



Energy and Climate Change Committee

Oral evidence: [Ofgem review of policy](#), HC 1284

Tuesday 13 May 2014

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Members present: Mr Tim Yeo (Chair); Ian Lavery; Dr Phillip Lee; Mr Peter Lilley; Sir Robert Smith; Graham Stringer; Albert Owen; John Robertson, Dr Alan Whitehead

Questions 1- 98

Witness: **Dermot Nolan**, Chief Executive Officer, Ofgem, gave evidence.

Examination of Witness

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Q1 Chair: Good morning, and welcome to the Committee. We are delighted to have you here. We have had a close relationship and dialogue with your predecessor. Congratulations on getting the job. I gather you have asked if you could make a short opening statement.

Dermot Nolan: A very brief one, for 30 seconds at most I hope. There are three points. One is that I am very pleased to be here. I hope to do my best to answer your questions today. I should say at the start that I am happy to reappear whenever you want me. In that sense, I am very much at your service. The second point is that I think the job is very challenging but also immensely interesting. I am conscious—at least I hope I am conscious—of the huge challenges that people have faced in paying their energy bills. I am conscious of the lack of trust in the area and I hope to do my best to ameliorate that during my time. That is probably all I want to say at this point, but I am obviously very happy to take anybody's questions.

Q2 Chair: Thank you very much. The first question I would like to ask is why on earth did you want the job? This is an organisation that the Opposition have pledged to abolish, that the industry is very dissatisfied with, consumers think is a little toothless, feeble and lazy tiger, and a number of other people turned the job down before you took it. Perhaps you would explain what your reasons were.

Dermot Nolan: Apart from the notion that I am an intense masochist, which I think is probably not true, I found the job hugely interesting. I find it a huge challenge. All the factors that you say are in place. It is an immensely difficult thing to do but I thought it would be really interesting. I am not going to say—I am certainly not going to promise—that I will be able to come and magically transform things, make everybody happy, reduce prices and so on. All I can say is that I will do my damn best to make sure that that happens. So, as I said, it is interesting, but I will do my best with it.

Q3 Chair: What do you think the top priorities are for Ofgem at this point?

Dermot Nolan: There are two priorities. One is to try to rebuild consumer trust in the energy sector, in the energy market; to rebuild consumer trust, to make consumers feel that they are getting a fair deal from their suppliers; to obviously strengthen competition in the sector but above all to build trust; and to have Ofgem itself as a more effective organisation going forward that is, within reason, known and trusted by consumers as well. If I can achieve some or all of those goals over my tenure I think I will be reasonably satisfied with that.

Q4 Chair: Given that on your analysis—which certainly I think I would share, and I guess most of the Committee would share—there has been an absence, perhaps even a collapse, of public trust in the industry, and clearly Ofgem has not managed to avoid that in the last few years, what changes do you have in mind that may produce a better outcome?

Dermot Nolan: A few changes, and I will absolutely come to that. One of the points, though, having been in the job for about two months, before making changes—and I think we have taken some action and made some changes already—I do want to hear from as many people as possible, including this Committee, on what they think the issues are, what they think the problems and potential solutions are. One thing I want very clearly to do, and I think I have already tried to do this in my time here, is to listen to as many people as possible, listen to as many stakeholders but particularly listen to consumer stakeholders.

In terms of things that are being done, one action has not been completed. We have proposed a reference to the Competition and Markets Authority. That is to look at the overall structure of the market: is that the best value for consumers? Is the set of structures in place best designed to facilitate competition? I appreciate that that will take some time, but I think it is a substantive action. It is an action that I hope will produce results, and it is an area I think we will be working on quite intensely.

Other actions will be to try to make sure that Ofgem itself is functioning as efficiently as possible. I will not go into the specific details of options for Ofgem's structure, but in particular to make sure it is entirely fit for purpose, including its administration of Government schemes, the E-Serve schemes that it does as well.

Other themes I would like to focus on is to listen to consumers, and in particular listen to those who I suppose are perhaps more vulnerable consumers, to say, "Why have you lost your trust? What is preventing you from engaging in the market? What is preventing you from switching in the market? How can we rebuild this? How can we take actions that will permit you to have that trust, permit you to switch and ultimately permit competition to work in your favour as consumers?"

Q5 Chair: Ofgem had been encouraged by a number of outside commentators to call for an inquiry by the Competition and Markets Authority—or its predecessor—for some time and had resisted those suggestions. What led to the change of heart and the decision to make the reference at this point?

Dermot Nolan: I cannot necessarily speak for what happened before I got there. I have been there about two months but I can say I came over in January and February a couple of times to look at the burgeoning analysis that has been done. The main reason—mainly speaking for myself here—is I looked at the evidence and I said, "This evidence indicates the market is not working well". I suppose I looked at it in a de novo way, not having perhaps been privy to some of the previous debates. I said, "This isn't working well. Some of the structures that are in play do not seem to be operating for consumers. We can see all kinds of negative signs". I thought we saw very clear empirical evidence that the market is not working well.

I suppose I should state in advance that we did not produce instant solutions. There is a variety of reasons for that, most notably the fact that in order for perhaps any substantive remedies to be applied it would need to go through a CMA inquiry. I felt that the CMA was the proper body to do it—as indeed set out by legislative purpose by Parliament—and, although it would take time to do it, the importance of the situation, the nature of the essential services and the evidence we had seen merited that this was the right time for a reference.

Q6 Chair: Were you leaned on by the Secretary of State to do this as a convenient way of kicking the issue into the long grass until after the next election?

Dermot Nolan: Absolutely not. We were not leaned on by the Secretary of State at all. I can say that very clearly, in the sense that my team and I went through the analysis. The board met. The actual piece of work upon which our reference was based was a joint piece of work with—it is rather complex—the Competition and Markets Authority and the OFT, which were in the process of merging at the time. Three boards met on one occasion. I think we all went through the analysis. We all had a fairly clear view. I would say this was an independent regulator decision, and I want to be very clear about that.

Q7 Chair: Thank you for making that clear. One of the inevitable consequences of this reference, and it has certainly been suggested by some people in the industry, is that it creates a period of uncertainty during which investment decisions may be postponed just at the time when it is universally recognised we need substantial new investment in a whole range of things, including generating capacity. Do you have any concerns about the investment climate during this period and the uncertainty that has been created by the reference?

Dermot Nolan: I think it is probably fair to say that there is a lot of uncertainty in the energy sector at the moment anyway. I do not know if the incremental uncertainty—I am not sure how I would measure that—has worsened things hugely. What I would say is that, given that uncertainty and given what I have heard from many market participants, even those participants who you might expect to be most opposed, this is the appropriate time to do it. There is sufficient uncertainty anyway. If this reference did not take place, then over the next two or three years that uncertainty would continue and there still would not be a terribly fertile climate for investment. A number of market players—and not just those whom you would suspect, have welcomed the reference and said that it will, through a hopefully dispassionate and thorough empirical analysis, provide a climate that will ultimately lead to greater certainty. So in that sense I think it is a good thing.

I should stress again that that is not why we referred it. We referred it because of what we thought the evidence was: that competition was not working well.

Q8 John Robertson: You have been in the job for two months, so the question I would normally have asked is: are you speaking to some of the smaller companies? Stephen Fitzpatrick, who is the MD and founder of Ovo Energy, said on breakfast TV, “We haven’t seen wholesale price rises for the last two years. Since 2011 we’ve seen wholesale prices stay roughly the same or even fall slightly back. In May 2011 we were paying 73 to 74 pence a therm for gas, today about 68 to 69. If we are buying more expensive gas, more expensive electricity, in a large part we think it is because the Big Six are selling to themselves. So when they report wholesale prices going up, it may be that the prices are going up but only as a result of them selling to themselves.” That is quite an indictment and quite a statement to make. Are you going to do something about this?

Dermot Nolan: I hope we are, but I will say one of the things we are doing is referring the market. I quite agree, wholesale prices have not risen over the past three years or not risen significantly. In fact, I would point out—and I suppose again I would like to make this clear—that even over the last couple of months wholesale prices have started to fall, for electricity, and obviously for gas. The wholesale price of gas is in some sense the price of gas, but gas is also important in the wholesale price of electricity and that has fallen slightly in the last few months. What that has done is driven down wholesale prices slightly and, if markets were working effectively, you would expect to see that that in time would be reflected in retail prices. If it isn’t—if that wholesale price is sustained and it doesn’t lead to a retail price fall—that will be further evidence that competition is not working well.

Q9 John Robertson: Yes, but part of the problem was that Ofgem takes so long in doing anything. It is not that sometimes they don't do anything—they do—but it is the length of time, and we have known this from 2011 onwards. We are in 2014 and yet they have done nothing. Will you sort that?

Dermot Nolan: I hope I will do my best. I would say three things to that. One is a general comment about time. Regulators always seem to take time. When I was in Ireland I was regularly asked, “Why are you taking so long?”, and it is a very fair query. The standard response is, “There are legal risks. If we do something untoward, if we don't answer a consultation point, then we will lose in court”. They are risks and I would not pretend they are not risks. In fact, I have to be very explicit—they are. But I suppose what I would try to signal—and this is something the board and I are thinking about quite intensely—is that it may be time to take a few more risks in the interests of getting things done speedily. If indeed I then promptly lose a court case I may look rather foolish, but none the less I think it is reasonable that a regulator would say, “Right, we are going to take a slightly more aggressive approach”. As I say, that may involve more legal risk but I think it is a reasonable thing to do.

I would say perhaps three things in terms of other actions. One is that, without repeating myself too much, we are consulting on a reference to the CMA. The second is that there have been other measures that have been put in that are only now in some sense coming to fruition. One is what we call retail market reform, which has been in place for about a month and we believe it will make it easier for consumers to switch and thus press down on prices. The other is that we have made interventions into the wholesale market to make it easier for small suppliers to acquire wholesale electricity from the Big Six. That will take a little time to evaluate, but those two actions have been made. We stand ready to evaluate them and make further ones if possible, and we hope we will still be working with the CMA.

Q10 Graham Stringer: After referral to the Competition and Market Authority, some of the papers were saying that the investigation would not cover power generation. I wrote to you about that and you said it would. Can you confirm that that is the case and just talk about that?

Dermot Nolan: I can confirm it is the case, but I have to give two caveats. One is that in fact the investigation will take place where legally, as I said, I need to make clear that we have proposed a reference and I hope that decision will be made before the end of June. The second point is that whatever reference is finally made, if the CMA then appoints a panel, that panel has considerable discretion on how it interprets the reference, including potentially making it broader. With those two caveats in mind, yes, I believe it will include the generation market.

What I will say in developing the point is that if you look at the patterns of prices and profits in the last period of time, inasmuch as we can measure the generation market itself—and I believe we can—if there are high profits being earned it is not currently in that, it is in the supply market. But in the sense of the structure of vertical integration, I think the fact that certainly all the larger companies have both generation and supply arms

is indicative of the fact that you cannot look at one without the other. You cannot just say, “Right, we are going to study the supply market and ignore the generation market”, nor in fact would it be sensible to do otherwise. So I believe that the reference will embrace both and in particular will focus on the links between the two markets and what is typically called vertical integration between the Big Six.

Q11 Graham Stringer: Do you have a role if the panel, when appointed, does not look at power generation?

Dermot Nolan: It is hard for me to answer that. I will do my best, in the sense that we have a role to examine the generation market in any case. We have a role to make sure that it is functioning as well as possible. I find it unlikely, I have to say, that if we told the panel, “We think you should look at generation and supply” the panel would say, “We are not looking at generation”. I cannot say it is inconceivable but I find it highly unlikely.

In theory I suppose we could then make another generation reference, which would be rather inelegant. But I would think it is very unlikely that they would not choose to look at the generation market.

Q12 Dr Lee: You have already mentioned that you think there is something wrong with the market. From an Irish perspective before you took the job, did you think that it was worthwhile making investments in the energy market in Britain? Would you have done that?

Dermot Nolan: I probably would have, yes, in the sense that if nothing else there is a clear need for investment in Britain. I think everybody knows that. There are various stories about the amount of investment required—

Q13 Dr Lee: Would you have expected a decent return on your investment?

Dermot Nolan: I probably would, yes, but if I can unpack that a little. As I said, I talked about it being impossible to look at supply and generation separately; if not impossible very difficult. What I would say is the generation market over the last two or three years does not seem to have been producing very high returns. Some of the complaints I have had are not just from small suppliers—who I will be meeting, as Mr Robertson asked—but also some of the independent generators who say, “We are not making enough. All the money is being made in the supply sector”.

Q14 Dr Lee: Do you think the business models of the Big Six are profitable?

Dermot Nolan: The evidence suggests that they are making profits, yes—

Q15 Dr Lee: I have been shown some data around economic profit. It is pretty scary actually. It basically says that all six companies—with the possible exception of Centrica, though they are now showing signs of stress—do not make money at all and in fact their business models are value destroying. What sort of metrics does Ofgem use to assess the

profitability of these companies? Do you make any assessment of their long-term viability as companies?

Dermot Nolan: I think we do. One of our duties is to make sure that our licence holders are capable of financing their activities. In the recent market assessment we looked reasonably carefully at profitability, and it would be a major theme for the competition and market investigation. What we found is that profitability for the Big Six, as broadly constituted in terms of their generation and supply arms together, has risen over the last few years. On the evidence we have seen, they are making a fair amount of profit in supply but less in generation. Overall, however—it does vary and Centrica is probably the most profitable—to us they seem to be making profits. I can certainly follow up in writing to you on this if you would like.

Q16 Dr Lee: The data I have seen is that EDF is totally unviable, and therefore must be receiving significant support from the French state.

Dermot Nolan: I have not seen that. The evidence I remember—and I will obviously write to you if I am incorrect in this—is that in the supply market EDF is not doing well but it is making significant profits in generation, predominantly because of its nuclear fleet.

Q17 Dr Lee: If you are right, then why is investment in the market not so good? If you are telling me they are making profits, why are people not stumping up the cash and looking for a good return?

Dermot Nolan: There are a couple of issues about that. I am certainly not trying to speak for the Secretary of State here, but I think he would say there is significant investment, and certainly there has been a reasonable flow of investment, including in gas plant over the last few years. We need a lot more; I freely acknowledge that. But coming back to what I said earlier, I would say—and this is one of the reasons why I think the model of vertical integration needs to be studied—the generation market by itself is perhaps not giving huge returns.

You could say there are four main arms to the fleet of generation that Britain currently has. There is nuclear, coal, gas and renewables. By and large, new nuclear is a long way off. There is going to be pretty much no new coal, and yet they are currently the two most profitable forms of generation. Meanwhile, new gas plant is less profitable, and yet gas and renewables are going to be the new generation build. That is one of the problems. Renewables has some subsidies to allow for the generation that needs to be built, but gas doesn't. So gas, which is where we really need generation, is one of the least profitable new builds and that is a problem.

Q18 Dr Lee: I am trying to marry what you are saying with the presentation that was given to me that essentially says the six companies are not viable. I am wondering what the metric is. How do you assess profitability? Is it total shareholder return over time? What is your

measure? If the people who came to see me are right, there is going to be no investment of the sort of order that is required to “keep the lights on” over the next five to 10 years. So if they are right, you seem to be quite wrong. Therefore, if Ofgem is wrong, there is not much hope of you having much trust any time soon.

Dermot Nolan: I certainly hope Ofgem is not wrong. We use a variety of measures. In particular we use something called the return on capital employed—sometimes known as ROCE—to measure generation profitability. We then use various other measures to look at the supply profitability, which is the margin above the supply price, and then we use a variety of measures to look at the overall level of profitability. Again, I am very happy to revert to you on this but I would still think that profitability has risen over the last few years.

If I may, I shall say a little bit about the future and the investment for keeping the lights on. There is a capacity mechanism being designed by the Department of Energy & Climate Change, which is due to come in from 2018 onwards, that is deliberately designed to encourage new gas plant to build. That in some sense is its explicit purpose. The idea of capacity mechanisms as they exist has been used across Europe, and certainly France and Germany are both seeking to bring one in. So I think those are the two that are being chosen to give profitability for future investments.

Q19 Dr Lee: Finally, if the profitability of these companies, as you state, is growing, would you expect to see more new competitors coming into the marketplace?

Dermot Nolan: I think I would.

Q20 Dr Lee: Are we seeing that?

Dermot Nolan: We are seeing more investment in the marketplace.

Q21 Dr Lee: Are we seeing more competitors in the market?

Dermot Nolan: I suppose what we are not seeing is competitors entering both supply and generation simultaneously. One of the essential questions for the Competition and Markets Authority to study is whether or not the structure of the market is sufficient that it would permit efficient entry on either one side or the other, or do you need to enter on both. That would be the key point. The Big Six have operations in generation and in supply. Whether or not the structure of the market is such that you must enter on both—it is very difficult to enter alone—is something I think the CMA will ultimately have to take a clear view on.

Q22 Ian Lavery: I am sure you are aware that profits transparency is a real live issue here in the UK. During your term of office as the Chairman of Ireland’s Commission for Energy

Regulation, Irish consumers had to pay some of the highest energy prices in Europe. Why were you unable to reduce the prices for Irish consumers during your term of office?

Dermot Nolan: I would like to think we did our best, but perhaps it is a rather self-serving thing to say. I will try to answer by giving a sense of what is driving the overall price of electricity for different countries. Ireland, perhaps more than any other country in the EU—I think Cyprus might be the exception—is hugely dependent on fossil fuels. In particular, it is dependent upon the price of gas. It has very little coal. Pretty much 60% of its electricity comes from gas. Over the period of time that I was there, certainly over the last seven or eight years in Ireland, the price of wholesale gas in international markets rose significantly. That drove up both the price of gas and the price of electricity.

If you look at us here in Britain, we are also fairly dependent on fossil fuels but a bit less. We have nuclear, maybe less than we used to have, and we have more coal than Ireland does. The actual price of electricity is hugely driven by the generation mix underlying it. If you look at a country like Norway where 95% of its electricity comes from hydroelectric power, 20 to 25 years ago in the 1990s when oil was \$10 or \$15 a barrel, Norway's electricity prices were relatively high. Now, because of the increase in fossil fuel prices, which frankly has not affected it very much, its electricity prices—certainly pre-tax—are relatively low. France, which retains 80% of its electricity coming from nuclear, has some of the lowest electricity prices.

To try to bring that to a point—and this is something I have to be very candid with, and would hope to be candid with any consumers I meet—certain things are not in our control, at least in the short to medium term. We cannot suddenly snap our fingers and change the generation mix and, in some sense, as long as we are dependent upon fossil fuels, we are very dependent upon the vagaries of international markets. It is one thing to say that. It is another thing to make sure—and in fact I think it is even more important at that point to try to make sure—that all those fossil fuel price movements do not have the unfortunate consequences of pushing prices any higher than they need to. Thus I think the job of the regulator in this kind of environment is even more acute, even more important to make sure that fossil fuel prices are not used as an excuse to raise prices more than they should be.

Q23 Ian Lavery: Do you think the Irish experience has prepared you adequately enough for the current role you have here in the UK?

Dermot Nolan: I hope it has given me some experience, but it is a different market here. It is a more complex market. There is a larger set of stakeholders. So it would be slightly arrogant to say I am adequately prepared. I hope it has given me some preparation. What I think it has given me is some sense of, through the price rises you have described, just how difficult people are finding it. In some sense the consumers are angry, irritable and want to be reassured that, even if prices are going to increase, they are paying a fair price for their energy.

Q24 Ian Lavery: Do you think your term of office in Ireland was successful?

Dermot Nolan: I don't know if that is for me to judge, Mr Lavery. I hope it was reasonably successful. Prices certainly rose. All I can probably say there is that I did my best.

Q25 Ian Lavery: They were the highest in Europe, weren't they?

Dermot Nolan: I don't think they are. First, I think our gas prices are at or below European averages. I think our electricity prices vary a lot by different consumer types. They are certainly above the average but I don't think they are hugely above average. It depends on the class you choose. Having said that, I would freely accept that they are above average for Europe, but as I said, that was primarily due to our dependence on fossil fuels.

Q26 Ian Lavery: As a result of the DECC Select Committee report, *Energy Prices, Profits and Poverty*, Ofgem agreed to update the methodology it used for calculating the SMI. How does the SMI more accurately reflect the practices of the energy suppliers?

Dermot Nolan: These are the recommendation from the BDO report a number of years back. There were eight recommendations at the time and I think Ofgem only took on board four or five of them. We have now taken nearly all of them bar one on board, and that was vis-à-vis the reporting time for Scottish and Southern Energy. I believe they may be changing that themselves in any case.

I would like to think that what we call the SMI, the supply market indicator that is published every month, shows reasonably accurately—I certainly hope it does, and if it doesn't we will be attempting to address that—the wholesale prices for energy, for gas, the retail prices, the gaps between them, and who is earning what in terms of profitability. I would hope that as a result it brings more transparency into the sector. I hope consumers or consumer groups will be able to read it and understand, “Okay, this is what prices are; this is what prices should be; these are the profits that these companies are making”.

Q27 Ian Lavery: Talking about profits, the last SMI produced by Ofgem indicated that there was a pre-tax profit margin of about £101 per customer. That cannot, in any way, shape or form, be acceptable, can it?

Dermot Nolan: This is the comment Mr Robertson made, which I was referring to earlier and I would like to state more clearly now. As I said, wholesale prices have fallen. As you say, the last SMI—the monthly reports that we do—indicated that wholesale prices have fallen and these margins have risen up to £100¹. In our discussions, the Big Six—I do not

¹ Due to an accuracy issue with the April SMI figure, the margin had been calculated incorrectly. The actual margin for April 2014/15 was £91. Details are to be found in the subsequent correspondence received from

like that phrase, but none the less I am using it for the moment—have said, “We believe the market is working competitively”, and if that is true then now is the time for competition to work. The margin that you have just suggested should be competed away and I would expect and hope to see more active competition and reduction over time.

If indeed, perhaps before the Competition and Markets Authority inquiry, we do not see that then I think it will be further evidence that competition is not working as well as it should be.

Q28 Ian Lavery: Just for the record, it wasn’t a figure that I suggested. It was a figure that was in your SMI report.

Dermot Nolan: It was a figure in the SMI. That is correct.

Ian Lavery: It is your figure, not mine.

Dermot Nolan: It is our figure, yes.

Q29 Ian Lavery: What is an acceptable amount of profit for energy suppliers to be making?

Dermot Nolan: I don’t know if I can give a precise answer to that. The level you have said is too high. I will say, however, that—and this comes back to something I said earlier—the 7% margin you have referred to was about 0.5% about four years ago. However, profits in the generation sector were then significantly higher. Profits in the generation sector are now lower and profits in the supply market have grown bigger. The point I made earlier to Mr Stringer is that it can be difficult to measure by just focusing on profits in the supply sector. One has to look at them both. Having said that, I would hope and expect to see that figure reduced. I don’t think it is reasonable to suggest that there should be a perfect figure. What I would have thought was the whole idea of effective competition is that whatever the margin is should constantly be competed down, and the last thing I want to do as a regulator is to say, “This is an appropriate level of profits. Go out and fix on that”, because I think that can have the effect of dampening competition.

Q30 Ian Lavery: So you think £101 is too much?

Dermot Nolan: I am not saying that. I think overall competition—

Ian Lavery: I think you did say that.

Dermot Nolan: Well, if I did—

Ofgem below:

<http://www.parliament.uk/documents/commons-committees/energy-and-climate-change/Ofgem%20review%20of%20policy%20-%20correspondence%20from%20Ofgem.pdf>

Ian Lavery: I think you did say that.

Dermot Nolan: I am very sorry if I did, because I would say that companies do need to earn profits. If I did say it, I certainly withdraw it. Companies do need to earn profits and I think that is perfectly reasonable, but to describe myself what is the appropriate level of profit I think is, if anything, functioning more as a co-ordinating than a competitive device in the market.

Q31 Ian Lavery: Moving on to something that this Committee has again discussed with Ofgem, which is the consolidated segmental statements, it was agreed that Ofgem would change the way in which it produced these statements. Are you on target to meet the deadlines set out in the final decision?

Dermot Nolan: I believe we are. I think we have made most of the changes. We are looking at some issues vis-à-vis trading but I think, by and large, we are on target to make those changes. I am sorry I cannot recall precisely the deadline. I will revert to you on that, but I believe we are.

Q32 Albert Owen: Can I come on to consumer engagement? You refer to the retail market review that was undertaken by Ofgem in 2010 and, as you indicated, the implementation has just started. What progress has been made thus far and what do you expect in the short and medium term?

Dermot Nolan: In some sense, the process has finished, now we have made changes. I believe the phrase used—hopefully it is an effective phrase—is we have made the market somewhat simpler, clearer and fairer. We have changed the structure of the bill somewhat. We have reduced the number of tariffs. By and large, we have tried to bring greater simplicity into the market. That has only been in place a month, so I cannot give you direct empirical reports. I suppose what I believe will happen, but certainly what I hope will happen, is that this will itself give further trust to people. People will be encouraged to switch more—there was the “Be an energy shopper” campaign, and I know some of you attended that last week—and will feel more trust in this and feel less confused by the market. If they go into the market to switch an energy supplier, they will not suddenly feel, “Oh my God, this is all horribly confusing and I will just stay where I am”. I am hopeful that it will work in that regard.

We will be trying to monitor this over the next period of time and, in particular, we will feed any early results from it into the competition and markets inquiry to produce evidence for the CMA, if in fact they are working in that area. That is what I hope will happen.

Q33 Albert Owen: I am pleased, and I did sponsor and host the energy shopper reception that you had. It was very successful.

What is interesting from my perspective—and I am sure for members of the Committee—is that we have held inquiry after inquiry. We have had the regulator, yourselves, in front of us, we have had the Government Ministers and we have had the energy companies. They started

off by saying that there was nothing wrong with the market, defending it, and they were basically saying, “There isn’t that complication”. Now, all of a sudden, all three of you are saying, “It was complex. We need to simplify it. We need to reduce tariffs”, and each of you is doing it and each of you is taking credit for doing it. We have energy companies advertising the fact that they have the minimum number of tariffs. I am pleased that you have done it, we scrutinise the retail market review, and we support many of your aspirations, but isn’t it a bit late in the day? We have had this upheaval, and your early remarks were that you want to be proactive in the future. Do you think that the Government, yourselves and the energy companies are just reacting to public anger?

Dermot Nolan: I hope not. Well, yes and no—that is a terrible answer—in the sense that if we aren’t listening to what the public are saying, there is something wrong.

Q34 Albert Owen: My point is that it took you a long time. We were given these advance notices about the anger and everything. We get into this mess, and now everybody seems to be taking that forward, which is a good thing and I am not arguing we are not in a good place now. But my concern is that we have these peaks and troughs of concern about what is going on and then the economy gets better and things just creep up in the future, so I am worried. To bring the Government in, do you think the Prime Minister was right to legislate and was there a need for it in the Energy Bill, or was it because the regulator was not doing its job properly, or was it because the energy companies were taking advantage of the situation, or maybe both?

Dermot Nolan: I really cannot answer for the actions of the Prime Minister. I don’t think it is appropriate for me to say anything about that. All I can say—

Albert Owen: With respect, we passed an Act of Parliament, which legislated to effectively change the tariffs to get the cheapest deal for the taxpayers. It is done through legislation, and in a free and open market that should have been the duty of the regulator. That is the reason I say it and, with respect, you are the person to respond as the head of the regulator.

Dermot Nolan: I will say that where we are now, given the things that have been put in place, I do understand the notion that it took a long time or can be seen to be taking a long time. I appreciate that. I hope I am not just repeating what I said to Mr Robertson, but I am anxious that we try to take decisions quickly in future as far as is practical. I will say that those decisions have to be informed by evidence. When I say “evidence”, I hope most of all it has to be informed by evidence relating to consumers and consumers’ own views.

One thing I will say about the retail market review is the proposals have been attacked by a number of people on the grounds that they say competition was working perhaps relatively well, and that perhaps regulatory interventions have worsened things. I do not think I agree with that but that view is out there. There is also a view that we haven’t gone far enough, that there should be just one tariff for all energy suppliers. I think the balance we struck is a reasonable one, going forward, and what I hope is that in future we will listen to the evidence as closely as we can and then—based on that evidence and based,

crucially, on consumer evidence—we will react and make decisions more speedily in future.

Q35 Albert Owen: I think in that response you are saying there is no need for Government legislation. That is my opinion on what you have said, and it is my personal opinion as well.

Everybody talks about switching. The Secretary of State is very keen on it and so are many other people, and I see the merits in it. But what about loyal customers? Do you think there should be loyalty bonuses for people who stick to the same companies? They may not want to change or they might not have the time to change, even with the simplest, clearest tariffs available. In every other set of retail markets people are encouraged to stay with them and they are given bonuses of some sort.

Dermot Nolan: I have to say I do not have terribly strong views, in the sense that I don't see the lack of loyalty bonuses as a fundamental problem in the market. I don't see that there is an automatic reason if you stay with someone that you should get a lower price. Correct me if I am making a mistake here. I would not necessarily seek to prohibit them, but it doesn't strike me that that would be something automatic that a regulator should put in place.

It comes back to what I said a little bit earlier perhaps. I think an important thing for the regulator over the next two or three years—I know people have tried to deal with it over many years and I cannot say there is an obvious solution to it—is to try to persuade customers who are reluctant to switch. Customers who are reluctant to switch—not all, but on average—are some of the more vulnerable members of society, and we need to find some way to give them confidence in the market. I am not saying I have answers to that but I think it is an important priority for the regulator over the next two or three years.

Q36 Albert Owen: One of the measures that you are bringing in is to reduce the time it takes to switch from five weeks to two and a half weeks. If companies don't reach that, what benefit are you going to give the customer and how are you going to penalise the companies?

Dermot Nolan: There are a number of things. We have brought in provisions to make it three weeks, and the companies have agreed by a voluntary undertaking by the end of the year to make it 17 days. What I will say is that, although it will take a couple of years to come to fruition, a very important thing for Ofgem over the next couple of years is to introduce new switching protocols to radically reduce switching time. When I say “radically”, I mean to reduce it to a day or two days. I think that is where we will be focusing a lot of our attention. If the companies fail in their current duties we will be enforcing against them as strictly as is necessary, but it will be important to radically reduce switching times.

Q37 Albert Owen: What will that include, naming or shaming or will there be fines or—

Dermot Nolan: I cannot necessarily predict the outcome of specific investigations. However, I will try to give you some sort of relevant answer than just kick for touch. If indeed there is a direct violation of rules then there would be an investigation, and if they have broken rules it would be fines. If it is a voluntary undertaking and we have no power to fine, it would more likely be naming and shaming.

Q38 Albert Owen: In your report will we be able to see a comparison of different companies and how long it takes them to switch?

Dermot Nolan: I am wary of giving you a direct promise on that, and I will revert, but I would imagine you will.

Q39 Albert Owen: That is useful, thank you. Recent research has found that some switching sites are obscuring access for the smaller energy companies. Are you aware of this and what can be done about it?

Dermot Nolan: We are aware of the—and I will have to use the quasi-legal word—allegation and we are studying it at the moment. If we think there is a significant problem then clearly we will act to do something about it.

Q40 Sir Robert Smith: I had better remind the Committee of my entry in the Register of Members' Interests of a shareholding in Shell and to do with the oil and gas industry.

On the switching, I don't know if you have been briefed that there is a class of customer that is on dynamic teleswitching, where the wiring of the house makes it almost impossible to shop around. Are you continuing to keep a spotlight on that to make sure that those customers are not being left behind?

Dermot Nolan: I know of the issue. I think it affects up to 500,000 customers. I think we are keeping a spotlight on it. I cannot precisely tell you what we will do about it at the moment, but I can tell you it is an issue for us. The idea of 500,000 customers not being able to switch is utterly unacceptable to me, so we are certainly taking all steps to try to resolve it.

Q41 Sir Robert Smith: Going forward with the tariffs, just as you get to the simpler system we have now, along come smart meters. The whole point of smart meters is time-of-use tariffs, and your car being charged up at a certain time and then you pay less or more and so on. Are you able to absorb the smart metering developments with the simplified market?

Dermot Nolan: I think so. I referred to switching taking one or two days, and one-day switching is explicitly designed to merge with smart meters, to have a situation in the brave new world—I know that phrase can be a bit of a cliché—in which we have a lot

more innovation. The idea of switching is supposed to merge with that, to ensure that they adhere well together. So the idea of having one-day switching is very much part of the smart metering world.

In terms of the changes that we call the retail market review, the RMR—the simplification stuff—smart metering in, say, 2017-18 will change things quite radically. It will change the tariffs as you suggested. So I would say the simpler proposals are for a non-smart metered world, but we will be working intensively over the next three or four years to ensure that the structure and the format of tariffs that are going to be offered by smart meters in the future also have desirable qualities of simplicity and understandability.

Q42 Sir Robert Smith: Your predecessor was talking about the UK increasingly relying on gas coming from abroad and the global gas price. In order to get hold of gas, we are going to have to go shopping around the world. What is your assessment of the UK's security of gas supply?

Dermot Nolan: I would say our current assessment is reasonably good, in the sense of a short runway of very strong winter stocks and so on. However, we will need more gas in the next five or six years. I think there is no question about that. As I said earlier in response to Dr Lee, the share of gas in Britain's generation mix will rise over the next five years. That is absolutely envisaged. Coal plants will retire and some more nuclear may close and, although we are bringing in more renewables, we will still need more gas. There are more and more diverse sources of gas throughout the world and I think it is important we try to access them.

One is the LNG market, which has been expanding. There are a number of LNG plants in Britain and certainly the European Commission—and one thing about the Ukrainian crisis is that it has concentrated people's minds—is trying to make as many entry points into the EU as possible to bring in more gas. There is the possibility of gas fracking in Britain, but I don't think it is particularly opportune for me to give an opinion on the non-economic pros and cons. None the less, if it did happen it would bring more energy security. Finally, and perhaps most interestingly, there is a very large set of gas stocks in the US. Gas fracking there has increased gas enormously and in fact has had a very significant downward pressure on energy prices there. At the moment the US is not set up to export gas but I think various facilities are being built. Some of the gas may go to the Far East where gas prices are slightly higher than in Europe. There are also issues in Congress, which I do not know the details of, vis-à-vis its view about whether or not the US should export gas. Although it is not a panacea in the next two to four years, if it did I think it would be very positive for Britain by both increasing available supply and also potentially reducing price.

Q43 Sir Robert Smith: On prices, I have heard an analysis that if you have taken the shale gas to the LNG plant in the States, compressed it and put on all those costs and then the shipping costs, by the time it arrives here its impact would be marginal on our prices.

Dermot Nolan: I have to say I have seen a few analyses, a lot of which say rather different things and it is hard to be precise. I accept there will be significant costs. There are

significant costs of transport. The cost of wholesale gas in the US at the moment—and I apologise if I am slightly incorrect—certainly for the last two years, has been roughly about 35% of the price of gas in Europe. That is a pretty significant difference. There is a sufficient margin there that, if it was exported, I hope it would still put some downward pressure on prices.

Q44 Sir Robert Smith: What is Ofgem's role in ensuring security of gas supply?

Dermot Nolan: Ofgem does have a role in that. It is the general security of supply issue. It is a role that is shared between Ofgem and DECC. We are taking action through various things, notably what is called gas balancing measures—which I know sounds dreadfully regulatory and obscure—to ensure that the flows of gas within Europe, the flows of gas over interconnectors are as efficient as possible, and to absolutely ensure that gas is flowing from areas where it is less needed to where it is needed. But the primary statute role is somewhat split between us and DECC.

Q45 Sir Robert Smith: While we do not directly take Russian gas, are the risks being assessed of the impact that Russian gas is likely to have on the regional market in which we are living?

Dermot Nolan: Clearly there are risks. I believe roughly about 30% of the EU's gas comes from Russia and the majority of that through the Ukraine. One thing that has been striking—and again it comes back to something I referred to earlier—over the last few months is that despite these risks the price of gas has not risen. If anything, the price of gas has fallen. Certainly the price of gas to buy tomorrow is significantly 15% to 20% lower than it was a year ago, and even the price of gas for the next winter is 10% lower than it was for the winter before. So despite these fears, the price of gas has not risen. I think that is quite striking.

If things in Ukraine did get in a negative state—sorry, I am not implying things in Ukraine are not already in a negative state, but if there was an energy issue—what is likely to happen is not so much that we would be short of gas but it is likely that countries like Germany would start demanding gas from the North Sea ultimately. That would raise prices here. So if there was something of a bigger crisis in gas in Ukraine, it is not that we would run short of supplies, but there would be upward pressure on gas prices and we would have to pay more for our gas. As I said, what is interesting is that that does not appear to have happened so far.

Q46 Sir Robert Smith: Does Ofgem take a view on whether more gas storage in the system is becoming a necessity in terms of stability?

Dermot Nolan: I think that is a policy view. My understanding is—and my apologies if I am incorrect here in any way—the Government has ruled out direct support for gas storage for the moment. Currently gas storage levels are relatively high. That is mainly

because we have had a mild winter. I do think it is a matter for policymakers but obviously we would be very happy to feed into any such debate.

Q47 Sir Robert Smith: If you were feeding into that debate, what would you feed in?

Dermot Nolan: What would I feed in? That is a terribly unfair question. To be honest, I am not precisely sure. The same question to some extent confronted me in Ireland. I would probably say—and this is a judgment call at the moment—that I do not at the moment see a need for Government support. That would be a highly subjective current view.

Q48 Chair: Even though the evidence points to market failure when it comes to investing in storage, that the market is not incentivising it?

Dermot Nolan: I think there are changes in some of the measures that we are taking that may provide more incentive, I do not know. I offered a highly subjective view and I am not sure that I am as best prepared to debate it as perhaps I should be. Perhaps if I have more time to consider, and indeed talk to my colleagues, next time we meet—which I am sure will be in the near future—I will do my best to give a more comprehensive answer.

Q49 Dr Lee: Would you agree with those people who say that because we do not consume that much Russian gas, somehow we are more resilient than perhaps Germany is, or would you say that that is a very simplistic position in that 27%, I think, of gas use in Germany essentially comes from Gazprom? When they stop receiving that gas, if that was to happen, they are just going to go to the Norwegians and offer more money, I suspect, for their gas, and we get 70% of our oil and gas from Norway. By definition, what is happening in eastern Ukraine could have a significant impact upon the cost of gas to the British consumer.

Dermot Nolan: I very much agree with that, Dr Lee. I think that is the case, yes

Q50 Dr Lee: That being the case—and I know you have already just said that there is a shared role here, which slightly concerns me that there is shared responsibility in this area—is there a measure of resilience? Has Ofgem modelled what would happen? I am reminded that the stock market in July 1914 was peaking; so much for markets predicting war. Do we have a doomsday modelling arrangement where we can say, “If this happens and this happens, then this is going to happen”?

Dermot Nolan: I am certainly not going to say that I have seen that kind of doomsday model. I know the team are working generally on this issue.

Dr Lee: There is work going on?

Dermot Nolan: There is work going on. There is also work going on with DECC. There are certainly measures. If there was ever a gas crisis, there are specific measures in place to deal with those kinds of crises. In terms of the specifics—

Q51 Dr Lee: How resilient are we, though? How many days? If the worst happens, how many days can we exist?

Dermot Nolan: I cannot give you that kind of figure off the top of my head but I will revert to you within a couple of days on this.

Q52 Dr Lee: Do you think you should have that figure at the top of your head?

Dermot Nolan: I possibly should, and I apologise for not doing so but I will revert to you.

Q53 Dr Lee: Are there people who have that figure at their fingertips?

Dermot Nolan: Off the top of their head? I am not sure.

Q54 Dr Lee: Should there be? I cannot see the future, but I think—

Dermot Nolan: No, I appreciate that.

Dr Lee: —it is particularly important, when it comes to energy, that we have some sense of what might happen here, because there is an unpredictability to the situation and it slightly concerns me that you don't know and that you sort of imply that others might not know.

Dermot Nolan: I am not sure if people have figures off the top of their head. I take your general point strongly, and I am certainly not putting forward any view that because we don't get gas directly from Russia we are not potentially affected.

Q55 Dr Lee: That has been the stated Government position. I have seen in the papers that the Government's position is, "It is okay. We only get a couple of percent from the Russians. We're fine". It is remarkably naïve, I think, because it is a tradable commodity.

Dermot Nolan: I would concur with your view that we could be affected, not so evidently in terms of direct shortages of supply here but I think we could be affected through the price mechanism that you referred to. I apologise for not having this figure offhand but I will revert to you.

Q56 Dr Whitehead: Following on from some of those discussions, of course you do an electricity capacity market assessment and you produced a 2013 assessment. What were the main results of that?

Dermot Nolan: The main results were that margins are relatively low, that they will potentially fall to 2% and that in some sense—and I am not saying we will face a crisis—we will face pressures to keep the lights on over the next years. However, partially as a result of that, we worked intensively with the Department of Energy & Climate Change and intensively with National Grid to take measures to respond to that. Indeed, we have given National Grid tools to deal with this by offering new balancing services, which they are likely to make an announcement on in the next few weeks for the next winters between now and the commencement of the capacity mechanism. I think that work has been positive. We have been working well with National Grid and DECC, and I am quite positive for the future in that regard.

Q57 Dr Whitehead: What sort of trend changes have there been on capacity margins since you produced your capacity market assessment, bearing in mind of course that the National Grid proposals are not yet in place?

Dermot Nolan: First, we are going to be producing another capacity assessment by the end of June or early July this year, roughly around that time. That will look at various factors that have influenced capacity over the last year. I have comments on two or three things. One is that we are seeing potential risks of plants being closed. A number of plants have said that they may close in the next 24 months, so there is pressure in that regard. A perhaps more positive sign is that we have seen continuing reduced demand for energy, both electricity and gas. That has been a pattern over the last 10 years but it is a pattern that is continuing. So there are pressures on supply but there are also countervailing benefits from demand. Finally, we have seen some changes in the patterns of interconnectors, where we would like to see that interconnectors are a more positive source of security of supply.

On balance, as I said, we will be producing an assessment towards the end of June, but in the meantime and even before that assessment comes out you will see announcements from National Grid about requiring these balancing services for the winter, which I believe will get us through the next few years.

Q58 Dr Whitehead: In the 2013 report you effectively discounted the role of interconnectors on the grounds that you could not be certain that they would produce a positive effect in times of difficulty. You did, however, in that report assess what might be the case were interconnectors to be included and that about doubled the margin, did it not?

Dermot Nolan: It did indeed. There has been a lot of debate about the role of interconnectors. I would speak positively about interconnectors and if I might talk a little

bit about them. There are two interconnectors to the island of Ireland but they are both relatively small. There are two interconnectors, one to Holland and one to France, that are a lot bigger. Last year we took a relatively pessimistic approach on interconnectors. On the evidence we have seen this year we will take a somewhat more positive one but I would say still a relatively cautious one. My personal view is that interconnectors are likely to benefit security of supply considerably, given the flow of energies. To be candid—and I spoke earlier about France with its 80% nuclear—wholesale electricity prices in France are lower than they are in the UK. As a result, we are likely to be taking power from France to here and I think that is a positive thing for security of supply.

In analysing this—and there are endless modelling results one can engage in—the potential risk might be, and it is less of a factor now than it might be in three or four years, if winds are very low in Britain to the point that we are not getting much energy from wind power, there is some correlation with the continent. Wind power might be slightly lower in France and they might have more need for energy as well. That is one thing that has introduced a note of caution to the interconnector debate, but broadly speaking I am positive about the role of interconnectors.

I would also be positive should there be interconnectors in the future—I think we are rolling out a regime that will bring on more interconnectors—in particular, although it is not guaranteed to happen, to say Norway or Sweden, that would give another string to our bow. It would give a connection to a market that is not connected with the wind patterns of the continent and their potential affiliations with here.

Q59 Dr Whitehead: Do you think it was a mistake in the 2013 report to downplay the role of interconnectors to the extent that you did?

Dermot Nolan: I think it was a conservative assumption and this year we are likely to make a slightly less conservative assumption. But I think the general stakes at play in terms of keeping the lights on are such that it is best to make conservative assumptions.

Q60 Dr Whitehead: The Prime Minister, in the recent Liaison Committee discussions, was quite emphatic about his view that there is no danger of the lights going out or there being serious capacity margin issues in 2015 or so. Is that a view you agree with?

Dermot Nolan: I would say I am confident—and hopefully these are not famous last words, but I have spent a lot of time on this since I got here—that the tools we are putting in place with National Grid will be enough.

Q61 Dr Whitehead: You have been talking about cash-out incentives, encouraging generation suppliers to balance their positions better so that then the demand on National Grid and the system balancer to bring in emergency arrangements would be lower. How are you going to ensure that those cash-out incentives do really work?

Dermot Nolan: We have just completed our decision on cash-out incentives, which we believe will encourage flexibility in the market—I suppose that is probably the fairest way to say it—that will encourage the cash-out mechanism. Without going into too much detail about the way to balance prices within the wholesale market, we believe we have put in place a mechanism that will encourage flexible generation, which I think is very necessary when you are bringing on more renewables. So that is in place, that decision is made. It has to go through a number of mechanisms, approval by the industry, code reviews and so on, and in theory it could be subject to appeal. All I can say is that we have made that decision. We will now press forward with implementation as rapidly as possible. I cannot prevent the possibility of someone appealing it, although I suspect it is unlikely.

Q62 Dr Whitehead: You have also mentioned the two new balancing services that you are encouraging and empowering National Grid to undertake. One of those, of course, is the supplementary balancing reserve, which is essentially a strategic reserve mechanism, is it not?

Dermot Nolan: Yes, essentially.

Q63 Dr Whitehead: The strategic reserve mechanism was a mechanism that was specifically rejected as a viable mechanism in the Energy White Paper in the run-up to the Energy Bill discussions, was it not?

Dermot Nolan: I am sorry, Dr Whitehead, I am not fully conversant with some of what happened in the run-up to the Energy Bill. My apologies for that. I can read up on it. I will say that the tools we have put in place with National Grid are essentially designed to bring plant that is off, non-available, on at the lowest cost possible, should it be needed.

Q64 Dr Whitehead: Yes. I merely raised that point because when the discussion took place at the beginning of the process of bringing the Energy Bill through Parliament on capacity markets, the option of going into a strategic reserve was set against the possibility of having a capacity market, and a capacity market was substantially preferred on the grounds that a strategic reserve might be less reliable. Yet we have here a strategic reserve for a period running up to the beginning of the capacity market. Does that strike you as odd?

Dermot Nolan: It strikes me as necessary given the capacity market will not be here until 2018. I spoke earlier of the need for conservative assumptions here; I would be strong on that. Being sure that the lights will stay on is very important and therefore, given the capacity market will not be here until 2018, it is absolutely incumbent upon us and the Grid to act using whatever tools are needed.

Q65 Dr Whitehead: If that proves successful in the short term, is there any reason in your view why that should not be extended over a period as the supplementary balancing reserve, which essentially keeps plants that might otherwise be mothballed ready to provide services?

Dermot Nolan: I would say there are no plans to do so. Having that and the capacity mechanism strikes me as unnecessary so it would be one or the other. The Government's plan is for the capacity mechanisms to go in by 2018 and at that point I would say the balancing reserve is gone. So it is perceived as an interim remedy.

Q66 Dr Whitehead: In your view, would that lead to further mothballing of plants in a way that might be detrimental to the question of successful balancing, or would that be overcome by the introduction of the capacity mechanism?

Dermot Nolan: I believe it should be overcome by the introduction of the capacity mechanism. The capacity mechanism is, of course, not just about mothballing; it is about providing incentives for new plants to be built as well. To me, it seems the capacity mechanism is first a choice that has been made. It is not an unusual choice in Europe at the moment and, given that it is there, it is probably best to just get on with implementation.

Q67 Dr Whitehead: There is a suggestion that the capacity mechanism may incentivise the introduction of new plants at the expense of existing plants that have a burden of non-profitability behind them. Those existing plants may close in preference to a route of opening new plants and therefore existing plants will be closed in order to make way for new plants that will do exactly the same thing. Is that a concern that you have, between the two mechanisms?

Dermot Nolan: It is not a concern I personally have. My understanding is that existing plants can bid into the new capacity mechanism and if they are still efficient they should be able to do so effectively and then stay on.

Q68 Dr Whitehead: Isn't that what the supplemental balancing reserve is intended to overcome?

Dermot Nolan: It is intending to overcome it until 2018, to keep on these older plants that you refer to. Come 2018, that should be gone. It should in some sense be replaced by the capacity mechanism. But if the older plants are still there, have kept going over that period and are still reasonably efficient, then at least in principle there is no reason why they should not successfully bid into the capacity mechanism and stay open. That certainly would be the principle in theory. I cannot necessarily predict what will happen, but it seems to me that, given we have the capacity mechanism, we need to be sure to have a significant balancing reserve for the next four years. I think it is useful to have it. At that point you have one or the other. Given Parliament has chosen the capacity mechanism, I think it is best to get on with implementing that.

Q69 Chair: I should draw attention to my entry in the register as a paid director and shareholder of Groupe Eurotunnel SA, which is currently building an interconnector between Britain and France.

On this question about the capacity market, which has taken some time to come on, do you also have any anxiety that we seem to be locked into a generation capacity mind-set, which is that the only way to deal with a small margin of capacity is to build more generating capacity?

Technology that has become available in perhaps only the last five years is facilitating a much more sophisticated approach to the demand-side response and the ability for consumers to switch off at very short notice—certainly a very large portfolio of available consumers—and that means you can guarantee to reduce demand when needed. Should we not be prioritising that, which is probably better value and certainly better in terms of emissions, if you can deal with a capacity crunch by cutting demand rather than by building more capacity?

Dermot Nolan: I think demand-side response has a hugely important role. In terms of the next four years and the balancing mechanism that Dr Whitehead and I were talking about, there is also scope for some of that to be demand side in terms of response. In general, the more demand-side response the better. The smart metering issues and the technology improvements will be important in that regard. The whole principle of smart metering, certainly in time-of-use tariffs, is to encourage demand-side response. I firmly believe that is a positive thing that is likely to make things more responsive and will be an effective response to increasing demand. Whether that negates the idea for a capacity mechanism altogether is something I am less sure of. If the capacity mechanism is well designed, and competition more generally is effective at the retail level—which I admit are two conditions that will need to be met—then the capacity mechanism should not raise the price of electricity. It should not get in the way of demand-side response. If it is bid competitively and if the suppliers who ultimately take this capacity price on board then bid competitively, then certainly the theory—and I appreciate the theory can be difficult to hang your hat on fully—is that it should be bid down to the most competitive level. So I do not see them as necessarily inimical in that regard.

Q70 Albert Owen: Can I take you back to what you said about the interconnectors? In particular I would like your comments, in your unique position, on the decision to suspend or not go ahead with the Irish connection for the Greenwire. This was hailed by both Governments as a way forward. Do you think that is to do with process in Ireland? Is it Government policy here, or is it—you touched on it and I thought it very interesting—that we need not to rely too much on wind but on other connections from Norway and so on?

Dermot Nolan: It is a wily, tricky question for me to comment on but I will do my best. I should say I am not privy to any discussions. There were intergovernmental discussions.

Albert Owen: We are talking about a significant project here.

Dermot Nolan: We certainly were. What I would say is the following. I do not know if it has broken down irretrievably but it has certainly been broken down for a period of time. My sense was not so much that this was a project that from our perspective was designed to solve our capacity issues. It was a project that was designed to help us meet our renewable targets. I do not think the whole idea behind the project was about security of supply. I think it was the idea of bringing renewables on. It was not so much whether wind is or is not a renewable but more a sense of is this a more efficient way of reaching our renewable targets than say—

Q71 Albert Owen: When you say “we”, do you mean the UK?

Dermot Nolan: Yes, “we” is Britain now. I think that is what it was intended for. There was a view that that might be cheaper than, say, offshore wind and more desirable. That is ultimately for policymakers to decide but that was the idea behind it. Why it broke down is more difficult to determine. I can only speculate but I will offer two possibilities. One is that there may have been worry on both Governments’ sides about the ability to deliver within Ireland. While the attitude towards wind generation in Ireland is relatively positive, there was some questioning about the sheer scale of the project and what it would mean and would it be bad for the local countryside and environment. There may have been qualms in that regard. There may possibly have been qualms on our side in terms of saying, “Okay, the growth, the jobs that would potentially come are all going to come from Ireland rather than here”. My guess—and I stress that this is a guess—is that they may have been the two areas in play.

Q72 Albert Owen: We talk a lot about retail and generation. Do you see there being a flaw in the market where there is no competition in transmission, which is a big part of the bill? You as regulator do have a role in regulating these monopolies.

Dermot Nolan: We do have a role and I believe we will be meeting again possibly in the near future to discuss that in more detail.

I think natural monopolies tend to be an unfortunate fact of life in the sense that they are monopolies. It is important that they are very strongly price-regulated. I think where possible one should try to make it—I suppose the phrase is—contestable. We should try to make as many of their activities potentially as competitive as possible. I think that would be a relative priority for us over the next few years. I look at the example of the offshore wind transmission assets. There has been a learning experience but, by and large, it has been positive. Where possible, one should try to introduce competition into these areas. I am not going to give you a precise sense of how that might be done today, but I think it is certainly a goal for us, where we can do it.

Q73 Chair: On that last point, I think it is easy to understand why it is difficult for transmission to be other than a monopoly. However, distribution is a rather more promising area for competition. One of the concerns that I have had is that in the past Ofgem has not paid anything like enough attention to transmission, and particularly distribution costs, which

are quite a big component in the bill. The distribution companies are not so visible to the public and therefore not the subject of frequent attacks, particularly in the print media, and I think Ofgem has thought, “We do not need to worry about them very much. They are under the radar. The fact that they account for nearly one-fifth of someone’s bill, never mind they are ripping off their customers in a completely unaccountable way, we are not going to worry about that”. One of the things I would urge you to do—and as you imply we have some work in hand on transmission and distribution—is to have a close look at distribution costs in particular, but also transmission costs, where we believe the companies have had inadequate scrutiny and have been able to get away with making very large profits.

Dermot Nolan: We will certainly look at that very intensely. I will do my best to assure you now though that in my view—and perhaps it is a biased view—as the regulator it is absolutely incumbent on us to regulate these things as strongly as possible. I believe, frankly, we have done a decent job on that. I look forward to debating that with you in the future. But in any case, regardless of what we have or have not done, I can assure you it will be an absolute priority. It is one area where we directly price-regulate and it is one area where we absolutely have to deliver.

Q74 Graham Stringer: As the Chair says, we are just about to take evidence on network costs. How effective do you think the last price control period was in controlling costs to the consumer and what difference will there be in the new price control period? How will it differ?

Dermot Nolan: The old mechanism that was known—I apologise for going back to jargon—as the RPI-X price control, which was done over a five-year period, has changed to something we call RIIO, which is done over an eight-year period. I think there are many strengths to this in the sense that it will provide a longer period of time. There are various points for review during it but it will provide greater certainty. In my view, we have taken pretty strong actions to ensure efficiency from companies. We have also put clear incentives in place to make them make efficiencies, and I can talk more about that if needed. But in particular we have also taken a strong view on reducing on what we call the cost of capital, so the cost of capital has come down significantly. Some of these price reviews are done, some are not. The ones that are waiting to be finished at the moment are for the electricity distribution companies and we anticipate finishing those in the next six months. I would like to think that we have taken a new approach, a strong approach, and one that has forced them to make efficiencies.

Q75 Graham Stringer: Perhaps you can tell us what those incentives are. Are they sufficient to overcome the lack of competition?

Dermot Nolan: I do not want to discourse philosophically, but the basic point is that regulation is a second best. An effectively competitive market would be better. If indeed there was competition working effectively—and it would need to be working effectively; if it does not, it is not much good to anyone—that is probably better than regulation. So we are against a background where it would always be better to rely on effective competition.

Q76 Graham Stringer: It would have to be judged against that theoretical competition.

Dermot Nolan: Absolutely. I accept that.

Graham Stringer: That is the question I am asking. Are those incentives—

Dermot Nolan: I would hope they are as good, as effective, as they could be. They are probably never going to reach a perfectly competitive outcome. The essential problem in any direct price regulation, I would say—and this is a problem that, as you say, it is absolutely incumbent upon us to try to resolve—is information, in the sense that the company knows more than you. It always has a huge incentive to overstate its costs and to say it will cost £50 million rather than £40 million. The main difficulty as a regulator—and it is something we must do—is to find out that information; force the company to reveal its true costs; force it to reduce those costs. That is why regulation is to some extent always imperfect. But I would hope that in taking on that task we have done it as effectively as possible. Although I think we probably will never quite get to perfect competition, which is why I made the comment earlier that where possible we need to bring in competition to those areas where we can, I nonetheless hope—and we are certainly prepared to discuss it next time I am back—that we discuss what we have done on that and what we will do on it in the future.

Q77 Graham Stringer: You have publicly disagreed, have you not, with the network providers on what impacts their costs will have on customers' bills? Is that a failure on your part or is it because the whole system is too complicated? Can you update us on that disagreement?

Dermot Nolan: I am not entirely sure what you are referring to, Mr Stringer. My apologies. I would like to think we are relatively transparent about the share of network costs in the bill. It is roughly around 22% of a total dual fuel bill.

If you look at network costs and how they are likely to evolve, there has been an increase—and I may be getting to what you are referring to—in costs over the last two or three years, which I would acknowledge. There have been significant new investments needed, partially to replenish the networks, partially to build new networks to bring on the renewable energy, which is typically—not always but typically—in out-of-the-way places. I suspect the disagreement you are referring to—and my apologies for not getting it immediately—was the idea of what is going to happen to network costs for the rest of the decade. In our view, and I will be clear on this, network costs should stay constant in real terms. They will be subject to retail price inflation but in real terms they should stay constant for the rest of the decade. That is certainly our view.

Q78 Graham Stringer: If some of those extra costs are down to connecting remote renewables, do you think those costs should be displayed separately on consumers' bills?

Dermot Nolan: I think it is possible to do. It is certainly not done and I do not believe it is done anywhere in Europe. I think the general theme—and this is not a pro- or anti-renewables remark—that to bring on renewables more networks are needed is a reasonable issue that nearly everybody in Europe is facing at the moment. In that sense, network costs are likely to rise slightly as a result. It is important that we be transparent about it. Whether or not to put it on consumers' bills, I do not know. I do not have a strong view but I certainly would not rule it out. Do you think it would be a good idea?

Q79 Graham Stringer: A lot of the debate over the last 12 or 18 months about energy bills has been about the cost of renewables and it appears that consumers want to know what they are paying for and there is a debate about whether that should be paid for by taxation or by the consumers. Personally I think it would be helpful for the consumers to know what they are paying for.

Dermot Nolan: The one comment I would make on the issue of whether or not it is paid for by taxation is that something like this, a network cost, is almost certainly unlikely to be able to be paid for by taxation because of state aid rules: it would have to be paid for by consumers.

Q80 Graham Stringer: One of our reports on the rollout of smart meters said that it believed you should keep the costs of the rollout under control. Can you tell us how you are doing that, what state the smart meter rollout is in at the present time, and what impact it will have on consumer bills?

Dermot Nolan: The smart meter rollout is proceeding reasonably well. Primary responsibility—and I am not trying to deflect the question—does rest with DECC, but we are working with DECC in ensuring the rollout happens reasonably efficiently.

In terms of consumer bills, DECC have a very large impact analysis on the CBA and I worked on smart metering quite a bit in my time in Ireland. I tend to be very positive about smart metering. There is likely to be a short-run increase in costs and I think DECC has put that at £5 to £6 on the bill in the short run, but I believe the long-run benefits from smart metering will be considerable.

The imperative over the next three to four years is to try to make sure that this happens as effectively as possible. I know that is a vague kind of thing to say, but I truly believe it. A key point would be to try to—not educate, which sounds almost patronising—hear customers' views as to how smart metering should work for them. One of the most important things Ofgem will be doing in that regard is to try to see what consumers want out of smart metering bills, which was touched on earlier. Is smart metering of the house what they want to see? How do they think it will benefit them? Will it facilitate their energy use? Will it reduce their demand-side consumption, as the Chair said earlier? We will be working intensively on that, but I think it will be a huge challenge over the next few years.

Q81 Graham Stringer: Do you think the system is fit for purpose? All around this Select Committee people are glancing at smartphones and iPads, and yet this system is not going to be compatible with smartphones currently on the market. Do you not think that is a failure and it will mean that it will be a straight-to-drawer process when the smart meters are installed?

Dermot Nolan: I am not sure if I am able to answer that question now in the sense that I am probably—and again I apologise for this—not sufficiently briefed on the details of the smart metering project here to answer that specific question. But again, as I said to Mr Yeo, I will revert to you on that.

Q82 Graham Stringer: You may not be able to answer this one, and I know nothing about the Irish experience but possibly you could write to us about it. Do you think it was sensible for the energy suppliers to be in control of the smart meter rollout as opposed to the network?

Dermot Nolan: In Ireland, it is done by the distribution company. There is only one distribution company in Ireland. I certainly worked with that and I see advantages in procurement and so on in having that. The disadvantage, I suppose, is potentially you lack a little innovation; there is one particular type of technology. So I would see pros and cons. I certainly found the Irish experience reasonably positive and a number of people have said it might be better here. That is probably all I can say at this point, apart from the fact that the system we have here, here it is. I cannot imagine that we could at this point resile from it or change it completely. I think we have to work with it and make it as efficient as possible.

Q83 Sir Robert Smith: Was the die not cast when the original dumb meters were given to the supply companies rather than the distribution companies?

Dermot Nolan: I would say the die was pretty much cast then, yes.

Q84 John Robertson: There are a lot of questions about vulnerable customers and self-disconnection. The Committee has been looking at this because a member of the public emailed us when we were doing a session in October about people who self-disconnected and the problems, and since then we have had a number of meetings with each of the companies. One of the big things that has come up is the fact that there is not an agreed definition of what a vulnerable customer is. What do you understand by that term?

Dermot Nolan: Ofgem has done some work on this and has its own strategy. A vulnerable customer is someone who for various reasons will find it difficult to engage in the market. If they do not engage in the market because of their situation, their place, their potential disabilities, they are particularly exposed to price increases, to not being able to have a decent life as a result of energy price increases. That would be my rough intuitive sense.

Q85 John Robertson: You make my case for me, in a way, that every company, big or small, has their own idea of what it is, as you do. What we do not have is a definition that they all agree with and can stick with and that is one of the things that we are trying to suggest. You will be receiving a letter from the Chairman soon with some ideas on it and I will look forward to getting your opinion on that.

But do you understand how customers can cut themselves off? The companies will put somebody on a prepayment meter, sometimes because they have debts, or sometimes it could be an elderly person who through no fault of their own has genuine problems in paying their bills. Eventually what happens is that they have no money, they cannot top up their electricity meter and therefore they, in effect, cut themselves off and there is nothing we can do about it because nobody knows that person is vulnerable. We need to look at that. My basic question is: would you consider helping industry to develop a better approach? I believe there is a will from the companies. They just need some kind of leadership.

Dermot Nolan: Yes, I would. I am not promising you the specifics of what it might come to but, yes, absolutely. I think it is a serious issue and something that personally I think we should try to do something about.

Q86 John Robertson: Do you see any barriers in doing it?

Dermot Nolan: One of the obvious barriers is—I think you said it yourself—how do we know that person is reaching the point of self-disconnection? How do we know when they cannot put money in? Who is keeping an eye on it? There could be a number of responses to that. One might be to say such people—and I am not saying this is something we can necessarily guarantee—should not ever be exposed to PPMs and should not be cut off. That would be one potential response. I am not saying that is the self-evident response but it is one way of dealing with the point of how do you know, how do we know, how does the local community know, how does the supplier know, that a person is vulnerable and on the point of not having access to electricity.

Q87 John Robertson: That is some of the stuff we are going to ask you in the letter that we are sending you so I am not going to pre-empt it. But having said that, there is a lack of flexibility in the system at the moment, particularly for people who become temporarily vulnerable, say a new parent, somebody who has been in hospital, somebody who maybe is diagnosed with a serious illness but gets better. These kinds of people are excluded from vulnerability and yet if they had a prepayment meter they would have that difficulty. The other big problem, of course, is the Data Protection Act and the passing over of information. There is a clause somewhere within the Data Protection Act that basically says that if somebody's life is in danger they can be protected, but it is all an interpretation. Would you see it as part of your job to try to make sure that the vulnerable person interpretation is a bit clearer and that all the companies and anybody else associated with their power understands that position there?

Dermot Nolan: I do see that as part of my job. I absolutely acknowledge that.

Q88 John Robertson: How would you enforce something like that?

Dermot Nolan: I am not sure, and I cannot give you a direct answer. I would hope to enforce it by clear and agreed industry protocols that would be, first, to name and shame them and if necessary and I felt that there were not the legislative powers for me to do so, I would come back to DECC and Parliament and potentially ask for more powers.

Q89 John Robertson: Is there any enforcement that Ofgem can do in terms of vulnerable customers? You give them a statement of what vulnerability is, and I appreciate that, but it is again an interpretation. Is there any enforcement that can be done in that respect? Unless we get in effect a code of practice that everybody can sign on to, I worry. I know my opinion but what is yours?

Dermot Nolan: Enforcement is generally for breaching licence conditions. The ability to enforce, the ability to fine is generally for breaching licence conditions. I would say—perhaps I am repeating myself, so apologies—if indeed we developed such an issue and felt it was not being dealt with seriously by the industry, then I would look for specific extra enforcement powers in this area.

Q90 John Robertson: Do you do any work with the companies on vulnerability?

Dermot Nolan: Yes, we do and we work closely with many organisations like Citizens Advice, Consumer Futures as it used to be, and the Fuel Poverty Advisory Group. I have met pretty much all the heads of these consumer organisations in the couple of months I have been here. I want to listen to their views as clearly as possible as to how we press forward.

Q91 John Robertson: But do you meet with the companies as a whole rather than individually on this subject?

Dermot Nolan: I have not met with them on this subject but I will make it my purpose to do so over the coming period, and I know Ofgem staff do.

John Robertson: I will look forward to hearing your reply to the Chairman's letter and the ideas that we have in relation to vulnerable customers. There has been a distinct lack of continuity between the companies but there would appear to be a will to look at it. What they need is guidance and leadership.

Q92 Sir Robert Smith: One of the things to maybe look at is the switch in the way the tariffs work and the reintroduction of the standing charge. It has caught out quite a lot of people on gas prepayment meters because they are used to living a lifestyle of switching on

the gas in the autumn, using the gas over the winter, switching it off in the spring and just using electric over the summer, and then starting that cycle again. But because of the standing charge that they were not aware of, when they switch the gas on in October, they have a huge bill built up before they get any heat. I do not know if you could look into that.

Dermot Nolan: I think we are looking into it. One thing I would say about change is that we are not prohibiting having no standing charge; there is no prohibition on that at all. I want to be very clear about that.

Q93 Sir Robert Smith: Yes, but obviously with a limited range of tariffs—maybe we need a warning or some way of getting it through to people, because obviously with vulnerable customers, that sort of big cash hit, just when it is getting cold—

Dermot Nolan: Two comments on that, if I may. The idea of the four tariffs is a new move. I think there was strong consumer support for it. We will have to keep that going forward. But one thing I want to be very clear on is that if any company writes and says they want to increase the number of tariffs for a tariff that has social purposes or is going to affect more vulnerable customers, I will approve that tariff; I will give them an exemption. I want to be clear about that.

Q94 Albert Owen: Still on the theme of vulnerable customers, many vulnerable customers in my constituency, and many constituencies, are off the gas mains. You are only regulating part of their supply and they do not get dual fuel discounts and so on. Do you have a view—you are very new in your role—on whether to take over responsibility for the off-grid sector? It is something I have raised with your predecessor, and indeed with Government Ministers, and they tend to ping-pong the answer. But I was interested to hear you say that when you feel there is an issue you will apply for more powers and maybe Parliament would grant you these powers if you made a request.

Dermot Nolan: I am conscious that all my predecessors have said this is an issue for policymakers.

Q95 Albert Owen: Policymakers have said it is an issue for the regulator, to make the application, so that is why I am pinning you down on it.

Dermot Nolan: It is terrible to be pinned down but I suppose that is part of the job. To me it seems there is something of a lacuna in the sense that something like 15% of people are off grid.

Q96 Albert Owen: If you look at the percentage of those that are vulnerable, it is very high.

Dermot Nolan: Absolutely. It is higher. Even the way that the current set of levies is in place strikes me as not great, because a lot of the obligations for renewables are on electricity and not so much on gas and that means you almost potentially pay double on electricity if you are getting electricity heating. I will give a partial answer. I will retreat to saying it is ultimately a policymakers' issue but that if it was done, and I could see an advantage to bringing the gas grid to rural areas, I think there will always be areas where it is not so much the extent of the grid, it is just that you cannot put a gas grid into, say, a block of flats. That is my understanding but correct me if I am wrong technically.

Q97 Albert Owen: My issue really is this: when the energy markets were privatised you took over the grid, but then there are lots of people not on the grid—still vulnerable customers—who do not have the protection of those on the grid who have yourselves. That is my point. There is nobody there to look after them. They have reviews and it goes to the CMA, the OFT, but really it gets lost in competition issues. There is an issue there for vulnerable customers.

Dermot Nolan: I think it is a very fair point. If I may finish my point and then come to that, because I think it is hugely interesting. If the grid is increased it is likely that, given the current test, that would have a slight—I stress probably very slight—upward pressure on tariffs.

Albert Owen: I appreciate that. There is no incentive to extending the grid—

Dermot Nolan: That is why in some sense it is a policy issue because it is a sense of we are bringing more people on—

Albert Owen: I think it is a regulation issue as well.

Dermot Nolan: Okay. On the second point I agree with you, in the sense that if you are getting your heating from gas you have various protections, which I hope are there to try to protect the interests of vulnerable consumers. If you are getting your heating from some totally different fuel service, heating is still an essential service and yet there are no extra protections for what is essentially the same product. I think that is incongruous and it is something—this is a just personal view at this point, not something I have discussed with the board—I would personally favour the extension to that. I think it is more consistent.

Albert Owen: Thank you. That is helpful.

Q98 Chair: I think we have come to the end. Thank you very much for your time this morning. We are going to see you again before very long. I am sure we all wish you well in the challenges that you are facing.

Dermot Nolan: Thank you very much, Chair. I stress that I am very much at the Committee's disposal at any point. I look forward to meeting you in the future. While I am

certainly not trying to make promises about what I will do—all I can say is that I will do my very best—but I hope to listen to as many people as possible on what should be done in the sector and I hope to hear as many ideas as I possibly can. Thank you and I look forward to working with the Committee in future. Thank you very much indeed.

Chair: Thank you.