken to get to net zero. That is a huge amount of support, but it is really important that consumers' money is spent well, so it is absolutely right that Ofgem scrutinises the spending requirements going into net zero. It has put a huge amount of money on the line. It is really unprecedented. There is also a risk there for customers that that process will be rushed and that there will not be the right level of scrutiny.

It is right that there is a good degree of scrutiny and a robust process, and one that should include engagement with stakeholders and with consumers, just like the spending plans for this process have. Once that need is clearly identified, we would want to see that money released quickly. We have had concerns that Ofgem's process on draft determinations was not nimble enough, so it is good to hear Jonathan talk about improving that. We all agree that, once we know what the need is and once we have identified the right solution and one that is robust and well justified, we should get on and do it. That is in consumers' interests and in businesses' interests too.

Q19 **Alan Brown:** Nicola, what would you say about the assertion that companies have left it too late to highlight the risk and reliability with regard to energy security? Ofgem have challenged companies that have come back saying how important this is.

Nicola Shaw: That is not quite right. We spent two years getting up to a business plan that we delivered in December, and the two years were spent in discussions with our customers and stakeholders. We took into account their needs. Indeed, we asked them questions about what they were willing to pay for different levels of reliability, and got back consistently that it was really important to them to maintain the level of reliability that we have now. Ofgem's draft determinations sought to



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reduce that in electricity for us by 24% and in gas by 19%, using its own calculations. I am glad that the conversations we have had since then have seen an improvement.

We gave Ofgem two drafts of our planning documents over the course of the two years I was talking about. It did not say anything about the quality of information. We gave it something like 15,000 pages of information. There is a lot of stuff. As has been said already, this is a really complex process. We are not underlining that it is not, but we gave a lot of information. We had not been given any indication that it was not sufficient until February. We have given lots more now and I am hopeful we will get to the right place.

Jonathan Brearley: I just want to come back on that point. I need to make it clear that we were disappointed with the quality of the business plans that we received in December. I have some case studies in front of me where hundreds of millions of pounds were being asked for with very little justification: in some cases, no lists of assets and, in some cases, very little description of their condition. We just cannot sign off funding on behalf of consumers based on that. I am really pleased that we have worked together since and we highlighted that earlier to all companies, but it is something that was of concern to us that we are all working to rectify now.

Q20 **Alan Brown:** Why decisions were made will be clear in the final determination and the information that you publish.

Jonathan Brearley: Absolutely.

Q21 **Paul Howell:** The focus of where I would like to move the discussion to is looking at the protection of consumers now and in the future. We have seen a number of different things and I would like to touch on a couple of points. One starts with how Ofgem has been able to evaluate the calls of networks saying they need money to invest when, clearly, they have an obvious need to make profit, so that we have a discussion on the balance of that. I would also like to explore Citizens Advice's claims about the £7.5 billion in unjustified profits. If that is the case, how can National Grid argue that its position is to put affordability at the heart, when Citizens Advice is making those sorts of claims? I would like to try to tease out a bit of a discussion around those first, please.

Jonathan Brearley: The word "balance" that you used there is exactly where we need to be. We absolutely support the need for investment. We support getting to net zero. I have spent 15 years of my career supporting climate change development and climate change action. Equally, I know from my own experience that we need public confidence in the system, which means that people get a fair price for the money that they give and for the investment that they get back.

Equally, we know that, if we are going to increase the investment to get to net zero, we have to be confident that companies are run efficiently



and that the proposals for funding that come through really are needed. That is why we are going through this process now. We are in a much stronger place and we have much firmer evidence, but, equally, we have to do our job of making sure that that is a fair deal to customers.

I would like to emphasise that I spend a lot of my time not only talking to the energy companies but going to customer panels and asking them what they need. I was recently at one in the north of England, where it was made really clear to me almost what Stew said: "We support net zero. We even know that our bills might go up but we do not want to see that done unnecessarily and we do not want to be ripped off".

Q22 Paul Howell: One of the problems is the difference between now and the future, and the timing of these investments. Are we just going to save money on infrastructure investment now to put costs, both green and financial, into the future? We can explore that as we go through the discussion as well.

Nicola Shaw: I agree that there is an important balance. As we have all been saying, we have to address the reliability of the network, the delivery of net zero and keeping costs as low as possible for consumers. That is a balance. The proposal that we put forward did have a reduction in the cost to consumers from National Grid and, overall, there is a reduction in cost to consumers proposed by all networks, so, overall, we should be seeing a reduction.

Your point about the long term is also really important. There is, as we have talked about, a need for more investment to deliver net zero and, therefore, more tensions in the bill. At the same time, we need to make sure that we do not end up with a really skyrocketing bill in the future because we have not allowed for the right level of investment now. There is always this balance between making sure we continue to invest and keeping the network steady. We need to make sure the skills are still there. As one of my colleagues has said, you cannot take a skills holiday. This stuff is complex. We are talking about people doing really dangerous jobs and we need to make sure that they are rightly skilled all the way through. It is always a balance.

Q23 Paul Howell: One question that sits there is that we are all talking about complexity, whether it is complexity of delivery or complexity of determination. We have to get past the complexity and get the decisions made promptly for us to achieve anything, so I will just leave that one as a point. Stew, I will let you come back on whatever you want to come back on, but Citizens Advice put this claim about £7.5 billion of unjustified profits. Is that a scaremongering number or is it real? Other people are putting numbers out there that are substantially less than that.

Stew Horne: That is our analysis for the RIIO 1 period for the eight year price control that is currently finishing. We looked at the rate of return for rewards to shareholders that Ofgem sets in RIIO 1, and compared it with



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what we thought the market would deliver if, rather than making the forecast that Ofgem had made, you indexed costs to market prices. We found that the level of shareholder reward and the return on capital was about £7.5 billion higher than it needed to be, and it does not stop there.

We have been looking at price controls for a long time. We did a separate piece of analysis looking back 15 years and found that, over a series of price controls, the total cost in energy was £11 billion. If you expand that to include water price controls, it is £24 billion, so a huge amount of consumers' money. This is about the way that regulators forecast the costs and returns to shareholders. It is quite hard to do but we think that Ofgem has a much better approach in the current price control by indexing costs using market figures that can be measured to try to estimate the real cost of rewards to shareholders that the market would deliver.

This is really important because these are monopoly companies. Consumers cannot switch away from National Grid and they cannot switch away from their local companies. There is no market force here that drives these costs down, so the regulator really has to do the best job that it can. Ofgem is moving in the right direction and could go even further. Market data says that it could go further by an additional £1.7 billion. In its final determinations, we are looking at Ofgem to hold its nerve. It is coming under significant pressure to increase shareholder rewards, but it needs to hold its nerve and it could go further.

A really important point here is that these rewards do not link into extra investment for net zero. These do not deliver tangible benefits for consumers per se. It is important to get them right but this is not really related to delivering more money for net zero. This is about setting a fair level of shareholder returns. That is important for consumers now but also for consumers in the future because these kinds of decisions set precedents and are locked in for time. If we set a level too high now, it is likely to be too high in the next period, and so on.

Jonathan Brearley: We have said that we do not agree with specific numbers from Citizens Advice. For example, the NAO said that that figure was around £800 million out of £48 billion for the last process. It emphasises the point I make: what we need to do is learn the lessons from RIIO 1 and make sure we get that investment in, but to do that in a way that gets a fair balance between customers and shareholders.

Q24 Paul Howell: I would like to move on to the £30 million that is proposed to support vulnerable customers and whether we think that is enough, and to tie that into a discussion of the consideration of the impact of Covid. A lot of the numbers were determined pre-Covid. I would like to talk about the money itself, as to whether there is enough, and whether there should have been a redetermination of what that support should have been on the back of the Covid impact. Again, Jonathan, you seem to be front and centre on this one.



Jonathan Brearley: We set what we called a “use it or lose it” allowance of £30 million to start with, but we did things in addition to that in the draft determination, including allowing vulnerability projects, projects to support vulnerable people, access to our £180 million innovation allowances.

In addition to that, we have some specific requirements on how customers should be treated. I would emphasise that part of this is about funding but part of it is about the way you approach people who are in vulnerable circumstances. For example, some gas distribution networks have done fantastic work, thinking about how you interact with a customer who has dementia. Unfortunately, one of the first displaying symptoms may well be gas leaks and gas problems, as things like cookers are left on. Trying to train your staff to deal with that is a really important part of tackling vulnerability.

As I mentioned up front, we got some very firm feedback, probably from Stew but certainly from a range of stakeholders, about vulnerability. We are thinking hard about that and seeing what more we can do. That is partly in response to that and partly in response to Covid. On Covid overall, though, because we are still working through the circumstances now, we will make sure that the price controls can adapt to the impacts of Covid, which are still going to be unclear for some time. We will make sure that we can adapt to that in the future as well as making that part of our determination in December.

Stew Horne: I really welcome what Jonathan has just said about looking again at the package. That is really important because with the Covid crisis we have seen a real increase in issues around debt, employment, people’s household bills going up and people struggling to pay their household bills. We recently found that one in nine consumers was struggling to pay a household bill over the recent period, so it is really important that, where these energy networks are really well placed to support consumers, especially vulnerable consumers, they can do so.

We saw in the business plans—again, some of this came from really good engagement with consumers and stakeholders on the ground by the companies—a really good identification of the need and a really good articulation of how these companies could identify and support their vulnerable consumers. As Jonathan said, there are some really practical outcomes from this.

More than that, there was a real demonstration that £1 spent by these companies on supporting vulnerable customers has a really significant return on investment that is multiple times the value of that £1 spent, so it is really worthwhile. The evidence that companies provided went well north of the £30 million package provided. Particularly looking at this through the lens of Covid, there is a real case for expanding that funding package. It is good news that Ofgem is willing to look at that again. That is the right thing to do.



Jonathan Brearley: I want to acknowledge the work that we have done across the industry—the network part of the business, generation and retail—to manage the impacts of Covid. It is an area where we have worked incredibly well together and I hope we can continue to do so, although we will have the odd argument about a price control.

Q25 **Paul Howell:** You have just opened my next question, which is my final one. What are you doing through price controls to make sure we get a just transition for consumers?

Jonathan Brearley: A lot of what we do within the price control, for example, tackles vulnerability and we have a package there that we are looking at very closely. Equally, though, we think very hard about the overall impact to customers of all parts of the bill. Ofgem, as a whole, for example, is capping retail prices. Ofgem is making sure that vulnerable customers are looked after, particularly prepayment customers. We also had a series of requirements on suppliers to make sure they treat people well in financial distress. There are some limits as to what we can do because this is ultimately cycled through the customer bill. The bigger question about whether that should happen or whether that should come through taxation is a matter for Government and not for us.

Nicola Shaw: I have sympathy with the last point that Jonathan made and look forward to working with the Government on the question. Chris Stark of the Committee on Climate Change has raised the importance of that just today. Again, it is one of those things where we could get very distracted by process. We have to make sure we keep moving forward, given the challenges ahead of us and the amount of work to be done.

We have worked really closely with our stakeholders, who wanted to make sure we did not go too far into the space that should be led by suppliers and others. What has been interesting is that question about how we all play the roles that we can play in the bit of the supply chain that we are part of. For example, we have helped some suppliers manage their cash flows during the pandemic, in conjunction with Ofgem, and National Grid has spent quite a lot of money on a warm homes fund to help people transfer out of really costly forms of heating into cheaper forms of heating over the last five years, so we try to play a role where we can.

Q26 **Mark Pawsey:** I want to ask some questions about the process that is being proposed. My first question is about the uncertainty mechanism and I want to ask that to Nicola Shaw. This is a mechanism whereby you can apply for additional funding. Is the uncertainty mechanism as set out appropriate?

Nicola Shaw: As I have said, we support the use of uncertainty mechanisms. It will be a helpful way of dealing with the move to net zero over time. We have not quite got the balance right in the draft determinations. There was too much risk, there was too much



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uncertainty and there was a sense of further delay that would have resulted.

Q27 **Mark Pawsey:** Why would there have been further delay?

Nicola Shaw: Just to give you an example, to take forward a major project, we have to get planning permission. That planning permission goes through something called a development consent order, through which the Secretary of State has to take a view as to whether the project is necessary and in the needs of the nation as a whole. In the process as it was set out, Ofgem would then take a view about whether it was necessary for energy, and that sequential step could add a year or 18 months to the process.

I am really pleased that Ofgem is now saying, "We can find a way around that and we can make the decisions together". As Jonathan has said, there should be an economic process aligned with the planning and delivery process; it is feasible. We were in the wrong place at draft determinations but I think we are going to get to a much better place now.

Q28 **Mark Pawsey:** You can roughly anticipate when those approvals are going to come through, can you not?

Nicola Shaw: You can, but we have not been doing so.

Q29 **Mark Pawsey:** Why have you not been doing so?

Nicola Shaw: Ofgem has taken the view that it will wait until after the planning permission is granted. I am pleased that it has changed its mind.

Q30 **Mark Pawsey:** You are saying that you cannot apply for implementation of an uncertainty mechanism until such time as a project is, effectively, signed, sealed and delivered.

Nicola Shaw: No, not signed, sealed and delivered, but it has gone through one step of the planning process, which is to get a right to start the build. Now, Ofgem has said it is going to make its decisions in alignment with that, which will help enormously.

Q31 **Mark Pawsey:** Stew, you said in answer to Paul Howell that it is hard to forecast costs and returns. Is there sufficient flexibility, as far as you are concerned, in the process of getting additional funding for new projects?

Stew Horne: In my mind, these are two different things.

Q32 **Mark Pawsey:** Let us just deal with the costs of projects then. You said that they were hard to forecast, so why should National Grid not have some degree of flexibility on that?

Stew Horne: Where we have a clearly identified need for infrastructure that needs to be built, and we know that that is going to be required for an offshore wind farm that is being built or for one of the new nuclear



power stations that have been proposed, once we are absolutely certain that that is there, it makes sense to go ahead and build it. Proposals still have to be fair and justified. There are quite a large number of bits of Government policy that have not been decided yet, which will have a big impact on this price control. We do not know what they are and it would be irresponsible to try to provide that funding in advance.

Q33 Mark Pawsey: Is that not the whole point of the uncertainty mechanism?

Stew Horne: It is. It is prudent to use these uncertainty mechanisms. We would like—and as Jonathan said, Ofgem has been working on this—to see them be much more nimble. There has to be a robust process in identifying the need and making sure the proposals are good.

Q34 Mark Pawsey: What do you mean by saying you would like to see them be more nimble?

Stew Horne: It is so that the process is as quick and efficient as it can be.

Q35 Mark Pawsey: Are you saying it is not currently sufficiently quick and efficient? Why has it not been sufficiently quick and efficient?

Stew Horne: Jonathan has spoken to that. Ofgem has to put together a process to make sure that these proposals are good, that they are value for money and that they meet the need that they are supposed to meet. Ultimately, it is the regulator's responsibility to put that together. As stakeholders, we want to have input to that. We want to make sure that they are efficient and deliver value to consumers, but, ultimately, it is Ofgem's responsibility to get that process right.

Q36 Mark Pawsey: Jonathan, we have taken some evidence from network companies where one of the uncertainty mechanisms is reopeners. You permit reopeners but we understand that they only have a narrow application window. Can you just tell us how a reopener will work?

Jonathan Brearley: In a sense, we proposed a process where we would have a window in which you would come forward with your project proposal. We rely very heavily on the companies to come forward with something that is comprehensive at that time. With that, we carry out a series of analyses about costs, engineering and, indeed, the risk of the project, to agree a funding framework for that project to go forward. As I have mentioned, what we set out in draft determinations probably set out a process that was too rigid. It had a narrow window and was taking time, not only to approve the project—

Q37 Mark Pawsey: What was the time window that you proposed?

Jonathan Brearley: In a number of years, you would get the cash coming through, so we thought it was too slow. However, since then we have disaggregated things. We have talked about the very large projects and how we deal with those. Nicola talked about the interaction with the



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planning regime. We have also thought about the regular upgrades and the more intermediate and, indeed, smaller projects that you might take through. There are different ways you can approve those. For example, there something we are looking at, at the moment, where you look at the volume of different things that are connected and to find some way to fund reinforcements to support that. We want to make sure that we are proportionate in our work and not holding things up but, equally, we are scrutinising what are, ultimately, hundreds of millions and sometimes billion-pound decisions on behalf of customers.

Q38 Mark Pawsey: You are saying that the window of time varies according to the complexity of the project. What would be the smallest window and what would be the largest window that you would consider?

Jonathan Brearley: There is a step before that. If a project is very small, as I say, we would probably find a more adaptable mechanism to deal with that, and that might be an aggregate. I would say that you do need a number of months. You do need to look at this in detail. For some of the larger, more complex projects, particularly as they change as they go through the planning process, we would need longer to scrutinise them.

Q39 Mark Pawsey: We took evidence that you might take 30 months in order to determine something, and the entire price control period is only 60 months, so you are taking half of the control period to make a decision.

Jonathan Brearley: That is not going to be the case. The process that we have worked through with companies is really talking about six to 12 months for some of the bigger projects.

Q40 Mark Pawsey: So the 30-month figure we have received is fanciful.

Jonathan Brearley: As I mentioned, I accept, in draft determinations, that the process was slower and more rigid than we would like, but we are making sure that we approve these things as quickly as possible. There is another side to this: as Nicola mentioned, these are big, expensive, complex projects and we have to do our job right on behalf of customers.

Q41 Mark Pawsey: I gather that, in a recent speech, you said you were looking at alternative models, including competition, to increase efficiency of the system. Tell us a little bit about that.

Jonathan Brearley: We have been a massive advocate of bringing competition into this network regulation. My personal experience is that, where you have a competitive dynamic, you get two things: you get a much bigger variety of technological alternatives; and you do get much greater competition on the costs of financing. We have built into this process the option of being able to open up some of these larger projects to competition. We have an ambition that the system operator will identify a need and people will come through with different alternatives.



It may well be a large transmission wire or it may be a combination of storage and other solutions.

What we really need and want is the legislation that allows us to do that within a very clear statutory framework, and we are hopeful that that will come through in the forthcoming energy Bill. However, we have said that, if we do not get that legislation, we would like to build that possibility into the price control.

Q42 Mark Pawsey: Are you confident that, given that legislation is in place, there are enough players available to provide the competition that you are striving for?

Jonathan Brearley: Yes, absolutely. There are a number of players. We have part of the market already that we opened to competition: the offshore network. We have been very positively surprised by the number of players that are in that market and, indeed, the level of competition that we have seen around finance.

Nicola Shaw: It is absolutely right, as Jonathan said, that competition will be good. My team, I know, will do well in that process, but it is also worth remembering that we have been expecting competition for eight years and we do not have legislation for it. It was provided for in the last round of discussions by Ofgem. There is a risk that we keep waiting and we do not make progress. The eastern link example that I was talking about is one that is tied up in this never-never waiting process. I am hopeful that we will get competition legislation but let us not slow other things down while we continue to wait.

Q43 Richard Fuller: Mr Brearley, just so I have the numbers right in my head—and correct me if I am wrong—RIIO 1's target rate of return by Ofgem was 6% to 7%. Your assessed regulated rate of return over that period was 7% to 10%. You are proposing 3.95% and the networks were asking for 4.32%. Are those numbers right?

Jonathan Brearley: All of those are right. The final number on what the network companies were asking for is a bit higher than that. That ranged up to about 6% to 6.5%.

Q44 Richard Fuller: Why was the assessed rate of return so much higher than what you were targeting in RIIO 1?

Jonathan Brearley: In RIIO 1, part of that was around the dynamic that Nicola described. We are pleased and we encouraged network companies to be innovative and to find ways to reduce costs. Therefore, those savings are saved between customers and the companies. The NAO has been very clear with us that that was not the whole story. That included some areas where our allocation of revenues may, with hindsight, have been higher than we needed. Part of that was about our economic expectations of how the economy would change, and part of it was about the underlying engineering and approving projects that, later on, turned out not to be needed. Some of that is innovation. The lesson I have taken



from that whole process is that we have to be very firm in the way we assess projects to make sure that we do not repeat some of those things.

- Q45 **Richard Fuller:** There is an aspect where, if one has made a mistake like the one in RIIO 1, you want to correct the processes so you do not repeat the mistake, and that is important. There is a second aspect, which is that you look at what you might have deemed to be an excess return and say, "Let me claw some of that back". Have you been looking to claw some of that excess return back in this determination?

Jonathan Brearley: Just to talk about the balance that we have there, the reason we are driving down rates of return is, fundamentally, because this regime is very stable for investors. In effect, it is a very strong commitment to revenue, which, in Covid times, is incredibly valuable, but you maintain that by not formally reopening the price control. We did talk to the companies, including National Grid—and I am very grateful; Nicola and I had conversations around this—to ask them to respond. In total, we got around £800 million back from the companies as a way of compensating for some of the things that changed in RIIO 1. That, to me, was a really positive development that did say, "Some of this funding is coming back to consumers".

- Q46 **Richard Fuller:** I appreciate that but, just to be clear on my question, in your assessment of the determination of the rate of return for this period, was that affected by the desire, in setting that return, to have some clawback because you had made a mistake or the excess returns were greater than you had thought in RIIO 1?

Jonathan Brearley: No. The clear instruction to our teams who worked through this was to get that balance right. We are really conscious of the need to get investment into the sector and, therefore, we are looking at the evidence of risk of the companies provided by people from Citizens Advice and, indeed, across the industry to make sure that we get the balance right between getting investment in place and making sure that customers get a reasonable deal.

Again, since those draft determinations, we have had a whole pile more evidence and we are continuing to think about that, but we are very conscious that this regime is a AAA-rated regime globally—one of a very few AAA-rated regimes globally—so we should be driving a hard bargain for customers to make sure that we get the investment in at a fair price to customers.

- Q47 **Richard Fuller:** That is a good advert for the regulatory regime. I will leave it to others to assess whether it is a fair advert. There is an experience with another regulator, Ofwat, of being taken to the Competition and Markets Authority. If that happens, Mr Brearley, that means it may carry on for quite a while. What will be happening in terms of price regulation if there is an extended Competition and Markets Authority review?



Jonathan Brearley: If there is a CMA review, any decision the CMA makes applies to the whole price control. We will work collaboratively and constructively with any party as part of that process to make sure the investment continues to flow. We absolutely need to get the balance right and we will try our hardest, when we get to final determinations, to make sure of that. Equally, we will work constructively to continue the work that we are doing across the board, to make sure we get the investment in place.

Q48 **Richard Fuller:** What happens while that review is going on? Do the current regulations of RIIO 1 stay in place, do you make it up as you go along or do we move to RIIO 2 pro tem? What happens?

Jonathan Brearley: We implement the licence changes. We propose the licence changes and then those are ultimately appealable to the CMA.

Q49 **Richard Fuller:** RIIO 2 takes place, they are at a lower number and it is up to the CMA to come up with a determination if it wants to change it.

Jonathan Brearley: Remember that behind all of these things are models where we calculate the financial revenues et cetera, so those are changed once the CMA determination changes.

Q50 **Richard Fuller:** The CMA has just done a provisional review of Ofwat. One determination does not say what another is. It is in very nice language but it is a bit of a rap over the knuckles of the regulator, because it moved it back up again. How are you feeling about a CMA review?

Jonathan Brearley: First, we take it very seriously. We have a big evidence base around this stuff and the CMA provisional determination is an important part of that, but it is provisional. I believe most regulators and, indeed, a range of stakeholders, including Citizens Advice, have responded to that, so are not at the final determination yet. All I would say at this stage is that we are looking very closely at what they said. We are taking it seriously but we have some concerns about what they said, and there are two areas that I would highlight here.

They have not looked across the market at benchmarks and where investors are investing elsewhere as much as they should. Equally, this argument that you should go to the top end of a range—this aiming up argument that they described—is something that we are looking further at and thinking very hard about as we get towards the final determination. Right now, it is something that we have a bit of a concern about.

Q51 **Richard Fuller:** I would like to turn to our other two witnesses and start with you, Mr Horne. I really want to focus on the word “fair” because everyone likes to use the word “fair”, but what do you mean by that? You mentioned in your earlier evidence in this session that returns have been £7.5 billion higher than they needed to be, and then you said it could have been even higher. If there has been such an excess return, how



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would I look for that in, let us say, Ms Shaw's annual accounts? Have she and her company been stuffing cash away? Have they been paying big dividends? Has their stock price been going through the roof? What has been going on with this excess?

Stew Horne: Returns to shareholders happen in a combination of those things: the dividend, the increased share value and the increased regulated asset base, which then increases the on-sell value of National Grid, to take Nicola's example, in the future. The money appears in that way.

Q52 **Richard Fuller:** Where does it appear? I do not mean to pick on Ms Shaw's company but she is here today. I have been looking at the accounts and I cannot see where that excess that you talk about has gone. Where has it gone, in your analysis?

Stew Horne: National Grid is quite a big company. It includes the regulated monopoly company, but also a North American company and a couple of competitive ventures. I cannot put my finger on exactly where that money has gone within National Grid.

Q53 **Richard Fuller:** What about one of the other companies? Can you talk about them? Where is the evidence of this excess in terms of substantially increased dividends, massively increasing stock price, big cash balances or excessive deleveraging, which would be some of the ways in which it would manifest itself?

Stew Horne: If you look at the way the market responds to some of these companies at times of crisis, as in the current period during Covid, regulated companies that are listed on the stock exchange fall much more slowly than other companies and they recover much more quickly. That is an indication that investors are expecting high returns.

Q54 **Richard Fuller:** That is not right, is it? I looked at the stock price of National Grid, which is in the FTSE 100, and I looked at the FTSE 100. If you look precisely five years ago to those two numbers, the stock price of National Grid has gone from 990 pence to 962 pence, and the FTSE index has gone from 6,118 to 6,363. In fact, there is no difference at all. What you just said is not correct, is it?

Stew Horne: If we look at the data this year for FTSE 100 companies, they are down 16% from the start of the year. National Grid is up 1%. If we look at this year's process, water companies, which are a good comparator to electricity and gas utility companies, are up 2%. Investors look to these companies as safe havens.

Q55 **Richard Fuller:** We know about low betas and I understand that point, but RIIO is about the longer term. It is a five-year process and perhaps we should be looking at those numbers.

Nicola Shaw: I absolutely agree with you. It is really important that we continue to have the right level of returns for investors, but I would also agree that that needs to be lower than it was in the previous control



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period. The challenge here is making sure that we get that right. The CMA work has been really helpful in saying that there is a good, important balance between making sure we continue get investment in these sectors and keeping bills low for consumers. That is an important balance, but the reason that bills stay low is that we can keep, over a long period, a steady amount of investment and a low cost of capital. Reverberating around a lot does not help in that process, so that is why it is important that Ofgem reflects on the work of the CMA.

Chair: Thank you for that. I am afraid the Minister is waiting for our next session, so we need to move on. It is very clear that this next pricing control period is going to be crucial for our net zero targets. As a Committee, we will be looking closely at the final determination and, no doubt, may call you back if there are any problems. We wish you all well in resolving them in a way that means we can deliver on our net zero targets with the right balance across all the stakeholders. Thank you, Jonathan Brearley, Nicola Shaw and Stew Horne, for your evidence and time this morning. We appreciate it.