



Energy and Climate Change Committee

Oral evidence: [Network costs](#), HC 386 Tuesday 4 November 2014

Ordered by the House of Commons to be published on 4 November 2014.

Written evidence from witnesses:

- [DECC](#)
- [Ofgem](#)

[Watch the meeting](#)

Members present: Mr Tim Yeo (Chair); Ian Lavery; Albert Owen; Christopher Pincher; Sir Robert Smith; Graham Stringer; Dr Alan Whitehead

Questions 212-325

Witnesses: **Dermot Nolan**, Chief Executive Officer, Ofgem, **Martin Crouch**, Ofgem Senior Partner, Transmission, Smarter Grids and Governance: Transmission, and **Maxine Frerk**, Interim Senior Partner for Smarter Grids and Governance: Distribution, Ofgem, **Rt Hon Matthew Hancock MP**, Minister for Energy, Department of Energy and Climate Change, and **John Fiennes**, Director, Energy Strategy Networks and Markets, Department of Energy and Climate Change, gave evidence.

Witnesses: **Dermot Nolan**, Chief Executive Officer, Ofgem, **Martin Crouch**, Ofgem Senior Partner, Transmission, Smarter Grids and Governance: Transmission, and **Maxine Frerk**, Interim Senior Partner for Smarter Grids and Governance: Distribution, Ofgem, gave evidence.

Q212 Chair: Good morning. Thank you very much for coming in. Do you just want to introduce yourselves very briefly as we have the television on today? They like you to say who you are, although we know perfectly well.

Dermot Nolan: Thank you very much, Chair. We are very glad to be here and thank you for inviting us. My name is Dermot Nolan. I am the CEO of Ofgem.

Maxine Frerk: Maxine Frerk, I am the interim senior partner covering the distribution networks.

Martin Crouch: Martin Crouch, the senior partner for transmission.

Chair: Okay. I think you want to make a short opening statement.

Dermot Nolan: Very, very briefly, Chair, just 30 seconds or so. I just wanted to say again we are glad to be here. We are glad to answer any questions the Committee might have for us, or do our best to answer such questions. We do believe that the overall system of regulation of networks has delivered for Britain over the last 25 years. It has been a positive system, which has delivered considerable cost savings and also improved the quality of the network. In that sense, we believe it is a framework that has served the British energy customer well. That does not mean to say that everything is perfect. It does mean to say that we have to learn from the experience we have had. We have to make the system better going forward, and that is very much a challenge for us. That is all I wanted to say at this point. As I said, we will do our very best to answer your questions.

Q213 Chair: Okay, thank you very much for that. The pie chart that you helpfully published shows that the biggest component in an energy bill is obviously the wholesale costs, something that is largely outside the control of either you or the Government. The next biggest single segment is the network costs and, therefore, this whole area of transmission and distribution is very, very important. I am frankly staggered that in virtually every industry that we look at costs are driven down year by year, particularly industries where technology has a growing application, and yet we are supposed to believe somehow that the transmission and distribution industries are unable to achieve that. Do you think that is because they are monopolies or is it because, since customers do not pay their bills directly to any of these companies, they do not get much scrutiny from the media? Or is it because in the past Ofgem has been too feeble?

Dermot Nolan: A couple of comments on that, Chair, if I may. First, I think they are monopolies. It is very clear they are monopolies. I would very much prefer they were not monopolies and I certainly have some hope that over time and due to perhaps political and regulatory actions we will make more elements of these companies open to competition. That is very much a goal for Ofgem. Nonetheless, they are monopolies. They have to be regulated directly and I do think that monopoly regulation is always going to be a secondary idea to effective competition. In that sense, I think the system is imperfect.

Given that, it means it is even more important for the regulator to make sure that we do as good a job as we possibly can, and I believe we are trying to do that. I would have one slight issue, though, Chair, if I may say, about the reductions in costs. I do feel that over the periods of regulation of these companies, which was broadly around 1986 to 1990, there have been significant cost reductions for the British consumer. If you look at the cost level now as compared to in 1990, average costs for the network, for running a slightly bigger network, are 17% lower per person than they were at that period of time. That is a bigger network. Those costs actually fell more radically in the first 15 years and at one point they were over 40% lower by about 2006. Now, the actual costs of networks have risen somewhat since then, predominantly because the networks themselves needed to be renewed and in many cases more networks needed to be built, partially just to refurbish the network, to extend it and to bring on perhaps new forms of generation. But we still have a 17% lower cost than we had when we started out. I do think that is a positive outcome. It does mean, however, that going forward, and against a framework where there will probably be further network build to bring on other forms of generation, we need to push even harder. We need to be more novel. We need to bring in new systems, including the RIIO system that we brought in.

In trying to give a conclusion, Chair, I would say I would very much prefer they are not monopolies—let us try to make them less monopolies going forward—but I think to a large extent they have delivered. I want to force them to deliver more going forward.

Q214 Chair: Well, I am encouraged to hear what you say about the monopolies, though it may be difficult to make much progress in the case of transmission. Nevertheless, if that is in your sights, that is excellent. Where do you think you can make further improvements in that case?

Dermot Nolan: Well, I think, Chair, we will probably always—and this is perhaps a bleak comment—have a situation where one person builds a transmission network. One person builds part of it and then one person, one entity I suppose, will be responsible for maintaining it. That in itself is not great and, as you noted earlier, it is the fact that there is no direct relationship between customers that is part of the problem, though in our frameworks—and we can come on to it later perhaps—we are trying to bring more interaction between customers.

The most obvious case of further competition is larger projects—what we have called, somewhat technically, strategic wider works or major transmission projects—that are designed to bring in large amounts of the grid together, sometimes of hundreds of millions, in certain cases even billions, where we would like to make those much more competitive in the sense of making them open to tender. If I might give a specific example, recently we approved a project in the north of Scotland called Caithness Moray, which is a very large project offshore, which is absolutely essential to strengthen the grid and bring further generation, particularly renewable generation, into the system. Now, in doing so we were working with a transmission company. I am not alleging anything went wrong. It was a positive relationship; we are going through the process at the moment. But to my mind it would have been much better if we could have tendered that process out publicly, if we could have had an open competition with people entering, not just the particular transmission company there. That is where I think we want to go very strongly in the next few years. In fact, we are developing such a regime now.

Q215 Chair: Good. Ofgem's own reports have said that under RPI-X all the gas transmission and distribution companies exceeded their targets. British Gas has said the same thing seems to be happening under RIIO. Do you think you set the targets too low?

Dermot Nolan: I do not believe we have, but at the same time I would stress that is a belief. We are in the first year of RIIO for two sets of price controls, which are the transmission price controls for electricity and gas and then the gas distribution controls. We are presently towards the end game, I would say, of the electricity distribution control. In fact, we will make a decision on that by the end of November. I have looked at the first year returns and I will say they are somewhat higher than expected; I will certainly say that. I do think in any price control it is always far too early to judge how effective the price control is at this point. I would say that if at the end of eight years everybody is earning higher returns, then it is probably indicative that perhaps something has gone wrong.

Q216 Chair: Do you think that perhaps the potential savings from smart grids are greater than the networks had thought they would be and, therefore, that is where some surplus may come in?

Dermot Nolan: Well, the idea of smart grids is very important in terms of the electricity distribution price control we are now currently going through and close to finishing. I cannot speak with full clarity here, Chair. For legal reasons, we have not yet made a decision, but I can certainly say that we have challenged robustly the electricity distribution companies' assumptions that the smart grid might only give a certain amount of benefits. By and large, in the proposed decision we put out a couple of months ago, we said in our view there were much more benefits to be earned and we were going to hold them to a very high standard in that regard. I genuinely believe there are significant benefits to be gained from smart grid and I anticipate, though I cannot speak for the authority's final decision, that will be carried through in that regard.

Q217 Chair: Okay. You just mentioned the possibility after eight years we might find that the returns have been higher. From the consumers' point of view, that is a bit late in the day. Do you think there is a case for having an earlier review?

Dermot Nolan: Well, two things, Chair, I suppose. One is I think we will have to wait and see. I very much take the point of what you said about the consumer and it is important we get things right at the start. I would say two things, however. One is that there is an automatic mechanism that if companies outperform the targets we have set them, consumers get a substantial element of that back. That happens automatically. That is an automatic sharing mechanism if they do outperform—and sometimes companies outperforming is a good thing. They may be innovative or we may have pushed them in ways that perhaps otherwise would not have happened. In that case, there is an automatic sharing mechanism for consumers.

The second point is we would not reopen a control. We would certainly monitor during it, absolutely we would monitor during it, but both because of the statutory nature of the framework and because of the need to give investment clarity for what are medium and long-run investments we would not reopen a price control during that period.

Q218 Albert Owen: There are a couple of things that you said there, Mr Nolan, with regards to the tendering process. Again, I know this is new—and new development I can understand—but how could you introduce competition into existing areas where there are no new connections? How is that going to be less of a monopoly?

Dermot Nolan: That is more difficult in the sense that certainly in the transmission area—I might ask my colleagues to come in on this—it will be more about new build. For distribution, there may be more scope in connections, but I might ask each of them to come in if they may.

Martin Crouch: From the transmission perspective, at the moment we are going through a period of significant build of new assets. Based on experience offshore where we have had some independent review of the benefits—and we are looking at benefits potentially of 200 million to 400 million from the first tender round—and looking at international experience as well, we think there are real benefits, as Dermot said, from extending that to the major separable projects onshore, at least over the next few years. We think it is possible to introduce that. It may be helped by some legislative change to make that process more effective, but it is largely for the discrete new assets.

Q219 Albert Owen: The distribution companies themselves would be able to tender, I assume, yes?

Martin Crouch: Would be able to bid, yes.

Q220 Albert Owen: If they have all the in-house facilities, it is pretty easy for them to win.

Maxine Frerk: On the distribution side—

Dermot Nolan: I might just come in on that. They will be able to bid and, frankly, I would not want to prevent them. The more competition the better. I will say on the offshore transmission aspects where National Grid has, frankly, not won contracts, it has bid but newer contractors have come in and have generally won such contracts. We expected National Grid to win more. It has not, so while I am not saying the offshore regime is an absolute panacea, I do believe the competition it has wrought will save consumers—

Q221 Albert Owen: Would that allow not-for-profit companies to tender as well?

Dermot Nolan: It would allow anyone to tender. We would have to have basic safety requirements and so on, which would be set in a way that would hopefully maximise the opportunities for people, but certainly, yes, any company could bid in that regard. My colleague might wish to say something about distribution, my apologies.

Maxine Frerk: On distribution, as you say, again it is all about the new build where you have new housing estates or new connections that are needed. Historically, that has been open to competition for quite a while. We have seen good progress on the gas side in terms of other parties other than the gas distribution companies winning business. On the electricity distribution side, about a third of new connections are delivered by independent connection providers. But we are concerned that more needs to be done in that space, so we are looking at how to make that happen.

Q222 Albert Owen: Is there any evidence that the customer benefits from that?

Maxine Frerk: The assumption is that the customer has chosen out of competing providers to go with an independent connection provider, so that is evidence that they thought those companies were providing a better deal either in terms of the cost or customer service provided.

Q223 Ian Lavery: Looking at the volatility, the energy infrastructures are now long established. There should be some certainty in the market with regard to that. Why is there so much volatility in the network charges year after year after year?

Dermot Nolan: I will try to answer that in the sense I am not really quite sure if there is that much volatility year on year, but perhaps I am misconstruing. I will say there has certainly been volatility in the sense that they fell strongly for a period of time and then because of the need for new investment and refurbishment they rose. As for volatility year to year, I suspect, unless I am

misunderstanding, there is always a small amount of volatility year to year depending on the actual quantities of electricity used. In some sense, the network company through the various price controls gets a certain amount of revenue and then that is split depending on the actual amounts of units. That will have a small amount, I would say genuinely a small amount, of volatility from year to year.

Q224 Ian Lavery: It is your understanding it is just a very small amount of volatility?

Dermot Nolan: From one year to year that would be my sense, but my colleague may have a comment here.

Maxine Frerk: We have heard from people like Haven Power, who are very concerned about volatility. It is an issue that we are aware of and have been trying to take steps to address by making those charges more predictable in the first instance. We are minded to approve a modification that would give companies 15 months' notice instead of three months' notice of the changes. The volatility tends to come as a result of there having been a few major changes to the methodology for how you allocate those costs between different categories of customer. As Dermot says, the overall revenues that the companies get are stable over time, but sometimes you can get what are quite big swings as a result of how they are allocated between different categories of customers.

Q225 Ian Lavery: You mentioned the modelling arrangements. How do you think the charging model arrangements could change to increase stability for suppliers?

Maxine Frerk: One thing we are doing is giving them more predictability, which means they know in advance what the charges are going to be. The whole arrangements for charging are subject to an open governance procedure. Other parties can propose changes to those arrangements if they are concerned that they are unduly volatile. I know that some of the suppliers like Haven Power are working as a group in industry to look at how to make those charging arrangements slightly less volatile, particularly for the customers connected at high voltage.

Q226 Ian Lavery: Do you think that the extra costs associated with the current levels of volatility on occasion act as a barrier to competition?

Dermot Nolan: It is a good question. It is certainly not something we have heard as a major comment from most of the smaller suppliers. However, as Maxine said, one or two of the smaller ones—Haven Power—have looked for this 15-month change. I think that particular issue on volatility of costs is something that is being addressed by the Competition and Markets Authority, so we will see what they come out with in the sense of trying to lower any barriers to entry into the market. Depending on what they come out with, we would obviously make any changes depending upon their recommendations.

Q227 Ian Lavery: Mr Nolan, you appear to be of the understanding, if I am picking you up correctly, that volatility is not really an issue. Am I getting the right vibes from you?

Dermot Nolan: I have to say I have not seen it as a major issue in terms of the complaints I have heard, but maybe I am not picking them up. I will go and try to get a stronger sense of that. We would hope that looking forward we would be able to bring a degree of stability into network costs between now and 2020 in the sense that we do very much expect that network costs will stay constant in real terms—I accept in real terms as there will presumably be some level of inflation. We hope that they will be constant for the next six years. If I am missing something on volatility, I will absolutely go and try to think a bit more on that. Certainly, it has not been raised to me as a major issue, but then perhaps I am missing something and I will try to find out more.

Q228 Christopher Pincher: Mr Nolan probably ought to try to find out more because First Utility has said that the variation between regions can be very large. It can differ between single digit percentages and 20% to 30% differences year on year. It may be something that you do want to take a look at.

Dermot Nolan: I certainly will take a look at it. I can say, I suppose, two things. One is I was originally interpreting volatility as year on year and, indeed, your comment did mention year on year. The other point is between regions, where there is a variation certainly in the distribution tariffs across regions based on different geographical areas. There has clearly been some discussion of that recently. Some areas, generally less heavily populated areas, tend to have slightly higher network tariffs than those in dense city areas. That is certainly an issue we are looking at.

Q229 Christopher Pincher: Well, 20% to 30% year on year increases are significant and I would have thought Ofgem would have recognised that.

Dermot Nolan: Sorry, are you referring to the rises from year to year?

Christopher Pincher: That is what it seems to suggest here. That is what First Utility is saying.

Maxine Frerk: The changes that will give the companies more notice of those changes are very much designed to help companies like First Utility, who if they know things are going to change with sufficient notice can factor it into their charges.

Q230 Christopher Pincher: Just to complete, if I may, Chairman, the question I was going to ask was about something you said, Mr Nolan, right at the top of your remarks about the cost of renewed network and extended network in new technologies driving greater volatility. I wonder if you can tell us whether there are any specific technologies— because of greater connectivity challenges, for example—which encourage and engender greater volatility in network cost.

Dermot Nolan: I am not sure; possibly I did. Earlier, unless I mis-said, which I suppose is entirely possible, I think I was referring overall to general likely increases in network cost to bring on new generation. I did not say that by itself would make such network costs more volatile. I am more referring, I suppose, to a pattern over time where we are extending the network to bring on new generation. For instance, one of the projects I have referred to that might—it is probably too

early, frankly—be the kind of project that could be put out to tender and competition is the network build to bring on potentially Hinkley C plant, the new nuclear plant. There are the certain kinds of projects where the network has been extended and that overall will tend to drive up network costs. I do not necessarily think that will make tariffs more volatile, but over time it will drive them up slightly unless—and indeed we will—we can drive them down for efficiency reasons as well.

Q231 Albert Owen: This Committee, and indeed myself, have been campaigning for some time to get more and more customers who are off grid on to the main grid network, particularly gas, of course. I know you were sympathetic in your first session to us about this, but a not very ambitious target has been set here of 80,000 off-grid customers on the network over the next 10 years when we have seen quite easily 10,000 per year under the current system. What incentives can the regulator, yourselves, do to improve this? People are getting ripped off, and I am going to repeat this. When we talk about average fuel costs, the people who are off the grid do not benefit from those reductions.

Dermot Nolan: If I may say two points, I think I did express sympathy and I still feel that sympathy. I will come to hopefully some practical action on it. There are two ways of tackling this, and I accept the first is probably more satisfactory. The first is to extend the grid. The problems with that fall into two areas, if you will. One is it could be potentially very expensive to extend the grid and it could drive up average costs. Secondly, certain buildings just are not sometimes suitable for the grid. Within the gas distribution price control in particular, we have delivered incentives to increase the number of gas customers, but I accept the point that it is still a relatively small fraction thereof. Unless there is a very clear policy direction, I am not sure if we can add to that until the next price control, but we will obviously make sure those numbers of connections are made.

The other point I would answer is slightly different and perhaps less satisfactory but I think is important. I would very much like to be able to at least offer a framework—and that would ultimately be for Government and Parliament to make a decision—for consumer protection measures that would be given to people who remain off gas grid. As I think I may have said before, I do find something incongruous in the sense that society has given special protections above and beyond ordinary consumer law but not to people who are essentially buying the same product. Now, we are currently trying to think about how that might sensibly work. It is not a trivial thing, but we are working on it and I hope to be able to give it to Government and see what they will make of it. I am not pretending there will be magic solutions and ultimately it will be a political decision, but I think it is incumbent on us to try to think of sensible ways in which we might be able to offer such protections.

Q232 Albert Owen: I have been campaigning for that for some time— that customers off grid should have the same protection that you give to customers on the grid. The Government talks about turning the Big Six into the Big 60,000. Whose responsibility is it at the end of the day? You have talked about creating a framework. You have talked about Government, but at the end of the day it has to be the private sector because of the costs. Or is there going to be a big subsidy from Government to extend the grid? In times of austerity, is that a good use of Government money when these companies are making huge profits?

Dermot Nolan: I am not sure. If you are talking specifically about the grid, as I said, in the gas price control we have given allowances for them to extend the grid. It certainly would be outside the regulatory framework for a company to extend the grid and not be remunerated for it. If Government wish to intervene on that, that is a matter for Government. I am not trying to necessarily kick the ball down the road in that regard, but we would certainly advise Government in that regard. I do not see any sense that it is currently happening, I have to say.

Q233 Albert Owen: Okay. What more can you, the regulator, do to bring more low carbon generation on to the system? Again, it is something that the Government has been telling us when we talk about extending the gas grid—that there are alternatives. Again, you do not regulate them if they are oil or if they are communal benefits, so what can you do for low carbon, for, say, solar and various other ones as a generator?

Martin Crouch: Earlier this year, we launched the domestic renewable heat incentive, which particularly for customers off the gas grid—which is Government policy that we administer—gives support to now domestic properties installing renewable heat, which can be a more sustainable and attractive proposition, obviously, than extending the gas grid, depending on where properties are located. We have just seen the first 10,000 customers successfully apply for that and it has only been running since April. I think that is an encouraging start to the scheme and clearly that is already a system that the Government runs.

Q234 Albert Owen: You cannot regulate, you just said, the off grid in the same way as you can the on grid, can you, but you can monitor this?

Martin Crouch: This is a specific support scheme where the Government has mandated levels of payment per kilowatt hour of heat that is generated in most cases, which we administer the scheme and make the payments for. Clearly, we also administer the feed-in tariffs and so on, which again supports local generation.

Q235 Albert Owen: Sure. Can I come to a general theme that we have had in early evidence? It is about the customer and how you measure if the customer gets value. Many of the energy companies that we have spoken to complain about a long wait of several years to get connected, and yet many of these companies are making annual profits and shareholders are getting annual rewards. The customers have to wait a long time. Do you have a general opinion on that and what can you as a regulator do to make sure the customer comes first?

Dermot Nolan: Well, I suppose I would make an initial comment and pass over to my colleague. Without getting burdened with acronyms, we replaced RPI-X as a model with what we call RIIO over the last couple of years. The whole idea of RIIO is to try to make companies more accountable to their customers. As the Chair said earlier, in a monopoly that will never be perfect, but to make them more directly accountable and, in particular, make their revenues gain or suffer depending on how they treat their customer is very much an objective. In terms of connection times, this is a particular issue in certain areas where smaller businesses trying to connect say it takes too long. We want to do further work on that and we are looking at potential solutions, particularly in London. My colleague might develop that further.

Maxine Frerk: Yes. As Dermot said, through the RIIO framework we are putting incentives on the companies both in terms of guaranteed standards around connection times, so that they have to deliver connections within a certain timeframe, and incentives for satisfaction around performance on connections. Overall, the ability to deliver connections more quickly is an integral part of RIIO. Some of the really long lead times arise where additional reinforcement is needed in the network, and again a lot of what is happening there is through a lot of the smart grid initiatives, with ways for them to offer perhaps non-firm connections. You basically have a connection more quickly but with a warning that we might need to curtail you if we have real network constraints. A lot of the DNOs are just beginning to introduce those sorts of connection offers that mean that they can respond more quickly.

Q236 Albert Owen: That is useful and I am sure you have the evidence now after RIIO's first years on how this is working out. You talk about incentivising the companies and I understand the need for that for the shareholders. Is there a mechanism to penalise if they do not deliver?

Maxine Frerk: Absolutely. When I say incentivise it is a stick and carrot regime.

Albert Owen: Yes, they get less incentives, but that is not really a—

Maxine Frerk: Yes, and if they do not hit the guaranteed standard times for connections, then they get a penalty for not hitting it. We incentivise them by hitting them—

Q237 Albert Owen: How big is that? We are talking jargon here. To the average company now who has a massive amount of assets, who is making a lot of money, what kind of penalties are they getting from not doing this?

Maxine Frerk: I do not know the absolute amounts that they get, but we can come back to you on that.

Albert Owen: There is a formula?

Maxine Frerk: It is a set time that they have to give a quote and then to deliver that connection.

Albert Owen: You understand why I am asking the question.

Maxine Frerk: Yes.

Q238 Albert Owen: We are talking monopolies. They are making lots of money. They pay their shareholders on a quarterly basis, on an annual basis or whatever. A penalty has to be severe. If you have been following the economic debate, we are talking about broadband, we are talking about railways and fast connections. Utilities are up there with that. To spread economic growth across the United Kingdom, we want a better network in those parts of the United Kingdom that are lagging behind. I think there should be some sort of stiff penalties. I will leave it at that. I have touched on most of the questions.

Dermot Nolan: We will revert to you on that.

Q239 Sir Robert Smith: Can I reinforce Mr Owen's point about the off-grid customers and reinforce your resolve to see what you can do to protect them? One of the things that is coming out of this is there is quite a complex methodology in the way the pricing structure for networks works. Therefore, suppliers have difficulty in forward planning their prices. Is that something you understand and is there anything that can be done to cut through that?

Dermot Nolan: It relates, I suppose, to the points that some of your colleagues made. It is a complex system, I acknowledge that. The last thing we would want is the system—which is, as the Chair said earlier, essentially a very important pass-through cost for suppliers—to deter new entry, to have people confused by it or suppliers confused by it. My colleague has already suggested we have changed it. We are changing the idea to give notice 15 months in advance. That strikes me as sensible and that will hopefully give more surety to smaller suppliers in the future.

Again, I do not want to overburden this and I am conscious of what First Utility has said, but it does not seem to me the single biggest barrier to entry for new suppliers. Perhaps I am wrong on that and, as I said earlier, we will look at that further, but we will try to give as much surety as we can for new suppliers' entry.

Q240 Sir Robert Smith: Do you think the distribution companies should have a more direct relationship with the end consumer?

Dermot Nolan: Broadly, yes, and I think that has been a problem in the past. The RIIO arrangement is designed to make them more accountable to their consumers, I mean directly so into—

Q241 Sir Robert Smith: So, what, putting their charges on the customer's bill?

Dermot Nolan: That is the same issue. We have not done that as of yet. The process that was gone through over the last year or two of retail market reform that Ofgem put in I think about a year ago, just under a year ago, was designed to listen to consumers about what they wanted on their bill. By and large, all the survey evidence said that they wanted an uncluttered bill without a network charge. I am personally very open to revisiting that at some point, certainly if consumers said they wanted it. I think at least one possibility is to make sure that the network charge is on the yearly statement someone gets. Certainly, on the survey evidence we saw, customers said, "I do not particularly want to have my network charge on the bill".

Q242 Sir Robert Smith: How would the network companies get more related to the end consumer?

Maxine Frerk: One of the things is we have encouraged them very strongly to engage with local communities in developing their business plans. Obviously, that is talking perhaps through surveys to customers, but also meeting with local groups to try to understand what customers want in that area, what the particular worries are, whether it is around undergrounding works and so on, so that their business plans are based on what their customers are saying they want.

They also have to report each year and publish a report of their performance so that they are accountable back to those kinds of groups who are acting on behalf of customers. As you say, for the individual man on the street, I think it is about trying to build a level of knowledge about what the networks do and their charges. As Dermot says, things like annual information, some of the suppliers already put that on their bills, but doing more to try to get that basic message across is important.

Q243 Sir Robert Smith: Are you looking at standardising their reports on their network costs so that people can compare the different distribution companies' performances?

Maxine Frerk: At the minute they all have to produce an annual report, and at the minute the information that is required in it is the standard information that they provide to us. We make sure it is on a comparable basis, but the actual reports may look different. We have a new section of our website where we bring those reports together and over time we will be looking to make sure that that kind of comparable information is available.

Q244 Sir Robert Smith: Finally, you touched on it earlier. Just because historically we evolved 14 electricity distribution areas and 12 gas regions, is there any reason why in this day and age they should all have different charges?

Dermot Nolan: Another very good question. In some ways, it is a social policy issue. They do have different charges. To a large extent, they reflect underlying costs in that particular area.

Sir Robert Smith: But only because you have drawn a line round that area.

Dermot Nolan: That is true and I do not think those areas are wholly arbitrary. They are sort of geographical areas but you could draw different lines, I fully accept that. You could redraw the map quite differently or you could say they could all be one tariff. If there was to be one tariff, then unless you brought everybody together into one monopoly, which I think would be very bad because then you would not be able to force companies to compete with each other to be more efficient, you would have to have a situation whereby, given they are different commercial companies, you worked out the revenue they would get and then had systems of side payments, which then were aggregated into one overall average that any supplier would take. That is not undoable but it is highly complex. To be honest, I think there would be a case for exploring that further if I felt society really wanted a national tariff. I am not sure if they do or do not.

Q245 Sir Robert Smith: Obviously, for Royal Mail we have a national tariff.

Dermot Nolan: We do, yes.

Sir Robert Smith: As distribution changes and as transmission changes, are these areas the natural areas that going forward—I do not know whether you should be just looking to see what the challenges would be of having a clearing house that was universal.

Dermot Nolan: We are looking at that and we will look at it further. As I said, I think it can be done but it would be a very, very major change. It would be essentially a change that would be not delivered but decided upon by policymakers, or so it seems to me. There would also be

administrative costs, but it might be considered fairer. I absolutely take the point. The mail service is nationally priced. The distribution service is not. That does seem to me to be a societal choice.

Q246 Sir Robert Smith: Do you have a timescale for looking at it?

Dermot Nolan: A timescale for looking in the sense I can report back within a matter of months, but I would be very reluctant personally, and I am not speaking for my board here, to just make that decision to say we are going to make that change without—

Sir Robert Smith: But you could inform the debate.

Dermot Nolan: You could inform the debate, yes.

Q247 Graham Stringer: Can I follow up one of the discussions? If you ask me do I want a cluttered bill, I will say, “No, I do not want a cluttered bill. I want to know what I am paying for”. The answer you gave to Robert earlier seemed to be at odds with the evidence there is that people have wanted to know what goes into the bill, they have wanted to know what the extra costs of renewables were and intermittent supply. Will you relook at that issue because I do not trust the information? I am not saying you are lying; I just do not trust a survey that says people do not want to know what they are paying for.

Dermot Nolan: I think we will relook at it but I am not necessarily promising change in the next six months. What I will say is that the process of survey evidence on what people wanted out of their bill, which was the RMR regime Ofgem engaged in, was done before I got here but it was incredibly thorough. It went on for a long period of time. They talked to many, many consumers, very large selections of them, and said, “What do you want out of a bill?” My own instincts personally are very much yours. I think consumers do want to know what the share of the bill is. Is networks a big component? What am I paying for renewables? That is what I would like to know. I suppose maybe I am biased working in the area, but that is what I would like to know.

At least in the meantime we are trying to bring as much information as we possibly can outside the bill. I said earlier that I think we will do action on this in the short run, ensuring that network costs, renewable costs, and so on, are sent in a yearly statement. We put out a fact sheet recently about how networks work, what share they are, what you are entitled to in your network. I will try to bring as much information forward as possible to consumers in other ways. As to whether or not it should be a requirement on the bill, that is something I will return to but probably not in the next few months.

Q248 Graham Stringer: There is an inconsistency there, isn’t there? If you are going to show the cost of renewables but the cost of extra connection charges are still left within the distribution costs, you are not comparing like with like. You are not showing the whole cost of the renewables. Will you be able to provide that information either on the bills or elsewhere?

Dermot Nolan: It is an incredibly thorny area in the sense that people very often have a very strong view on renewables.

Graham Stringer: Positively or negatively—

Dermot Nolan: Positively or negatively.

Graham Stringer: —but people should be able to have the information.

Dermot Nolan: I must say I very much agree. Maybe I should not say this, but I was the regulator in Ireland and there was a requirement that all renewable costs through the entire country were calculated regularly by the regulator, with various Government subsidies put in, and placed on the back of every bill. I am not saying it was good or bad, but it was certainly done and it brought a degree of transparency. The complication that you referred to in the sense of potential extra network costs for renewables is something that is more difficult to calculate, but it is something a regulator should be able to elicit the network companies to produce. What is the incremental amount of cost required to bring on extra forms of generation if, indeed, there had been no targets? Personally, I think we should be putting that information into the public domain for good or ill.

Q249 Graham Stringer: Do you have a schedule for that?

Dermot Nolan: No, I do not have a direct schedule, but I will come back to you with one.

Q250 Ian Lavery: How do you propose to improve the current set of benchmarks for network companies? The evidence we have received previously suggests quite clearly that they are inadequate.

Dermot Nolan: Well, I spoke earlier about the sense that if there was one giant distribution company it would not be good, I think, because we would not have competition between them and we would not be able to benchmark each other's costs. We do engage in very active benchmarking. There are essentially six electricity distribution companies. There are six owners in some sense. What we try to do actively is make sure people are benchmarked against each other and that only the efficient companies make more money.

From your question, I think you are saying that perhaps we have not done this as well as we could have and that you could force more out of them. I would make, I suppose, two comments on that. In recent processes—and particularly in the one we are going through at the moment, ED1—we have introduced more forceful competition into the process. We have introduced what we call a fast-track process. The six companies came to us quite some time ago and we said, “One or more of you could be fast-tracked. If you put in a really good business plan, demonstrate you are really efficient, we will do you quickly, so to speak. We will go over your business plan. We will approve your price control relatively quickly”. We did that in one case. The other five we did not. The other five we said, “Frankly, your business plans are not very good. You need to go back. You need to improve and you can be one of the fast-track companies”.

Now, what that did—and it will be a long-run process—is make the benchmarking process more robust. It will make it more effective. You will have more companies competing with each other and being able to drive down costs in order to be potentially the fast-track company. I accept the point that we need to do more, but I believe we are doing that and reacting to the past in that regard.

Q251 Ian Lavery: There has been criticism that the DNOs have been overrewarded based on current incentives, and benchmarks play a role in setting these incentives. What is your view on the link between the current benchmarks and the effectiveness of incentives?

Dermot Nolan: I think incentives are key, and I stress incentives—as my colleague said earlier—cut both ways. It is not just an incentive that you get money if you perform well; it is an incentive that you lose money if you perform poorly. Incentives are key to network regulations of monopolies for the unfortunate reason, and I want to be candid about this, that they always have more information than the regulator. They are not effectively competing in a standard market. Therefore, the regulator has to force them to reveal information to us, accurate information rather than overstate their costs. Much of our approach is designed to do that.

In terms of benchmarking, I really do believe that any lessons of the past we have learned, and we have put more effective benchmarks in for the future, which will, I believe, ensure that people are not earning what you would call excessive returns going forward. The RIIO process is particularly important in this regard.

Q252 Ian Lavery: Do you agree with the criticisms that the DNOs have been overrewarded?

Dermot Nolan: Looking over the regime, no, I do not agree with that criticism. I think it has delivered very significant cost reductions. I go back to what I said to the Chair at the start that a 17% reduction, for a bigger network and a network that has less faults, is a considerable improvement over time. I do accept, however, that there will always have been points where we certainly did not make perfect decisions during that process. One point I will say, looking back at the last few years, is that in some sense—and I think this applied to almost every regulator, financial and other economic regulators—nobody expected the costs of the interest rates, which I suppose we would call the costs of debt, to stay as low as long as they did from the period of about 2008 to 2012. Thus, I would say that the returns earned on average by these network companies over that period are slightly higher than I would have wanted them to be, but that is something we have learned from. We said, okay, we set an interest rate back then and it was fixed and interest rates turned out to be lower than was expected, as happened, as I said, in every other area of the economy. What we have done for the new regime is to change that, to modify it, to say we have learned from that and we have now set a mechanism where interest rates trail the way the economy behaves. I do not think that pattern will happen again.

That was one example of where these things can happen, where you can get a situation where returns were higher than they should have been, but I would also say that we have reacted to it, we have learned from it, and we have put in place a mechanism that we hope will ensure it will not happen again.

Q253 Ian Lavery: Network companies had formerly used comparators from other regulated industries such as aviation, rail and water to inform company benchmarks. How does Ofgem draw on these sectors when setting new network cost benchmarks?

Dermot Nolan: We have looked very closely. We have a very complex benchmarking system of the companies themselves. That is our main basis, but we also do look and have dialogue with the other network regulators, notably Ofwat, the water regulator, which is the most similar example of a network company that is similar to an energy network company; also the rail

regulator and Ofcom. In particular, in the last year or so there has been an entity set up called the UKRN, which is a regulatory network designed to share information between network companies on cost of capital, on benchmarking, and so on. We are working on projects in a joint way and I believe they will inform price controls better going forward.

Q254 Ian Lavery: Finally, with regard to asset depreciation, what is your view on the networks changing from 20 years to a 45-year asset depreciation?

Maxine Frerk: That change is something that we have agreed to as part of the RIIO process because it better reflects the life of the asset. These are long-term assets, so it is right that they are depreciated over 45 years rather than 20 years. The process of changing for that will be only for new investment and it will be phased in. Clearly, there is a balance there between what current customers pay and what future customers pay, but we think the regime is doing the right thing in reflecting the length of the lives of the assets that are in the ground.

Q255 Dr Whitehead: What arrangements are in place for Ofgem to encourage the minimisation of losses on distribution from DNOs?

Maxine Frerk: Losses is a really important issue because, as you know, if electricity is lost through the system then it adds to the cost to customers and it has an environmental impact. We have consistently over time in our price controls attempted to incentivise those companies to do more to reduce losses. We historically had tried to have a quantified measure of how much losses there were and drive an incentive in that way. We had some problems with the measurement because of the suppliers updating some of the information that feeds into that process, so we are currently in a legal challenge about the way that that regime works. I cannot really say much more about that historic issue.

Going forward, rather than a numerical quantity, we require the companies to produce plans to set out what they are doing to drive reductions in losses. Again, there can either be a reward if they show particular innovative plans to reduce losses, or we can take action against them for breach of licence if they are really not delivering the reductions in losses that we would want. Going forward, one of the contributions that smart metering can make is that it will enable us to get a better handle on losses and enable the DNOs to do a better job in knowing where losses are and managing them.

Q256 Dr Whitehead: There have not actually been any reductions in losses over the last 10 years, have there?

Maxine Frerk: What our previous settlement that is currently being challenged did was give some reward to the companies, because we believe there had been some reduction in the losses that they had achieved, but we disallowed half of the money that they were claiming because we considered they did not represent real reductions in losses. I think there has been some improvement, but it remains a big challenge where we absolutely say that they need to do significantly more. We have said in our ED1 decision that their business plans did not deliver enough in that space, so they are on notice.

Q257 Dr Whitehead: On the figures you have published, certainly between 2000 and 2010, losses rose if anything. Certainly, they varied enormously between DNOs, between about 3% and 10%. They should be about the same, shouldn't they, between DNOs?

Maxine Frerk: A lot of the losses get driven by how hard you are loading your network. There may be some differences between the DNOs, but it has proved a very difficult area for us to measure exactly, which is why we currently have this legal challenge.

Q258 Dr Whitehead: The fact of the matter is that there are incentives for companies to reduce losses—

Dermot Nolan: Yes.

Maxine Frerk: Yes.

Dr Whitehead: —but there are no reductions in losses?

Maxine Frerk: It has been a very difficult area to measure whether or not there have been real reductions in losses.

Q259 Dr Whitehead: I believe in 2009-2010 there was an initial report on losses, which suggested that there should be a penalty of £140 million on companies as a result of not really reducing losses. The companies then went away and had a look at their own losses again and came up with a figure of £409 million in incentives as a result of recalculating their own reported losses, which was rather magically good, wasn't it?

Maxine Frerk: That is currently the subject of a legal challenge so it is hard for us to say very much about it. At one level we agree with you. We disallowed half of the revenues that they were claiming that they should have, and we have proposed what will be seen as handing about £161 million to customers as a settlement of this. We did not take their figures at face value, but we are being challenged for that at the minute so we cannot really say very much more.

Dermot Nolan: One of the companies is challenging us and saying that we did not give them enough money. Obviously, we are resisting that challenge and I think it is going to go to court in the next couple of months.

Q260 Dr Whitehead: Right, so the outcome will be they get a fair amount of money as opposed to a substantial penalty, as opposed to a large amount of money as opposed to a substantial penalty, is that right?

Dermot Nolan: I am not sure if I agree with that, Dr Whitehead. I am not trying to dodge this, but I might come back to you specifically on that because I have to be slightly cautious of what I say. My sense would be that they came out with something. They said, "Oh, look, we are entitled to X". We said, "You are not entitled to X at all. You are entitled to Y and you have to give money back to consumers". As a result, we are now getting sued for that. I do think we have taken

decisions—I would say this, wouldn't I?—that, given our legal duties, are the strongest consumer interest we can possibly give, but I might try to revert to you on that further if you wish to do so.

Q261 Dr Whitehead: Yes. We are talking about 2009-2010 figures here.

Dermot Nolan: Yes.

Dr Whitehead: Has anything significant happened, in your view, since then in terms of losses? In terms of your own published figures, it appeared to be the case that certainly in the decade up to 2010, as I say, not only was there no significant improvement in losses, but in some instances they dipped slightly in the middle of the decade and then got substantially worse. The variation between companies remained fairly static over that whole decade. Neither of those you would expect to happen if you had a regime in place that seriously incentivised the reduction in losses by those DNOs.

Martin Crouch: I am not sure that is really true. The losses are primarily driven by the physical equipment on the networks, which changes quite slowly. Assets are still in the ground from 30, 40, 50 years ago. If they are the same assets run in the same way, they will have the same losses. It is only by investing in new, more expensive, low loss equipment that the physical characteristics of the network change. As more generation comes on in more remote parts of the network, that will tend to drive higher losses.

Q262 Dr Whitehead: Yes. Bearing in mind that £400 million is what, £50 on a consumer bill—

Martin Crouch: Yes, it is a big issue.

Dr Whitehead: —you might think that it would be quite a good idea to incentivise the updating of equipment to minimise losses, wouldn't you?

Martin Crouch: There are now standards coming in at a European level requiring the companies to use lower loss transformers, which will encourage them to or require them to move to a network that has lower losses going into the future. They are under general obligations to promote the economic and efficient development of their network, which requires them to plan their investments taking account of the costs of losses. We completely agree it is a key issue and we are trying to drive companies to make the right investments to reduce losses over time, but they are also affected by the degree to which generation materialises in different parts of the network and the networks are used in different ways.

Q263 Dr Whitehead: Essentially, then, the incentive is a reputational one at the moment, that is all?

Martin Crouch: There is a requirement to produce a strategy and they are financially held to account for the quality of the strategy and the way they deliver against it.

Dermot Nolan: I take the point. It has been a messy area, not one perhaps as successful from our perspective as it could have been in the past. I know this sounds glib but we want to try to do better in the future.

Q264 Graham Stringer: Can I just, before I get to the question that I was going to ask, go back to the question Ian was asking? If this was not a regulated industry, at a time when you have halved the costs of depreciation and borrowing is very cheap, cheaper than it has been ever probably historically, you would expect an industry to be investing heavily. How have you managed to mirror that or have you managed to mirror that or incentivise the industry to invest at what is a wonderful time to invest, really?

Dermot Nolan: It is a good time to invest. First, we have set costs of capital that are, as you said, at a traditionally low rate. Sorry, the cost of borrowing is traditionally at a very low level. We have proposed a cost of capital, which includes the cost of debt, which is also at a very low level. As I said earlier, I think, to Mr Lavery, it will change over time as interest rates change over time. That mechanism does give a general incentive to invest in the sense that through the RIIO process we have taken what we call a TOTEX approach rather than OPEX and CAPEX. I know I am sounding a bit nerdish at this point, but we have done so in a way that is supposed to say to a company, “Right, we have given you this potential basic return. We have asked you to make investment decisions on behalf of your customers, but particularly you have the freedom and flexibility to invest and, if you deliver good outputs for consumers, you will be rewarded. If you invest and you do so poorly and you deliver poor outcomes for consumers, you will lose money. If you do not invest at all and you do not deliver good outcomes, then you really will lose money”. I do not think we are getting into the specifics of checking each minor investment decision by the company, but we are giving them a framework against a background where, as you say, it is incredibly easy to invest and if they do so and produce good investments for consumers, they will be rewarded.

Q265 Graham Stringer: I understand the difference between the RPI-X formula and the new way you are doing it via RIIO, and that you have changed the incentives. Do you have evidence yet or when will you be able to show us evidence that that extra investment that would normally be taking place in a competitive industry is taking place in a regulated industry?

Martin Crouch: The first 20 to 25 years since privatisation there was £80 billion worth of investment, so that is £3 billion or £4 billion a year on average. At the moment, the investment rate is about £6 billion a year, so there is an increase—

Q266 Graham Stringer: That is one piece of evidence, yes. I realise it is a complicated issue because also kit is wearing out, isn't it?

Martin Crouch: Yes, absolutely.

Graham Stringer: There is a demand side to it, which is why I would be interested in a more detailed explanation if it is possible.

Dermot Nolan: Right now?

Graham Stringer: No, in writing.

Dermot Nolan: Okay, we will do that.

Q267 Graham Stringer: Thank you. What I wanted to ask questions about was the EU third package network codes, which as I understand it—and I am sure I do—are there to harmonise costings so that you can get a competitive environment across Europe. How is this likely to affect the United Kingdom?

Martin Crouch: There are a range of issues addressed in the network code. Some of them are about trading across interconnectors, which is the most obvious angle. We have already implemented early some of the provisions there that mandate more efficient trading across the interconnectors, which should help our wholesale prices rather than the network issues. We are also seeing under that regime much more interest in investing in interconnectors, which we are trying to promote because that should have benefits for GB consumers.

A few of the codes have a more direct impact on our onshore existing networks. Part of the idea is it is there to standardise arrangements across Europe. That will probably have a bigger impact on the generators that are connecting into the network rather than the networks themselves. It will help to standardise some of the technical standards they have to adhere to when connecting to the networks. The aim, as addressed in the impact assessments that the Commission has done, is that by adopting common standards across Europe, the manufacturing costs of the equipment should be cheaper than if we have a GB version of the equipment and a continental European version of the equipment. It is really hard to prove that even after the event but that is the intention. There will be some costs in administering the implementation of the codes, but if the codes do have the desired impact of enabling cheaper generation through standardisation, then those costs will outweigh the costs of implementing them.

There are also some early lessons from places like Germany where they have much more renewables, more photovoltaics. They have looked at the impact that has had on their grids and in the European codes there are some provisions there where they have tried to learn the lessons from that. What are the mechanisms they need to have in place? What are the standards they need to have in place so that when a PV system connects to the grid it does not cause difficulties of tripping off at various times? Hopefully, through some of the codes, we will get advantages from learning the lessons from other people's experience as well. We need to trade off. We have been very active in the debates around the codes to try to make sure that the costs that are imposed on our networks and on our systems are moderated, are kept as low as possible, but we still get some of the benefits of having common standards and, therefore, hopefully cheaper equipment going forwards.

Q268 Graham Stringer: Thanks. In what we are told is a very technical and complicated negotiation, there are obviously threats to the UK and potential gains. What are those threats and potential gains? How will this Committee be able to judge whether the negotiations have been successful or whether they have been disastrous?

Martin Crouch: Some of the gains are already becoming evident from more efficient use of the interconnectors. In the past, sometimes we have exported to France, for example, when the price has been higher in GB than it was in France, which is counterintuitive. The new system requires flows to go from low-priced countries to high-priced countries. That sort of mechanics is already now coming through in ACER's reports, the evidence of that.

For the more technical codes around grid connections and so on, it will be harder to tell what the impact has been, and it is always the case in these types of negotiations where those who are adversely affected have a much louder voice than those who benefit. We will be tracking through the implementation and trying to monitor, both directly and through ACER, the effect of the codes. That is a requirement of the third package on ACER—to monitor the effect of the codes on markets across Europe.

Q269 Graham Stringer: Why has the talk stalled?

Martin Crouch: In the third package discussions on electricity in particular, it has been very difficult to get them to make progress. Partly that has been due to technical legal issues that the Commission has been dealing with, which, frankly, I will not profess to completely understand. Part of it has been that a decision was taken early on to have 11 different codes in electricity compared to four in gas trying to move through at the same pace. Frankly, that has slightly overwhelmed the machinery within the Commission of dealing with these things. They have been trying to deal with 11 different things at the same time and have not managed to do so. I do believe that through the comitology meetings that DECC is involved in it is now beginning to make progress again.

Q270 Graham Stringer: National Grid are leading in these negotiations, aren't they? Are they doing a good job and do they need more support either from yourselves or the department?

Martin Crouch: National Grid lead the discussions within ENTSO-E, the transmission companies' body. DECC lead the negotiations in the comitology meetings among member states at European Council level. We would see DECC as leading the actual negotiations on the codes. Grid are leading the UK input into the drafting process of the codes that it begins with. We work very closely with them and with DECC. We have regular tripartite meetings between the three of us to try to make sure we are aligned and pushing in the same sort of direction and we fund them for the costs.

Q271 Graham Stringer: As you said earlier, there are long-term implications for the public in this. What attempts are being made by yourselves or anybody else to communicate that with the public or do you think it is the wrong time to do it?

Martin Crouch: There is certainly scope for improvements there. We have tried to communicate, at least to begin with, with stakeholders, so with other industry parties that were not directly affected and with other interest groups, with consumer representative groups. We worked quite hard to involve what was Consumer Futures at the time and BEUC, the European Consumer Organisation, in some of the discussions. The consumer representatives find it really hard to get into some of the more technical discussions, which I think is evidence that it will be difficult to communicate with the public on this. It is something I think we need to continue. We need to think more creatively about how we do that.

Q272 Sir Robert Smith: I need to declare my interests in the oil and gas industry and, in particular, the shareholding in Shell that is in the register of Members' interests. On the gas codes, have you

done any cost-benefit analysis of how the new codes affect the UK in terms of the extra costs on suppliers upstream?

Martin Crouch: I am not aware that we have. We have certainly contributed to work that ACER were doing to look at the costs on a European level. There have been issues with some of the gas codes where some of the gas industry stakeholders, who were aware of the progress going through, have come back very late in the day—once the codes have been through comitology, adopted by the member states and by the Commission—and have then come after the event with a view that there are much higher costs than people anticipated. That is now being looked at and they have proposed a modification to the code that would help them. That is now being assessed.

Sir Robert Smith: They proposed the modification?

Martin Crouch: Yes.

Q273 Sir Robert Smith: Do you have a role in expressing an opinion?

Martin Crouch: As a member of the board of ACER, we get involved in the ACER view on the code. At the end of the day, it is for the European Commission to decide whether to propose modifications into the comitology committee, which is made up of the member states' representatives, who decide. We have a part of a role through ACER in advising the European Commission. It is a slightly indirect role.

Q274 Sir Robert Smith: Obviously, most EU countries do not have a production side so maybe have not been aware of the consequences of changing all the meters and all the contracts that will go in. Do you accept that there is something to be looked at?

Martin Crouch: We accept that potentially there may be upstream costs. We do not regulate the upstream oil and gas industry so we are probably not as close to that as the officials at DECC that do regulate the upstream industry.

Q275 Chair: One final question, which does not relate directly to this inquiry but is topical. We have been contacted by the consumer campaign organisation The Big Deal, about which there has been some publicity recently, suggesting that consumers may be losing out on the best energy deals because some of the comparison sites may filter out tariffs that do not pay them commission. Are you concerned by those reports?

Dermot Nolan: We are somewhat concerned for two reasons. One is the specific issue that The Big Deal has raised, and we have already been consulting on the specific issue that they raised. I would hope to have a decision before Christmas on that; possibly January, but hopefully before Christmas. That is a specific concern they have raised and we want to try to address that.

More generally, I absolutely accept that these are important issues to be resolved, but I really want, if I can, to try to give a message that consumer switching sites are things that should be

trusted by consumers. They are absolutely vital to the market and it is very important that they do give consumers trust. But once they do, I really hope consumers use them. We have seen some evidence that even in the last two weeks the use of such sites has fallen, which I think makes it doubly important to try to engender trust in them again.

Chair: Right, okay. Thank you very much and thank you for your evidence this morning.

Dermot Nolan: Thank you very much, Chair.

Examination of Witnesses

Witnesses: **Rt Hon Matthew Hancock MP**, Minister for Energy, Department of Energy and Climate Change, and **John Fiennes**, Director, Energy Strategy Networks and Markets, Department of Energy and Climate Change, gave evidence.

Q276 Chair: Good morning. Welcome back. Sorry we have kept you after the first witness session. I wonder whether you share a general concern I have. In most industries that we talk to costs are driven down, particularly by the application of technology, sometimes quite dramatically but certainly significantly. Distribution is one of the largest elements in a consumer bill over which some control can be exercised via regulating. The biggest element is wholesale prices; nothing you can do about that. But this is quite a big chunk. Transmission distribution is largely a monopoly. It does not get so much public scrutiny, certainly media scrutiny, as generation and supply because people pay their bills to generation and supply companies but they do not pay bills directly to either National Grid or the DNOs. Thirdly, some people argue that the regulator has been a bit less than rigorous in the past in the way they have treated transmission and distribution costs. Do you share the sense that we have not managed to reduce this element in the bill more than has been the case?

Matthew Hancock: I think that it is important that this area has the focus of the regulators and gets the attention that it deserves. The need to drive down costs is very clear. However, there are different ways of driving down costs and some are helpful and some less so. What we really need to do is increase efficiency. You can drive down costs through increased competition and I think we should continue to explore all options for increasing competition in distribution in particular. However, there are areas of natural monopoly or quasi-natural monopoly that inevitably make that difficult just because of the physical infrastructure. The easiest way to drive down a cost is to stop investing and that would be a mistake. Especially since a lot of this infrastructure is between 50 and 60 years-old, we are at a point in the cycle where we do need to have that investment.

The third area where we can put pressure on, as well as the increased competition where that is feasible, is on use of technology and efficiency to improve the value for money of our distribution system. I think we have to separate out cost and value for money, essentially, and drive down on value for money and make sure that the costs are appropriate and balance the need for investment and an effective service. For instance, I get as many complaints about speed of network connection as I do about costs of distribution. It is a bit like people complaining about phone masts being built and then complaining that they do not get any mobile phone signal. These two things have to be in an appropriate balance.

Q277 Chair: Given what you have just said about the opportunities for technology to promote innovation and reduce costs in a good way rather than a bad way, do you think the way that RIIO is operating at the moment is driving innovation at a pace that you think is good enough?

Matthew Hancock: I always want innovation to go faster and so do most of us. Nevertheless, RIIO is a big step forward in this area. I think it is far more dynamic as a framework than its predecessor. There are still some advantages to be unlocked. The new framework in electricity distribution that will come in in April 2015 has further advantages and is more dynamic still. We are moving in the right direction but we need to keep the pressure up.

Q278 Chair: Do you think there should be a way to let consumers get a bigger share of the benefits when companies significantly exceed the targets that have been set on RIIO?

Matthew Hancock: You need to balance the incentives. If the consumers got all of the benefit then the incentives on the companies would not be as great. Getting that balance right is always going to be a matter of judgment and I think we have it broadly right. As costs come down of course that benefits the consumers in the long run, but in order to get costs down you have to make sure that companies benefit as well in order to have the incentive structure. If there is no benefit at all to companies of bringing costs down, then there is no efficiency going to be shared. You have to get a balance.

Perhaps one of the challenges here is keeping the pressure up when there is a need to balance competing priorities. It is much easier to drive something either in Government or in a regulated monopoly or close to monopoly when there is an unambiguous direction to travel. For instance, the need to balance investment in kit with the need to keep costs down makes it harder to be unambiguous about that drive, but I think the attention that you are bringing to this area is good. We are working on a voluntary agreement with energy companies to ensure that distribution costs are split out in bills, for instance. That will be a step forward.

Ofgem has the capacity to regulate in that area if it needs to and I think that came up in the previous evidence session, but in the first instance a voluntary agreement will be a good step forward. I think this sort of transparency is important because you can too easily slip into feeling like everything is a trade-off and not realise that you can push the boundaries of the benefits to both sides of the trade-off as well.

Q279 Chair: Is the cycle satisfactory? In the previous session Ofgem were saying, “At the end of eight years we might find that returns have been rather high”. Well, from the consumers’ point of view, that is a bit late in the day. I appreciate there are obviously legal issues here, but do you think there is any aspect that might involve an earlier review of what has happened?

Matthew Hancock: These things are kept under review but, again, there is an important element of making sure that investment can be financed and can be financed with certainty. There is an advantage to certainty. There is a cost premium to uncertainty and that, again, has to be balanced on the speed with which benefits accrue to consumers. If we can get the cost to everybody down by having a period of certainty then ultimately, over the longer term and over

the period of most people's lives, that will benefit consumers. Of course, that can be frustrating in the short term. Again, I think the balance there is about right.

To take this to its ultimate extreme, if you went to an annual cycle or a spot market, God forbid, this would be much more complicated and, ultimately, much more expensive. But if you went longer than it currently is you would essentially be removing some of the benefits accruing to consumers and that would have a downside. You have to have a balance. I think we are about right. I have not seen a strong argument either way to say that the time period should be shorter or longer.

Q280 Graham Stringer: The Government has said that it wants to turn the Big Six into the Big 60,000. You are not making a lot of progress, are you? How are you going to improve your rate of progress?

Matthew Hancock: Let me get the figures. We are making progress. In fact the proportion of the retail market taken by those outside of the Big Six has more or less doubled in the last year. Do you have the figures to hand?

John Fiennes: I have not, but there have been a very large number of new entrants in and their market share has risen to 9% at the moment and they are taking a very significant portion of new switches.

Q281 Graham Stringer: How many more local producers are being plugged into the net?

Matthew Hancock: Market share is the best way of looking at this. Of course, you can look at it across the piece in lots of different ways. I do not have that figure precisely to hand. I can certainly get back to you. The Big Six that we inherited have undoubtedly been chipped away at over the last few years and that has happened at an accelerated rate. I will find the figures and come back with the exact figures. The change over the last year in particular has been quite stark.

John Fiennes: Equally, the work of the Competition and Markets Authority will be critical in this area. As the Minister says, there has been lots of work done to make sure consumers are in the driving seat for their energy bills. We have been acting to reduce switching time and we think we are on track for halving that by the end of the year. We are working on the ability to use the consumption data, with consumers' consent, to provide them bespoke quotes for switching and we are intervening upstream to help improve liquidity in the market in order to provide the ability for small generators and small suppliers to hedge their risk. There is an awful lot of work that is going on there. The key question is: is that going to be sufficient to ensure this market works for the benefit of consumers? We think there are real issues for the CMA to be looking at and we strongly support that process.

Q282 Graham Stringer: You are obviously relatively satisfied with the progress, so when is there going to be 60,000? When is the Big 60,000 going to be a reality?

Matthew Hancock: We have not put a target date on it.

Q283 Graham Stringer: That is not very satisfactory, is it?

Matthew Hancock: Frankly, the situation in 2010 was deeply unsatisfactory. I presume this is not on the distribution you are asking about but on retail companies. Is that right?

Graham Stringer: Also small production.

Matthew Hancock: Small production, right. The situation was deeply unsatisfactory. We have been moving in the right direction. We have made some significant progress that is accelerating and there is a long way to go. There are a couple of things that will help here. The first is having a more competitive market; for instance, making it easier for consumers to switch. It was painfully difficult for consumers to switch before and no attention had been seriously given to that. Now it is much easier to switch and suppliers are under an obligation to allow switching to be fast. Secondly, technology will help to expand this market and access to the networks will become easier just by the fact of it becoming easier to use technology to increase competition to consumers. So that will make a difference. Also, consumer awareness, especially as prices are higher, is driving attention.

John Fiennes: Let us also be clear that the actions that have been taken will greatly enhance independent generation and small-scale generation. We have the small-scale feed-in tariff, which has been going great guns. We have the renewable heat incentive, which promotes renewable heat. Through the capacity mechanism and the CfD, what you have are instruments that are designed to allow for independent generators to come into the market and we have been quite encouraged by the response for that. This is more large-scale, but what it means is you have a larger diversity of companies. They are better, bankable products as well as being cheaper for consumers. We think the picture is changing as a result of the action the Government has taken in quite a significant way. The issues that you are talking about are more on the retail end and are consumers getting the deal—

Q284 Graham Stringer: I was talking about generation—

John Fiennes: You were talking about generation?

Graham Stringer: —and community production and I was leading up to the question: do you think there are any more barriers that could be removed that would enable community production to be engaged more easily into that?

Matthew Hancock: One key thing is the connection time of production as well as the connection time of demand. I think, within electricity in April, the time to connect incentive will help to ensure that the distributors have a commercial incentive to make sure that connection is faster and, indeed, they will have a requirement to do so. The frustration of small-scale producers, and some medium-scale producers, at the speed of getting a connection has been a problem that is being addressed.

John Fiennes: It is definitely an active area of work for us. If the Committee has evidence that there are barriers that have not been addressed, I would have thought the Minister would be interested to know.

Q285 Graham Stringer: Are the charging methodologies a barrier to small producers?

Matthew Hancock: In what way?

Graham Stringer: I don't know, I was hoping you would tell me whether there were or there were not. It was a genuine question. Are they a barrier?

Matthew Hancock: Let me answer it this way. Of course, the fact that there has to be physical change means that there is a cost to that and so, in the same way that the cost of any production is a barrier to it taking place, there is a real physical cost and somebody has to bear that. Then there has to be a balance as to which costs are borne over the network by everybody and which costs are borne by the individual who directly benefits. One of the things we are trying to do here is ensure that we get that balance better by having a second comer regime.

Graham Stringer: Sorry, I missed that; by having a—

Matthew Hancock: What is called a second comer regime. In the past the issue has been that either the network as a whole can bear the costs of putting connections in or potential connections in place. The downside of that is you can end up with some stranded investments if the demand is not there, but the benefit is you get cheaper connections where the need is. That is one option. The alternative option is that the first person in a locality that needs the connection pays for it. The problem is that puts a very high burden of cost on the first person who wants a connection in that place but then a much lower cost on everybody who subsequently comes. We are putting in place a regime to allow that cost to be spread so that the burden does not have to be across the whole network but can be across a more appropriate group of people.

John Fiennes: Could I add to that just briefly? In a way, when we are talking about the financial value of charges, obviously this is an area where Ofgem has a key role but there are two issues. There is the overall level of the charge and whether that is disadvantaging particular projects. When we are currently setting administrative support levels we take into account the costs that projects face to make sure we have done it reasonably. In the future, that will move more towards a competitive process, which will be good, and that will make sure that we find the right level.

The second issue that people do talk about is: what about the volatility of these charges and does that allow people to plan their business with sufficient certainty? If you are a small undertaking, then the risk of a change there may be less easy to absorb than if you are a larger business. There is a balance there between the need for some flexibility to provide the certainty of investment on the network side, which we have been talking about earlier, but also fair treatment of the people having to pay the charges at the far end. Ofgem is working on a way of reducing the volatility and giving more forward certainty for a number of months for people rather than for the short period they have at the moment, which we think ought to improve. It certainly is not the case that we have, as far as I know, community groups saying that this is a particular issue for them. If there was, I think we would look at that again.

Q286 Graham Stringer: Just changing the focus slightly, the Energy Intensive Users Group have said there are significant indirect costs that they have to bear because of coupling up renewables into the system. Do you think those charges to the energy intensive users is justified?

Matthew Hancock: You go first, John.

John Fiennes: Obviously energy is a critical component for them and, because the Government recognises the risk of carbon leakage if people relocate and you do not improve any environment outcomes, there have been some steps taken to reduce the burden on energy intensives by way of compensation for carbon price floor and contract for difference and so forth. There is absolutely an issue there about the level of financial burden on mobile energy intensive businesses and the Government has responded to that.

Matthew Hancock: What I would say is it comes down to this balance again between, when you need a connection, is it the whole network that pays, in which case the energy intensive users who are already connected have to bear a part of that, or does the individual who is being connected pay. The more you move the dial in one direction or the other, either the person who is connecting then complains that their costs go up or existing customers bear the costs.

What we have to come back to is that there are two separate questions. One is the distribution of who pays the costs and the second is whether we can reduce those costs and improve the service, have faster connection times. You have to separate out these two questions because one is a sort of batting a ball back and forwards between different groups of people and inevitably people will always make the case for their position and I understand that, but the second is how you can reduce connection costs overall, no matter who pays them, and improve connection times. I hope the incentives in the new system and the requirements in it will put more attention on them reducing those overall costs, which are the actual economic costs that somebody has to pay.

Q287 Graham Stringer: Just moving to the domestic consumer, do you think they should be told, either in their bills or separately, about the costs of renewables within the network costs?

Matthew Hancock: The costs of renewables?

Graham Stringer: Yes. Not the actual costs within the charging system but the extra charges that the distributors necessarily have to bear because of the connections. At the moment that is not transparent. Do you think it should be transparent?

Matthew Hancock: I am generally in favour of everything being transparent, broadly, unless there is good reason not to, and in this area the clearer we can be about the makeup of bills to consumers the better. Separating out which distribution costs are due to which technologies is difficult.

Q288 Graham Stringer: But not impossible.

Matthew Hancock: Well, it is not impossible to get a measure of it. If a particular connection or strengthening the grid in a certain area both helps to allow for new renewables in a geographic location but also helps to allow, for instance, for an urban expansion in the same area, logically it is not straightforward to work out who bears the burden of those two costs. It is not possible to be 100% accurate. That does not mean you could not make some kind of estimate and we are

moving in this direction in terms of being more transparent about distribution costs, but it is one step at a time.

John Fiennes: There is a series of nested information here. For the real enthusiasts there will be reporting on the levy control framework, talking about what we bought, what we spent for it and so on, and we have had this conversation with this Committee before. There is masses of information about what is in the business plans for these companies and what they are being paid, but that is for people who are properly enthusiastic and want to go for it. The question of how much you put on individual's bills, we think the evidence shows that people care about what energy is costing them and if they can get a cheaper deal.

We do think there is scope for more transparency there and we are working on a voluntary agreement to do that but, the Minister is absolutely right, it is very difficult to disentangle the distribution elements. Quite apart from the issues that he has talked about, what is the counterfactual? If you were not connecting a low carbon generator in a particular place, what other sort of generation would you have and what account would you make of where that would be? If you are not careful what you get is a level of spurious accuracy on those things and we certainly would not want to burden the bills with an explanation about what that is and what it is not.

Q289 Graham Stringer: A final question from me. National Grid have raised concerns about the process in the Government's Planning Act, which they believe inhibits connections. They have suggested a fast track for projects that are not major projects. Would the Government be supportive of that?

Matthew Hancock: I am always willing to look at everything that can speed up planning, but we also have to be consistent with the understandable local amenity and the need to take local views into account, especially when things are not counted as major projects and, therefore, of national interest and national importance. We rightly have a localised planning system. Again, we have to strike the right balance. What can be done often is the speed of planning decisions, whichever direction they go, be sped up and we have a huge amount of work on to try to improve that.

Q290 Graham Stringer: A quick decision of no as well as yes is often as useful to the company to know what is going to happen or not happen.

Matthew Hancock: Absolutely, but I would not limit the need for that to just connection and kit. That applies across the piece and there is a whole load of work in Government to try to speed that up.

Q291 Sir Robert Smith: Many of my constituents do not have access to the gas grid and, therefore, miss out on the benefit of dual fuel deals and have to go for more expensive options to heat their homes. Do you think Ofgem are ambitious enough with a target of 80,000 extra homes connected to the grid in eight years?

Matthew Hancock: The expansion of the gas grid is important and the gas grid is going to be used for a long time to come, even as we move to low carbon generation, and so continuing to connect is important. There is a real cost of expansion of the gas grid, especially in rural areas. Like you, many of my constituents are off grid, including my own constituency home, so I suppose I have to declare an interest.

My interest would be very much to get more on the grid, but we have to be realistic about the very real cost that that poses and, again, it comes down to a question of who bears the cost. There would be considerable additional amenity to my constituents to get connected to the gas grid. However, there is also considerable cost in rural areas, and the question of whether that should be borne by all consumers or just by local consumers who benefit from the amenity is a balance that has to be brought. The system is designed to try to support connection where it is economically viable and to try to expand the grid at a reasonable rate.

Q292 Sir Robert Smith: Do you think Ofgem's attempts to see what extra protection can be brought to those relying on other sources that are not on the gas grid is something that we need to support?

Matthew Hancock: Yes, I do. I think there is a lot of work to be done here and Ofgem are on it. For instance, encouraging people to buy their oil early if they are on an oil-based system, to stop bottlenecks in oil supply when suddenly the weather gets worse and when the distribution is also more difficult, is very important, and something that we as constituency MPs can all play a part in. Trying to make sure that the distribution systems for heating oil are resilient and reliable is important.

Again, the rollout of technology has a big part to play here in two areas in particular in the retail market. One is in improvements in what you can call finance technology if you want to give it a posh name, but it means direct debit payment, which increasingly is being used in the off-grid heating oil market, rather than a big lump-sum bill in the middle of winter when suddenly your fuel tank is empty. The second is connections of oil tank level readers directly to the companies, which happens both with gas and heating oil. The technology is now coming on stream and I think the internet and things will make much cheaper the communication between individual gas tanks, individual oil tanks and the supply companies so that although the distribution is physical, as in human, by lorry rather than down a tube, it can be much more automated.

I do not know the exact numbers, but I know that some have switched to a system where they have a piece of kit that talks to the internet on their oil or gas tank, that talks to the supplier, say Calor Gas or one of the other companies that are available, and then bills automatically. You, as the consumer, do not have to phone them up when your tank is getting low and they can pre-plan their distribution and therefore keep the costs of distribution down, because they can say, "We know that in this village there are 20 people who could do with a quarter of a tank", and so make one visit rather than having to make 20 when they got down low and, likewise, whether it is gas or oil. Again, there is the opportunity for technology. Incentivising the rollout of that technology is important. The incentives are already there in the cost reductions that distribution companies can make, but this is an area that is ripe for improvement.

Q293 Sir Robert Smith: Do you think there may be a role for Ofgem in consumer protection and vulnerable customer policies?

Matthew Hancock: Yes.

Q294 Sir Robert Smith: On the network charging, do you share the concern of some of our witnesses that the complexity of the network charging is going to be a hindrance to people competing by trying to work out their pricing structure?

Matthew Hancock: These things are inevitably relatively complex. It always costs to understand a complex system but there are good reasons for that, too. Yes, but with reasons.

John Fiennes: The volatility is clearly an issue, which I talked about earlier, that people have logged with us. When we look at the barriers for competition, things that people mentioned was more about the credit and collateral arrangements in the market where we have done some work in talking to the industry about what that now means, but these are all things where the Competition and Markets Authority will be looking. I am sure if they felt there was an adverse effect on competition flowing from these things then they would do something about it. It will be interesting to see what they make of the relative barriers from charges and patronisation and other features of the market that may be going on there.

Q295 Sir Robert Smith: The other issue raised is this historic legacy of 14 distribution companies and 12 gas regions all charging different prices. Ofgem are doing some work on how that could be levelled or have uniform pricing. Would the Government be at least sympathetic to looking at the results of that work to see if there was a policy decision to be had there of a uniform price?

Matthew Hancock: These things are always worth looking at. Again, these differences in charges reflect differences in costs. A decision to go to a national unified cost would have winners and losers and it would involve some of those in areas of the country that are cheaper to connect paying, by cross-subsidy, for some people in areas of the country that are more expensive to connect. That would be a reality of a single national charge. Some of the locations of the winners and losers are not what you might expect. For instance, the south of Scotland has relatively cheap charges. Scotland does not have a particular problem here although, of course, the north of Scotland is the most expensive for easy-to-imagine geographic reasons.

Having said that, in the move to RIIO we have not only brought down these charges but significantly flattened the charges across the country. For instance, in the north of Scotland there has been a £27 reduction in the annual average domestic charge, whereas in the south of Scotland there has only been a £4 change, but that is because it is a reduction from £170 to £143 in the north as opposed to an increase of £82 to £86 in the south. I have picked on the two Scotland sub-areas precisely because that shows that some of the winners and losers are slightly unexpected in this area.

Q296 Sir Robert Smith: But I suppose they are also just historical of where people chose to set up distribution companies.

Matthew Hancock: The areas may be historical but the charges are real because they reflect the real difference in costs in different parts of the country. It is true that which part you are in is determined historically, but anything that has subnational regional variance is always going to have boundaries in that way. What I am saying is that this policy proposition is not a free hit. It reflects a real difference in cost. There are arguments on both sides as to whether you would want to make that nationally the same. Even with the cost of stamps, it costs more to deliver letters to more remote parts but we still have a national price for stamps. It is a perfectly reasonable policy argument but, equally, there are arguments just as reasonable in the opposite direction.

Q297 Sir Robert Smith: You touched earlier on what should be in the bill and we have this constant battle between clarity and information. Do you think the actual overall network charge should be in the bill or do you share Ofgem's view that the consumer does not want that detail?

Matthew Hancock: We are working towards a voluntary agreement to put this in the bill. Ultimately the decisions over the regulation of billing are for Ofgem, but my bias is to trust people with more information rather than less.

Q298 Chair: Some of the evidence we have had has suggested there is a difficulty trying to evaluate network costs because there are no real benchmarks that can be used. Do you think that is an area where there might be something that could be improved?

Matthew Hancock: There are benchmarks. There are international benchmarks, for example, and if you look internationally at our friends across the European Union then you will find that our network costs are below the EU average and only Cyprus and Malta pay less as a proportion of their electricity bills. Given that our costs are below average, our network reliability is seventh out of all member states for continuity of electricity supply. Of course there are benchmarks. Can benchmarks be improved? Yes. Should we improve them? Yes, we should. I do not think it is accurate to say you cannot benchmark these costs.

Q299 Chair: The change from depreciating network assets over 20 years to 45 years, is that a neat way of transferring the burden from current consumers to future consumers?

Matthew Hancock: I would not respond in the same pejorative way as you put the question. The truth is that interest rates have come down across our economy and the flipside of a lower interest rate is a longer discount period. That gives a reasonable explanation.

John Fiennes: Packed up in the question is an assumption that the future consumer is being asked to pay for something for which they are not going to benefit. For assets that last as long as this, asking today's consumers to pay upfront for the whole thing when the benefit is going to be reaped that far into the future probably is inter-generationally unfair to start with. We think the longer depreciation period creates more fairness between the people who are receiving the benefits over time because it aligns better with the asset lives we are talking about.

Q300 Chair: It is always remarkable when fairness happens to be served by reducing immediate costs. That is a happy circumstance. Is there a danger, however, that the regulatory system we have may incentivise these sort of accounting quirks rather than actual innovations in the way in which distribution takes place?

Matthew Hancock: Well, changes to accounting systems always have to be scrutinised properly to make sure they are reasonable but if, as you say, this sort of change increases fairness also because it matches more accurately the lifetime of the assets, the lifetime over which it is paid, then it is a reasonable change. If that change is incentivised by the structures, which I think it is, that is no bad thing. Do we need to make sure that real lifetime costs are also brought down? Yes, absolutely we do.

John Fiennes: I do not think the characterisation of this as an area where there is no innovation is fair. You have the smart meter programme rolling out. You have the smart grid work, which has benefited from something like £500 billion worth of investment, which is now paying direct dividends into the RIIO distribution process. We have more about this coming on 1 April next year for the network innovation competition, so there is a lot driving there. If it was the case that we felt that what was being done was trammelling that innovation then that would obviously be a concern, but that is not a picture that we recognise. There is a lot going on.

Q301 Dr Whitehead: The rollout of smart meters has been characterised by the Public Accounts Committee as something that appears to be not particularly noticed by distribution companies in terms of what they could be doing to reduce leakages and track losses. Is there anything the department is intending to do to make that link a firmer bond as the rollout takes place?

Matthew Hancock: The rollout of smart meters is a very important part of modernising the way that electricity consumption occurs and we have talked about it at this Committee before. I am very enthusiastic about it. Making sure that we get all of the benefits from it is important. Of course, the direct relationship is with Ofgem rather than the department. Nevertheless, drawing attention to the benefits to all different parts of the grid of changes to consumer behaviour that you can get through smart meters is important.

The smart grid programme, which is obviously interconnected with the smart meter programme, is something that the department, as well as Ofgem, the distributors and, of course, transmission, are heavily involved in. This is a massive change and it is a huge challenge to all parts of the system. Obviously it is inaccurate to say that any part of the system is not engaged in moving to the smart grid, but there is a huge amount of work still to do and there are big benefits to be reaped. We cannot sit back and wait for it to happen because it is happening because of the changes in consumer behaviour.

Q302 Dr Whitehead: Are you anticipating, as the smart grid system rolls out, the percentage of losses by DNOs, particularly in electricity distribution, will fall very substantially?

John Fiennes: I do not have the number for the projected loss, as it turns out, but I know that, of the £6 billion benefit projected for the programme as a whole, £1 billion of that is benefit to network, about half of which is avoided losses. So there is about £500 million worth of benefit in

there. That is a material fall, but I do not have the percentage impact number in my head I am afraid.

Q303 Dr Whitehead: Is it the intention of the department that that avoided loss should be returned to the customer in terms of lower bills as a result of the lower losses that will be a component of the DNO bills?

John Fiennes: Absolutely. The RIIO process is designed to incentivise these companies to do that and, where they make improvements, those are shared with the consumer.

Q304 Dr Whitehead: Yes, but I think you would agree that the system at the moment is that DNOs are getting substantial payments to reduce losses but are not actually reducing losses. Is that going to change?

John Fiennes: I am not sure I would agree that they are being paid to reduce losses in a way that is not reducing losses. Any electricity system will have a certain amount of losses given the physics involved. There are a number of incentives designed to ensure that the companies are efficient and Ofgem is keen that there should be robust strategies in place to manage those. I do not think we would accept that there were things that were being done that were being wasted on that.

Q305 Dr Whitehead: The fact of the matter is, in terms of the period certainly between 2000 and 2010, which was the subject of a revision by the DNOs of what their losses consisted of, there was an initial review, so I understand, that awarded DNOs something like £100 million in incentives as far as their losses were concerned and then the DNOs revised their calculations on what their losses were and they got another £400 million. But over the period, if you look at what the losses were early 2000, if anything they have risen between then and to date rather than reduced. That is £50 on the bill, isn't it, with that £400 million going to DNOs for recalculating, unilaterally, their own losses but then coming out with a performance over the period that doesn't appear to indicate that any losses have been reduced. Furthermore, the differential in losses between DNOs is a factor of 7% or 8%, isn't it?

John Fiennes: There is a complicated issue, which goes back a number of years, about the interface between the quality of the settlement data that suppliers generate and what that says about the losses and how that interacts with the losses incentive in place and the previous price control regime. Now, this is a matter for Ofgem as the independent regulator. I do not recognise the £400 million number. It may be I have misheard you. Ofgem arrived at a decision in March of this year seeking to strike a fair balance between the need for not reopening a regulatory settlement that was done on a particular basis before, but also the need to provide value to consumers. As a result of that, I understand £161 million was returned to consumers, which is an average reduction of £3 on the electricity bill. We welcome the fact that that money is being returned to consumers.

Q306 Dr Whitehead: With respect, that was an apparent reduction in an amount of money given out to DNOs on an original self-assessed amount, which meant that the self-assessed amount was reduced by £161 million. The idea that that was returned to customers is a little strange, isn't it?

John Fiennes: There was an investment plan linked to the regulatory settlement in that period and Ofgem's job was to strike the right balance between the consumers who have an interest in paying as little as they can but also the need to maintain a fair approach to settlements that had been made in the past.

Q307 Dr Whitehead: The central point, certainly in terms of going forward to what Ofgem is proposing over the next period in terms of incentives to reduce losses, is that to date it does appear that incentives, albeit perhaps to some extent clawed back, have been provided for no reduction in losses—if anything an increase in losses—and the 2015 regime appears to produce no significant increase either in incentives or indeed in penalties as far as shaping further loss reductions for the future are concerned other than the question of what happens when smart grids come in.

John Fiennes: My understanding, although you are going to reach the edge of my knowledge about the detailed RIIO settlement, is that Ofgem have adopted a different approach for the distribution settlement that comes up in the light of the complexity of trying to base this on settlement data and all the complexities that I have been talking about before. I think they would say that they have learned a lesson from that and they have changed accordingly.

Matthew Hancock: But there is an important point here, which is that, since losses are never going to be zero, the goal has to be to reduce losses from what they otherwise would have been. Therefore, there is a level of incentive payment that is appropriate for any given level of losses. You can always say, but it is an absurdity to say, that there are losses yet there are incentive payments. To argue that, because there are losses, there should be no incentive payment is to miss the point. The point is to incentivise better performance than otherwise would be in terms of losses and then to make sure that when things are improved the benefits are spread appropriately.

Q308 Dr Whitehead: Yes, but the “otherwise” benchmark surely, while accepting that losses will never be zero, is what has happened over a period of time in terms of the percentage losses that occur as a result of distribution. Certainly the figures show that there has been very little movement in those losses over a period and indeed the variation in losses between different DNOs—now possibly accounted for by different age of equipment and replacement rates and various other things—however, is in the order of 7% to 8%. That is, the best performers are about 3% but have been consistently about 3% over a period and the worst performers are about 10%, consistently 10% over a period. That seems to tell a rather different story than the simple idea that, since you can't get losses down to zero, you need to incentivise people to do a little bit better.

Matthew Hancock: No, but there is a physical difference as well. Losses occur because of physical properties of the electricity system, of which distance is one of the biggest, but the quality of the kit, which is obviously heavily determined by how new it is, is also another one. The fact that these figures do not move very fast tells you that there is something innate in them. For instance, bigger geographical areas are going to have higher losses and there is nothing you can do about

that. Even if they had the worst kit, you would still expect to have losses even if you managed it as well as you possibly could in the bigger areas. I think it is pretty unfair on the distribution companies in more sparse areas to say, “You have higher losses and you have done nothing about it compared to the low loss areas and, therefore, you are consistently and repeatedly failing”. That is not fair.

Q309 Dr Whitehead: No, but you have done nothing about it over a period of time. Admittedly they will be different losses, but if the losses remain static over a period of time, even taking into account the differences that you have mentioned, that is something to be concerned about, isn’t it?

Matthew Hancock: Obviously it is better if losses fall. However, as kit gets older you would expect losses to tend to rise and having that investment programme to replace old kit is a value-for-money judgment because you have to have big investment in order to deal with it.

Q310 Dr Whitehead: Where do we stand on international benchmarking our losses? Do you know about that?

John Fiennes: They are quite hard to compare. I would be quite cautious about them, but a recent country ranking based on IEA, OECD and UN data said that we were lower losses than most others. If the first country enlisted the highest losses, we were number 101 out of 185. So we are in the top third with a similar level to Ireland, Norway, Sweden and Italy.

Q311 Sir Robert Smith: The EU third package network codes are all about trying to harmonise network charging and capacity allocation across the member states. How does DECC assess the impact of these policies and look at the interests of the British consumer when they are being implemented?

Matthew Hancock: You go first.

John Fiennes: The aim of the network code is to make sure that, in effect, cross-border trade is able to happen on a lot more efficient basis, which ought to be welfare enhancing. There is a great deal of detailed work going on and we rely to a great degree on the expertise of National Grid and Ofgem in making our assessment of these codes. As your previous witnesses said, there is an initial process between the system operators to come up with proposals that the Commission then examine and those are considered, ultimately, in a comitology process. But, overall, we think they are sensible improvements to establish the single market that we think will provide significant benefits to consumers overall.

Q312 Sir Robert Smith: What is your view of National Grid’s performance in that process?

John Fiennes: We think they are very well connected and respected in Europe and, consequently, they are very effective defenders of a right market-based solution.

Matthew Hancock: No pun intended I am sure. The big issue for us in this is interconnection, which is obviously a matter of transmission rather than distribution. We think we have a pretty robust distribution regulation system, especially the new system rolled out for gas last year and for electricity next year. There are always improvements that can be made but, nonetheless, for our purposes, we think that is pretty good. The big opportunity here is to push for more interconnectors. We are doing that domestically and making progress with the Norwegians and with other EU counterparts. We are also pushing for that to happen between other EU states, both within and with neighbours to the Union. Even though that will not directly affect our market, it will improve energy security and it will make the system more competitive and, therefore, you would hope to have lower prices. As Ofgem were talking about, making sure we have a well regulated system of flow at the interconnectors is an important part of that. For me, interconnectors are the exciting opportunity here in terms of what happens domestically. Ofgem are well placed, along with Grid, to manage that.

Q313 Sir Robert Smith: Are you aware of the concern in the gas upstream market of the impact of the gas codes on costs?

Matthew Hancock: Yes.

Q314 Sir Robert Smith: Do you share that concern?

Matthew Hancock: There is a balance to be struck, as with all of these things, and there are strong arguments in each direction. I think most of the corporate interlocutors in this debate take the position that is dictated, understandably, by the effect it will have on them and I get that, but we have to balance the needs of different corporates. I understand the problem but I hope that we can work through it in a reasonable way.

Q315 Sir Robert Smith: Do you think there is still scope for some kind of accommodation within the European system?

John Fiennes: I personally do not think it is practical to reopen the detail of the code at a European level. The conversation earlier highlighted the fact that we are unusual in having the upstream as well as the downstream. We made attempts late on in the negotiation to see what could be done about that and, at that stage, the answer was it was not possible to secure a change. So we are where we are by way of the law. That does not mean in the future it will not change, but the task now is to look for a sensible way forward given the position that we are in. There is now a fairly intensive process going on between ourselves and the affected industries and National Grid to find a pragmatic way through that is reasonable. We now need to work with some of the people we have at a European level rather than hoping that we are going to reopen those at that point. Given, as was talked about earlier, the extent to which the Commission and other member states are working on all of the other network codes and the market codes going on at the moment, the prospect of reopening that does not seem to be very high.

Q316 Sir Robert Smith: Will those costs feed through to consumers?

Matthew Hancock: Not if they can be managed. I arrived and looked at this quite early and pushed back quite hard and the difficulty is that reopening this discussion would reopen a whole load of other things that landed much more in the UK's favour. When you ask a question on the impact on costs you have to look at the package as a whole and, in any negotiation, some points come out better than others. You have to look at the benefits of the package as a whole. I think that the benefits of the third package will be positive for the UK and for UK consumers, but there are elements of it that I would have written differently if I had held the pen. That is what a negotiation to get something that has an overall benefit feels like.

Q317 Sir Robert Smith: With the new Commission, what do you think should be on their agenda for taking EU energy policy forward?

Matthew Hancock: Interconnectors, interconnectors and more interconnectors. Energy security of supply has gone up the agenda rapidly, even over the last six months. Given that we have landed our EU 2030 package in a way that the UK was very happy with, with an ambitious overall carbon target but then no binding national targets on how to get there, that was very positive and I commend the work of the department and the Government in getting that landed. That having been done and, of course, with the consequential work towards Paris next year, I think the new commissioner now needs to focus on ensuring that we have strong security of energy supplies and that we reduce our dominance on Russian gas in particular, but also benefit from the advantages of stronger electricity inter-linkages internationally as well, including to North Africa. Making sure that the market functions well is a matter both of a strong regulatory structure but, crucially, it is a matter of physical interconnection as well and so I think that is a very important item on the agenda in order to increase the security of our energy supplies.

Q318 Dr Whitehead: Is interconnectors a public-good investment or a merchant investment?

Matthew Hancock: Both. Clearly a more competitive electricity market and a freer flow of gas, to a lesser extent for us because we have strong supply from the North Sea— both the British but also the Norwegian North Sea—is good for consumers because it means that you get access to the market wherever it is cheapest and that impacts on prices. It is also good for security of supply. Of course, building interconnectors need to be paid for and so it needs to be a decent commercial proposition to those who are going to pay for them. We do not propose to build them directly from the Department for Energy and Climate Change, although I am sure that we could if we chose to. Therefore, it has to be a decent market proposition as well.

Q319 Chair: I very strongly welcome the outcome of the 2030 targets. As you say, exactly the right package and I am glad that we got what we were pushing for on that. I hope the logical corollary of that will be moves to strengthen the EU ETS as well, which I know we are also—

Matthew Hancock: That was part of the conclusions, absolutely.

Q320 Chair: Just on interconnectors, I should declare an interest as a director and shareholder of Eurotunnel, which is building an interconnector at the moment. I am very glad to hear again your strong endorsement of what is a whole EU-wide policy now. There are consequences, of course, for

transmission in the UK once you build an interconnector. I think Nemo, which is the one National Grid want to build themselves from Belgium, has some issues about pylons going across East Kent to get to the ring round London. Is there a risk that, even though we may have investors who are now quite keen to invest in interconnectors, there may still be some planning and logistical barriers to getting this done?

Matthew Hancock: Of course there are going to be planning and logistical challenges. I think of interconnectors in the domestic context, which is the context I care about most, as a power station. They are effectively a power station that can supply power into the domestic grid. Now, they also happen to be points that can be big energy demand as well. They can be either a positive or a negative power station. That is the best way to think of them and they come with the same impacts, especially on transmission, as a new power station built offshore; very similar to offshore wind in that way. Of course, they have the consequence that the energy can flow the other way. That is an export, and so positive if we can afford to send it, but if we need it then we can have it.

Q321 Chair: By definition, an export that is going at the time to a country that is willing to pay more than is—

Matthew Hancock: Precisely, and they are very good for security of supply because it means that it increases the zone in which there is a price response to a supply shortage rather than a quantity response. Although I would rather have no supply shortages and a balanced system all of the time, given that this is an inherently uncertain world that we live in the first best response to a tightening is for a change in price rather than an absolute shortage. This is the subject of a whole other hearing, I imagine, but there is action that we are taking across the piece on that, including in order to do it in the most cost-effective way possible, but interconnectors have a positive energy security impact as well as improving, on average, the price available by making the market more liquid.

Q322 Dr Whitehead: Is there not a problem that, as interconnection increases from our present 3.5% or so to, say, more to the European norm, logically price variations between the various ends of the interconnectors reduce and, therefore, the ability of an interconnector to make money for itself through what happens at the moment, which is mainly arbitrage on differential prices, reduces? Therefore, merchant investors may think up front that that is an asset that will waste as it is installed and certainly as it is installed alongside others and, therefore, may be rather put off from the idea of investing simply on the idea they are going to make a lot of money on it.

Matthew Hancock: If you pursue the logic of that argument then there would ultimately be no trade at all because all of the gains from trade in any market would be taken advantage of and, therefore, the prices of goods and services in different markets would equalise and so there would be no need particularly to trade. I do not think that is—

Q323 Dr Whitehead: I am not suggesting that. Are you absolutely happy that the entire programme of interconnection, which I strongly support, will be able to be secured solely through people coming and investing lots of money in interconnectors because they think they are going to

make a lot of money out of them or is there not the possibility that a route B may be necessary that needs an element of public-good investment in order to secure interconnectors for our energy security over the next period?

Matthew Hancock: I do not think at this stage it is necessary to publicly subsidise interconnection. There is a clear revenue stream to make them a commercial proposition. I think the impact on price differentials will be a positive one, but there are different energy systems in different countries and so there are always going to be price differentials at the margin and that is where interconnectors provide a return. In France they have a much higher proportion of nuclear, so they have a much higher base load, but that means it is harder for them to manage peaks and troughs. We had 15% renewables last year, which has an intermittency that is based on factors outside our control and that are less predictable. This will mean that at the margin there will be differentials in the two systems all the time just because of the nature and structure of the markets. Those can be mitigated by interconnectors but, until you have as much interconnection as there is within a domestic system, I can see interconnectors mitigating price differences but I think it is unlikely that they will remove them altogether.

Q324 Sir Robert Smith: Do you think the lessons have been learned from the early gas interconnection, when gas flowed the wrong way in terms of price signals because of other constraints in the market in terms of security obligations on those at the other end? While the price should have sent the gas to us, we sent gas abroad because the European companies had such a strong obligation. Is that something that could happen in the electricity market?

Matthew Hancock: I thought Ofgem gave a pretty good account of the changes that have been brought about to make sure this does not happen.

Q325 Chair: Just one final and unrelated question but topical. The Big Deal, consumer campaigners, have been in touch with us and obviously there has been a lot of coverage in the media about what they said—that consumers may lose out on the best energy deals because the comparison sites may filter out tariffs that do not pay commission. Is that an issue that concerns you at all?

Matthew Hancock: Yes, of course. We are looking at it very closely. The question of consumer regulation is an important one. If activity that has been illegal has happened then undoubtedly action will be taken. If activity that has been unreasonable has been undertaken then we will certainly look at it.

Chair: All right. Well, thank you very much for your time.