House of Commons

Energy and Climate Change Committee

Oral evidence: Implementation of Electricity Market Reform, HC 664, Tuesday 13 January 2015

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Written evidence from witnesses:

- National Grid
- Low Carbon Contracts Company
- DECC

Watch the meeting

Members present: Mr Tim Yeo (Chair); Dan Byles; Albert Owen; John Robertson; Sir Robert Smith; Graham Stringer

Questions 172- 310

Witnesses: **Mark Ripley**, Director of Regulation, National Grid, and **Neil McDermott**, CEO, Low Carbon Contracts Company, **Rt Hon Matthew Hancock MP**, Minister of State, and **Jonathan Mills**, Director of Electricity Market Reform, Department of Energy and Climate Change, gave evidence.

Examination of Witnesses

Witnesses: **Mark Ripley**, Director of Regulation, National Grid, and **Neil McDermott**, CEO, Low Carbon Contracts Company, gave evidence

Q172 Chair: Good morning and welcome. Thank you very much for coming in to the Committee. Just for guidance we are going to move on to our next witness, who is the Minister, at 11.05 am, so we have just over an hour to get through this topic. I think that should be sufficient, but I am asking everyone to bear that in mind because after that we are after a certain amount of time pressure.

Could I ask to begin with a general question? If you would give us an overview, each of you, of your respective roles in relation to the implementation of EMR.

Mark Ripley: Certainly, yes. My name is Mark Ripley from National Grid. I am currently Director of Regulation with National Grid but, as the Committee may recall, I have been quite heavily involved with EMR since 2011 when the Department of Energy and Climate Change asked us to be the delivery body and I led our project for the development of our EMR arrangements.

During 2012 and 2013 it was largely about working with DECC and the industry and the development of EMR and then, through 2014, the development of our capability to deliver EMR systems and processes through to our implementation during the latter part of last year and ongoing.

Neil McDermott: My name is Neil McDermott and I am the CEO of the Low Carbon Contracts Company and the Electricity Settlements Company. The Low Carbon Contracts Company came into being earlier on in 2014, as did the Electricity Settlements Company. The two companies are intrinsic in the delivery of EMR, the Low Carbon Contracts Company being responsible for the contract management for the CFDs—the Contracts for Difference—the second key role there being the setting of the supplier obligation levy, being the moneys that we will collect from suppliers to then pay generators under the CFDs, and third is the settlements of the collection of the supplier moneys and the payment of the moneys to low carbon generators in the United Kingdom.

On the other hand, the Electricity Settlements Company is involved in the capacity market and is primarily involved in the settlements of the capacity market contracts, but in Q4 last year was involved with National Grid and ELEXON in collecting collateral for credit support ahead of the December auctions.

Q173 Chair: What would you say the main difficulties are that you faced in the last year?

Mark Ripley: The last 12 months have been very busy, which I think we always expected, and the legislative process came to a conclusion in July of last year before the summer recess. So it was quite a big push to get the secondary legislation through, and then we had a relatively short period in which to move into pre-qualification. The time scale was challenging but I would say industry, DECC and ourselves, worked very well together. It was extensive engagement; a lot of stakeholder engagement to get to a successful pre-qualification with the capacity market and an auction. So the challenge was that it was a tight time frame but I think as an industry we got through that in pretty good shape.

Neil McDermott: From the perspective of the Low Carbon Contracts Company and the Electricity Settlements Company, I would echo my colleague’s point. The key challenge has been the challenging timeline at a time when the two companies that went operational in August last year were building out the businesses and recruiting staff, fitting out offices, that sort of thing. We were also involved in delivering against a number of regulatory obligations in Q4 of last year.

The sorts of things that we were faced with delivering on were, first, in September-October time the minor and necessary change process, which is where applicants for Contracts for Difference ahead of the allocation round could apply for a minor and necessary change to the standard terms and conditions for the CFDs. We completed that on time. The second key deliverable was the collection of collateral moneys, working with National Grid and with ELEXON, around October time, ahead of the capacity market auction. Third was the setting of the supplier obligation levy, which we successfully completed in December last year.

So the key challenge, while setting up a start-up of a business has been being able to deliver on those things. Intrinsic in that—and I think a key factor enabling us to deliver that—was the work of the DECC set-up team, which was working from late 2013 through until August prior to go live with the companies. That enabled the settlements projects, the recruitment and the organisation of the businesses to get under way. That has been a key element of us being able to deliver against those obligations.

Q174 Chair: Are you confident that you are ready to actively manage the Contracts for Difference? It has been suggested that it is going to be quite a complex process.

Neil McDermott: Yes, we are. We have recruited an experienced contracts management team of people from the sector. So, yes, we have done a lot of work working with generators making sure the industry is ready. We have done a number of workshops throughout the period from August. In fact we have done 10 workshops with suppliers and generators to do our very best to make sure that suppliers were ready for the supplier obligation, and also that generators understood the contract and that they were ready to take part in the auction process. We worked with National Grid, with ELEXON and with DECC to go through that. So, yes, I am confident that we have a good contract management team and so yes would be the answer.

Q175 Chair: What are the standards against which you are both assessed by the regulator and by the Government?

Mark Ripley: For ourselves, we are regulated by Ofgem in our activities. Part of the legislation that went through last year was to enshrine our EMR duties and our licence, so it is one of our licence activities and, therefore, we are judged against that, as we are with all our other licensed activities—Ofgem's enforcement powers go with that.

In terms of the day-to-day performance, Ofgem place some operational incentives on us for the pre-qualification process, for the auction and the CFD, to incentivise us to do a good job in that. We are now in the process of developing a well-justified business plan to submit to Ofgem for enduring cost, which will include again performance and incentive measures. We think we are subject to the same level of scrutiny from Ofgem in our EMR duties as we have for all of our other licensed duties, which is a well-known and established framework.

Neil McDermott: For the Low Carbon Contracts Company and Electricity Settlements Company, the companies are owned by Department of Energy and Climate Change—by the Secretary of State—but they are independent of Government in the way that they are run, with an independent board of directors. I am assessed by my board of directors, which includes representatives from DECC and the shareholder executive, and then the framework document between the company and DECC sets out all of the obligations of the companies and the ways in which the reporting from the company to DECC on a monthly basis will happen. So there are clear objectives set, and there are clear reporting requirements, budgeting and the like. That is the way we are assessed and monitored by our shareholder.

Q176 Chair: Are you able to demonstrate that you are providing good value for consumers?

Mark Ripley: In terms of the services we provide—again I go back to the regulatory regime that we live in—in the run-up to the well-justified business plan that I have just mentioned, we have submitted our cost submissions to Ofgem, and they have allowed us to recover our costs, but that will be subject to an efficiency review. Ofgem will review what we have done to ensure that we have spent in an efficient and economic way. There is that check and balance there for consumers, again as Ofgem do for other activities.

In terms of the prospective costs, which I think will take effect from April 2016 given the way our formula year process works under the price control, Ofgem will review those in detail. That will be subject to public consultation and then Ofgem will opine on that later this year. They are subject to efficiency tests by Ofgem and they are subject to public consultation, so, yes, I believe the mechanisms are in place to ensure that we provide good value for money.

Neil McDermott: For the Low Carbon Contracts Company and Electricity Settlements Company, the budget for the operational costs of the companies is set out in our 2015-16 budget, which will be our first full year of operation following the set-up period in 2014-15. That budget has been reviewed by the board and by Department of Energy and Climate Change, and has been consulted on publicly with stakeholders.

To give you a couple of numbers, that budget is estimated to cost consumers 18p per average household over the 2015-16 period. Importantly, I think our guiding principle, which has been set by DECC, is one where we are there to maintain investor confidence in the CFD regime while getting best value for consumers. That is what we will be working with.

Chair: I should incidentally remind the Committee of my interests in the energy industry registered in the Register, including an interest in the nuclear industry.

Q177 Albert Owen: On the Contracts for Difference allocation rounds and the ongoing allocation round in particular, Mr McDermott, you mentioned that you have done a lot of work. Could you comment further on the allocation process so far and, in particular, what aspects have run smoothly and what have been less smooth, because that is a new process for everyone concerned?

Neil McDermott: It is. The main thing for us is that clearly the process has been delayed by the eligibility reviews and the work being done by Ofgem. From our perspective, of the challenges that that has given us, the key challenge has been that we were setting the supplier obligation levy in Q4 last year without the knowledge of the outcome of the allocation round and, therefore, a good understanding of what generation might come forward and commission during Q2 2015. That is probably the main challenge that we had, so we worked with publicly available information with the DECC budgeted pots for established technologies, and made an assumption based on what we thought may come forward—offshore wind or indeed solar or other technologies.

That was probably one of the main challenges. I think with it being slightly delayed—I mentioned some of the work that went on in Q4 last year for us, with the set-up of the business, the recruitment and so on—in fact it gave us a bit of breathing space I would say. We would have met with the deadlines but—

Q178 Albert Owen: Do you feel you have adequate resources now?

Neil McDermott: We have adequate resources. We plan to be fully resourced by April this year and so we are in a process of recruiting. We do have some interim employees as part of that set-up period. But, yes, it has given us a bit of breathing space and it has enabled us to spend more time getting ready to take on these additional CFDs. We have been working on things like contract management systems and also tools to turn around the contracts that will come out of that round. We have only 10 days to issue the contracts following the allocation round, so we have been able to spend a bit more time getting ready for that process.

Q179 Albert Owen: Mr Ripley, would you like to comment?

Mark Ripley: I echo what Neil said, yes. I would take slight issue with the word "delay". The reason why the final allocation will be later than was originally published is because there was a second round of appeals, but the appeals are part of the process. That has been built into the arrangements. As with the capacity market and the CFD, there is a first tier of appeals with us; that is an administrative checking process. In the event that there are further appeals, they go to Ofgem. That time is unspecified because of the nature of appeals. So, while we have perhaps not anticipated appeals in the CFD to the extent we did in the CM, where in fact there were only a handful, it has moved things back from the original date but it is part and parcel of the process and so expected.

Other than that, I would echo what Neil said. I think the process of allocation for both the CM and the CFD was successful. We spent a lot of time engaging with people in the industry to ensure that they understood what they needed to do, and understood the various bits of paper and the various commitments they needed to make. I think the pre-qualification process has been very good and we will see how the allocation process goes when that goes on later in the year.

Q180 Albert Owen: Mr Ripley, do you agree with Mr McDermott that the delay gave you extra time to get your resources into place and get people more focused on it? You do not call it a delay but it was a slippage in time.

Mark Ripley: Yes, a slippage; I agree with you, it is a slippage, Mr Owen. In our instance we were already set up for doing the allocation and the CFD, so all that has done is move it backwards a little bit, but I can appreciate that for other parts of the industry it would have provided additional time.

Q181 Albert Owen: What impact do you think the appeal that is already before Ofgem will have on the whole process?

Mark Ripley: My understanding of the whole process is that, provided the allocation has taken place—before the end of March, I think—we are okay in terms of things fitting together. There are some provisions in the secondary legislation for what happens if it goes beyond that, but I do not think anyone envisages that it will go on beyond that, so it is just a slippage, Mr Owen.

Q182 Albert Owen: Are you confident that that will be done? If it is not, are we collectively comforted enough that the Secretary of State can intervene and the process can go ahead or are things going to be unduly delayed?

Mark Ripley: I understand there are measures in place. I don't recall them off the top of my head, but I am confident that we will have the allocation done by 28 March.

Albert Owen: If not, will there be a decision by the Secretary of State?

Mark Ripley: There are measures there, yes.

Q183 Albert Owen: Do you think that will cause concerns for certain people in the future, that they don't think that their appeals will be adequately looked at because of time frames?

Mark Ripley: I do not believe so, and that is why Ofgem has not specified a time frame for an appeal and, therefore, it has the ability to give the correct weight and—

Q184 **Albert Owen:** Yes, because the Secretary of State can intervene after a certain amount of days.

Mark Ripley: Once you get beyond 28 March, I think the Secretary of State has powers, yes.

Q185 **Albert Owen:** Can you comment on that, Mr McDermott? Do you think that that—

Neil McDermott: No, it is—

Albert Owen: So everybody is clear when they are entering into the process that this is the method by which the appeals will be taken?

Neil McDermott: Yes. We have planned our role in this to be able to take on the CFD contracts as and when the allocation process ends. We have looked at the earliest dates and the latest dates and we will be ready to take those contracts on at that time.

Q186 **Albert Owen:** Can I talk about scrutiny of the whole process now? Some evidence that we have had from contributors says that they are very concerned about the lack of scrutiny regarding the CFD package. What specific actions are you taking to ensure that there is adequate scrutiny in the process?

Mark Ripley: In terms of the process, the CFD has been developed and consulted over an extensive period of time. I go back to the start of 2012 when we were debating which model to have—there was model 1 and model 2—so extensive engagement there led us to the model that we have with the Low Carbon Contracts Company as the counterparty. There have been a large number of industry forums to consider the contract, to talk about implementation, so there has been a huge amount of scrutiny and involvement in the process. In the allocation process, we held workshops where we went through that, so I think there has been a high level of scrutiny.

As I mentioned before, the time frame has been challenging. In an ideal world, could you have made use of more time? Yes, of course you can, but you have deadlines to work to and I think we are at a reasonably good position in terms of the level of pre-qualification we have seen. We will go through this appeals process and then run the allocation. As I say, I believe that will be before 28 March.

Q187 **Albert Owen:** Any comments?

Neil McDermott: No. As I said, we are expecting the process to conclude, we will be ready to take on the contracts at that time, and we wait to see the outcome of the auction.

Q188 **Albert Owen:** Mr McDermott, you said in reply to a question from the Chairman that there has been a lot of work with generators. We just heard Grid saying the same thing: there has been a lot of consultation beforehand with suppliers, generators and all that, but yet we have had some evidence—particularly from the Solar Trade Association—to say that many of the solutions that they proposed were not absorbed into the CFD allocation design. Was it just lip service? Did you always have a process that you were going to go through and you were just consulting for the sake of consulting?

Neil McDermott: Certainly from the Low Carbon Contracts Company's perspective, we have been leading the implementation of the industry readiness to take part in the allocation round for CFDs. To that end, as I mentioned earlier, we have done a number of workshops with generators and suppliers. Specifically from the generator perspective, we have worked with them on the minor and necessary process. When the terms and conditions for the standard terms and conditions were concluded, DECC joined us, with ELEXON and Grid, to present the structure of the contract to generators. I am particularly interested in the small end of the generators and suppliers. To that end we have run these workshops and we have had one-to-one meetings—we have offered them to all generators—to go through the contracts, to go through the minor and necessary process, and what they need to do ahead of the allocation round.

You mentioned the Solar Trade Association. We have worked with them. We have worked with Energy UK, RenewableUK and the Renewable Energy Association to be able to try to maximise the reach that we tried to achieve.

Q189 Albert Owen: What they are saying to us is that, at the end of the day, they weren't listened to. They feel that they have been smothered out of the system by some of the large generators. How do you respond to that and how can you restore confidence in the future if that is what they are telling us on record now?

Neil McDermott: From the Low Carbon Contracts Company's perspective, we are trying to lead the implementation and make sure that we do our very best to ensure that generators, large and small, are aware of the process, understand the contract, and can take part. To that end, we have run these workshops. We have worked with the trade associations to try to make sure that we can reach all of the generators out there and maximise the chances of the process going well.

Q190 Albert Owen: I know what you have done, but this is an ongoing inquiry and this is what they have told us relatively recently. What can you do in the future to restore the confidence of some of these smaller generators and smaller technologies who feel that they have been edged out of the system?

Neil McDermott: From our perspective, as the party implementing the process for CFDs, in terms of the industry readiness, we will continue to work with all parties, the trade associations, and large and small generators. We have a number of workshops planned over the next period of time and we will do our very best to make sure that they have opportunities to understand, hear from DECC, and hear from ourselves, National Grid and others, as to what they need to do to take part in the process.

Mark Ripley: If I may, Mr Owen, my colleague is correct. In terms of enabling people to participate in the process, this is very much what Mr McDermott is doing for the CFD, it is very much what we are doing for the CM. Are the rules appropriate? One of the things that the Government has committed to do is review the outcome of the CFD and the CM, and I think that is a hugely important thing to do. One of the things that I would happily put my hands up and say is, "Can you design something perfectly first time? No." There are processes to modify. We need to learn from the outcomes when we see them, and then there is the scope to make changes if need be, striking the balance between investor stability compared with evolution. So while from the point of view of whether we make sure everyone is able to participate, that is very much Mr McDermott's and my area. In terms of whether the rules are right, I think that is something that we will see coming out of the review of the process that DECC are conducting during the first part of this year.

Q191 Albert Owen: I accept what you have said there about it being a new process and there is a lot of learning to be gained from this. But one section that has been continuously concerned has been the financial sector—they were not engaged early enough in the process and

this may have an effect on investment. How do you respond to that criticism from them? It has been consistent. You talk about the different models in 2010. They were not concerned then, but things changed and they do not feel that they were involved early enough and they don't think that many of these projects can be bankable for the future. How do you respond to that?
Mark Ripley: I am not a financier so I would not comment on the financeability.

Albert Owen: Sure, but they have been telling us that consistently.

Mark Ripley: I accept that, Mr Owen, and what I would say is that you are absolutely right. At the very outset we looked at the models for the CFD. Model 1 was a mutualised means of payment. For myself—coming from the electricity sector where I have been dipped in the law of electricity—I was quite confident that would work, but it was quite enlightening for me to speak to investors who said, "No, that doesn't work for us because that is not the sort of thing we are used to." The Government listened to them and developed that. I know the Government spent a lot of time talking to finance companies and banks through the process to get their opinion and will have taken a lot of what they said on board. As I say, there is a review process to establish whether there are things that we can make better, and I am sure there would be lessons that can be learnt and enhancements that can be made, but certainly the financial community has been engaged by Government through this process.

Albert Owen: But they are essential.

Mark Ripley: Absolutely, given the level of investment needed in energy, which is the driver behind EMR in the first instance.

Neil McDermott: I would agree with what my colleague said there. I think that the process, the critical thing now, looking forward, will be the review of the contracts and the standard terms and conditions during 2015 as we head into the second round. The Low Carbon Contracts Company will provide comment to DECC and that process will be led by DECC during the year.

Q192 Albert Owen: For the record, are you hearing from the financial sector their concerns about not being involved early enough in the process?
Neil McDermott: The Low Carbon Contracts Company will provide comment and input to DECC and maybe it will be for DECC to comment on how we will engage the finance sector in that process.

Q193 Albert Owen: Sure, but I am asking you a direct question: have you heard these concerns from the financial sector?
Neil McDermott: I haven't personally heard these concerns from the finance sector.

Q194 Sir Robert Smith: First, let me remind the Committee of my entries in the Register of Members' Interests, in particular, to do with the oil and gas industry.

Mr Ripley, you mentioned there were two stages of appeal; an appeal to you to relook at—
Mark Ripley: Yes.

Q195 Sir Robert Smith: Were there any changes when people did that?
Mark Ripley: I think there were. I cannot recall exactly. If the Committee will allow me to explain briefly, part of our compliance arrangements and our complex conflicts of interest arrangements means that those that are involved in the allocation process are very tightly defined and restricted in number. I was not part of that process because I was doing other things for National

Grid at the time, so that was one of the things we did with compliance. But my understanding was there were a relatively small number of appeals. Some of those were addressed. It was for people who had forgotten to attach a document to their application or attached the wrong document to be able to go back and say, “Look, did you know you have done this?” Again, I think it was probably single figures that went to Ofgem, and all of those appeals were in fact rejected.

So the National Grid stage is very much an administrative stage, which I would have expected the first time we did this—for Grid to be some of that kind of thing, because people are getting used to the process. That is one of the reasons why we spent a lot of time and spoke to everyone who had pre-qualified through the process, and did a lot of stakeholder engagement.

Q196 Sir Robert Smith: You can maybe give us some statistics.

Mark Ripley: Can I provide those to the Committee in writing because I do not have them off the top of my head.

Sir Robert Smith: Yes.

Q197 John Robertson: I want to concentrate on the SMEs in particular. Contributors have noted there is a great deal of complexity in the CDF documentation creating additional difficulties, particularly for SMEs. How have you helped SMEs and independent generators understand these CFDs, and ensure that they are well prepared for the allocation rounds?

Neil McDermott: Low Carbon Contracts Company has been active both during the set-up stage by the DECC set-up team, but also latterly, since August last year, running monthly workshops and indeed sometimes repeating those workshops because of demand for attendance. Through those workshops, we have presented on everything from settlement systems to contract terms and conditions. As I said earlier, once the standard terms and conditions were finalised, DECC came to workshops to present on the contract and the contract structure. We have made ourselves available through dedicated surgeries for generators to understand the minor and necessary process, where they could apply for minor and necessary changes to the standard terms and conditions ahead of the allocation round, and indeed explained and answered questions on the structure of the contracts.

We have very much taken the approach of working with our partners—ELEXON, National Grid and DECC—to invite generators into workshops and present on the different aspects of the process and the contract in order to be able to try to maximise industry readiness. As I said earlier, the work we have also done with the trade associations, including the Solar Trade Association, Energy UK and others, has meant that that is one other route that we can use to try to get access to potential generators of low carbon electricity in the UK.

Q198 John Robertson: That sounds all very well except Leonie Greene of the Solar Trade Association said that the workshops were often at too short notice and they were often pitched at a level of complexity and detail that did not take a lot of these people with them. In other words, you were pitching at an area where it was hard for them to understand and you were also not doing it at times that suited everybody. Why would she make that complaint if what you are saying is so good?

Neil McDermott: Following each of the workshops we have taken feedback from attendees—

Q199 John Robertson: Yes, but, with the greatest respect, these are people who probably cannot attend. That has been the greatest complaint.

Neil McDermott: Apart from the workshops, we have made available Q&A on our websites and also made ourselves available for dedicated one-to-one meetings with generators. I will take the feedback that you have there from the Solar Trade Association and we will take a look at that as we go forward. We are not complacent in any way in terms of industry readiness. As I say, we continue to work with the industry and with our colleagues, to run these events in order to try to make sure that we can access and ensure industry readiness.

Q200 John Robertson: Would you agree with the other point that she made that if DECC were serious about trying to get more competition and new entrants into the sector, they would need to take a particular and special care to engage those new entrants, particularly the ones who do not have the expertise that some of the more advanced and bigger companies would have in relation to these allocations? So what are you going to try to do to try to help them, to try to encourage them? Because, correct me if I am wrong, they have to put up something like £200,000. How can a small company afford £200,000 to put in a bid for CFDs?

Neil McDermott: We will continue to work with DECC and with the industry. As I say, we have another seven workshops planned for the near future and we are developing further information on our website and making ourselves available to potential generators. The work we are doing with the trade associations will continue and we will try to make sure that we deliver, and make ourselves accessible to small generators as the process goes forward.

Q201 John Robertson: Well, will you take on board what was said?

Neil McDermott: Yes.

Q202 John Robertson: Let me ask a question. I always like to speak in English rather than in abbreviations, so help me along the way here.

Mark Ripley: I will try, Mr Robertson.

John Robertson: I just copy something that somebody has told me. I want to talk about—now I have the words here—the final investment decision enabling for renewables, which is FIDER. What lessons have we learnt under that scheme and what process, and how are these applied to the current CFD allocation framework, because that was an earlier version of where we are now? What have we learnt from it?

Mark Ripley: The FID for enabling for renewables was some of the Hinkley Point deal, in that there was a provision put in the original Energy Bill to allow contracts to be awarded to people to enable them to make their final investment decisions, and the scope of that was widened during the process to encompass renewables on the basis that there were some renewable projects that needed to reach a significant financial decision. The Government ran a process to allocate some of those contracts.

In a sense, that is a separate and distinct process from the CFD allocation process. The commonality comes with the contract, and while there have been comments about whether that represented good value for money because of the prices that were paid, that was the nature of it. It was identified that there were projects that needed an early decision and, therefore, Government took the decision that they would allocate contracts early to enable those projects to proceed.

Q203 John Robertson: But these would be the larger projects?

Mark Ripley: Yes, largish.

Q204 **John Robertson:** The more expensive ones?
Mark Ripley: Yes, largish projects, offshore wind projects. I think the majority were offshore wind projects.

Neil McDermott: Yes, there were five offshore wind projects and then three biomass projects; well, two biomass—one biomass was CHP—so eight in total. They are large projects.

Q205 **John Robertson:** Have we learned any lessons that make the CFD allocation better?
Mark Ripley: I think it is a one-off, Mr Robertson. It was because there were some projects that it was felt needed to make an early decision, so a process was created to enable that. It is a process that will not be repeated in the renewables space because the allocation will be through the CFD allocation process.

Q206 **John Robertson:** Can I go back to the allocation rounds? As I said earlier, several companies and stakeholders have said we need more of them. Have you anything in the pipeline that would help these companies, rather than trying to hinder them by not having as many rounds? I get the feeling that everybody has the will to try to get smaller companies involved and they really do want to help them, yet nobody is willing to do the work for it and there needs to be more rounds to allow these companies to bid, to get help and to understand the system. If you don't do that, how do you expect these smaller companies to invest in the long term?
Mark Ripley: I am assuming by "allocation rounds" you mean the number of times per year rather than the actual allocation process itself?

John Robertson: Yes.
Mark Ripley: There was debate through the development process about there being two allocation rounds. In terms of year one, that was quite challenging in terms of the appeals processes and getting through from start to finish of cycle 1.

Q207 **John Robertson:** Sorry, to interrupt, what I meant is: what are the pros and cons of having both or either?
Mark Ripley: The pros of it would be—I think you are alluding to more frequency—more opportunity for people to participate in terms of frequency, and recognising that a 12-month period is a long time to wait. The cons would be that you split the pools of money into two smaller pots and, therefore, if you are at the wrong time you might not be best able to compete. As I said, in terms of the first year, there were a number of cycles that had to be gone through, not least of which the review we have talked about that will potentially propose enhancements.

It is possible. It is something that would be the subject of the review. From our perspective, in terms of qualifying people, we would be perfectly able to do it and I am sure Neil is perfectly able to accommodate it if that was what the Government decided to do.

Q208 **John Robertson:** Let me quote Dr Nina Skorupska, of the Renewable Energy Association. She says: "This framework is still geared up for people who really understand the market very well and less so for the people who want to enter the market, which is what we want to encourage." Do you agree with that?
Mark Ripley: I am not sure I agree with it, but certainly if you are familiar with the market, it would be an easier process. I think some familiarity with the electricity sector is in fact necessary if you are going to chose to be generating.

To build on the point of engagement that we talked about earlier, Mr McDermott talked about the number of engagements he did from the CFD. We did a similar number for the CM, industry workshops and bilateral discussions. One of the things that we need to look at is whether that is the best way to engage with a wide range of people. We will need to have a lessons-learned exercise in terms of making sure that we give the widest range of people the best opportunity to participate. We will look at that.

Q209 John Robertson: What kind of changes would you envisage to be able to do that?
Mark Ripley: I don't have changes to recommend at the moment. What I am suggesting is we have employed what you might be calling a more traditional approach of consultation, bilateral meetings and—

John Robertson: You are talking to people?

Mark Ripley: We find it quite effective.

John Robertson: Yes, funny that, a lot of people do. So why aren't we doing it?
Mark Ripley: We have had over 250 bilateral meetings. We have spoken at over 100 conferences. We have had a number of interesting workshops. We need to ask ourselves if there are things that we can do not necessarily more of but differently in order to make sure we get the widest range of people participating.

Q210 John Robertson: Dr Skorupska went on to say: "Not all our members—some of them are individuals or one person companies, through to 10s and 20s-size companies—can attend all the sessions in a way that colleagues in larger companies can. Surely you have to identify that as being a major problem and help them.
Mark Ripley: This is why we have done a number of bilateral meetings and we have an open offer that we will go and talk to people. We talked to trade associations as well and said we would talk to their members, so we have explored a wide range of ways to communicate with people. As I say, we will continue to look to see if we can improve that.

Q211 John Robertson: Leonie Greene also added: "We know that there are good quality companies that are not bidding." Surely that is wrong.
Mark Ripley: They may have their reasons for not bidding. People have a commercial decision to take in this space. What we want is that as many people as possible have the opportunity to bid if they want to.

Q212 Sir Robert Smith: Going back to the capacity market, how satisfied were you with the pre-qualification process and the first auction?
Mark Ripley: We think it went very well. I should go back to my opening remarks about the timetable being quite compressed. We did in fact open pre-qualification almost immediately after the secondary legislation was passed. That was extended by the Government for reasons of some small rule changes, but we pre-qualified 65 GW of capacity for the CM, 513 capacity units. Of those 513, 306 were finally awarded contracts. So against a requirement of just shy of 50 GW, a significant number of people pre-qualified, which gave us some liquidity in the auction. It wasn't without its challenges. As some of you may be aware, we had some difficulties with systems in the early stages. We created some contingency arrangements; we spoke to everyone and talked to them through the pre-qualification process. So I think, given that it was the first

time, given that it was in close proximity after the legislation, it went very well. We think everyone who wanted to qualify was able to get their information and qualify.

Q213 Sir Robert Smith: So next time there wouldn't be a manual process; the portal should be up and running?

Mark Ripley: Yes, that is being built as we speak.

Q214 Sir Robert Smith: In terms of success of the auction, it seems to have benefited existing nuclear gas and coal-fired power stations, so in a sense has it just paid those that were going to be there anyway?

Mark Ripley: The auction was designed to bring forward capacity in the broader sense. There wasn't any design preference that says, "I want this much of this category; this much of this category; this much of this category." Yes, there were different contract loans to reflect the different states of plant. If the lowest cost to the consumer is for those existing plants to remain connected to the bars and generating in winter '18-'19, I think that is the right outcome. That was the design of the capacity market.

Q215 Sir Robert Smith: I suppose the worry is they might have stayed connected without—

Mark Ripley: The evidence we have seen over recent years is people have been mothballing or closing, so I think it is possible that some of them will be around, but the decision was taken for the market-wide capacity arrangement, and now we have provided some guarantee that they will be around.

Q216 Sir Robert Smith: The concern is in a sense that it is in your interest to have more capacity on the system. The Panel of Technical Experts did have concerns that you were being overly conservative.

Mark Ripley: I don't think we are incentivised on that. We provide analysis to the Government that says what we believe is the right level of capacity to meet the Government's standard. That is underpinned by our stakeholder analysis and what we call our future energy scenarios, which look at four possible views of the future in terms of the base case. Those are informed by stakeholder input. We then apply a number of sensitivities to that modelling to come up with a number, which the Secretary of State has the option to accept or not accept.

The point the Panel of Technical Experts spent some time on was the role of interconnectors. We have based our assumption on how much we receive from interconnectors based on historic flows. Their view was that you might expect more at times of scarcity. That may be the case, but an interconnector flow at the moment you would have to describe as less firm than a generator with a capacity contract. So we believe that relying on historic data was the right approach here. Next year, when we believe there will be an interconnector product, then interconnectors will be able to bid as a firm product, and then we will establish what we might expect from interconnectors based on commercial evidence.

Q217 Sir Robert Smith: That brings us on to another concern—that you are also a player in the interconnecting market.

Mark Ripley: National Grid does have interconnector interest, but this gets to the conflicts of interest piece. We have a long history of managing that potential conflict of interest between National Grid, their core regulated businesses and their non-regulated businesses. In terms of the CM, it will be a product that is designed by DECC and then it will bid as capacity and be judged in the auction. The auction is a fairly mechanical descending-clock process. We don't exert choice on it. That is a price-based decision. I think the potential for any conflict there is well mitigated by both the arrangements we have in place as an organisation and the design of the qualification and auction process.

Q218 Sir Robert Smith: Citizens Advice also felt that you did not go into depth in responding to the Panel of Technical Experts.

Mark Ripley: We had extensive dialogue with the Panel of Technical Experts and—

Q219 Sir Robert Smith: Was that post their—

Mark Ripley: We had dialogue with them throughout the process. Through the modelling process, we meet with them periodically and they talk about our approach. They recommend suggestions that we might do. For example, we had some debate with the Panel of Technical Experts about what the right de-rating factors were for thermal plant. We commissioned a piece of work to look at what de-rating factors were used around the world and, as a result of that, we made some changes to our underlying assumptions. So there is regular dialogue with the Panel of Technical Experts. Both of the reports—ours and theirs—were in the public domain as part of the delivery plan. So, yes, there is extensive work with them throughout the process.

Q220 Sir Robert Smith: I suppose the other concern is that you have gone for the traditional solution to capacity rather than embracing on an equal footing demand-side response.

Mark Ripley: The design of the capacity market is intended to create as equal a footing as possible, and we—

Q221 Sir Robert Smith: One could do longer contracts.

Mark Ripley: That is a question that has been posed. We have heard from some demand players that they would like longer contracts. We have heard from some that say, "We don't want longer contracts because we don't know what we are doing that far ahead." What I would say is that we do not yet know the full picture in terms of demand. There are 2.5 GW of capacity reserve for the T-1 auction, and one of the things that the demand-side community has said to us is, "We know much better a year ahead what we will be able to do than we do four years ahead." To an extent, we do not have the full picture of demand-side yet, but certainly—I go back to the review that is taking place—we need to review the outcome of the auction and decide whether changes need to be made, and whether there are things that we want to do differently.

Q222 Sir Robert Smith: While a supplier can go up to four years it does not have to. Haven't you had supply capacity over a year?

Mark Ripley: That is the duration of the contract. What I am alluding to here, Mr Smith, is when you get your contract. What we have just run is what is known as the T-4 auction, because the delivery year is four years ahead. If you are a generating plant, that is your business. You are pretty sure you are going to be there four years ahead. If you are a demand-side player, you are perhaps not quite sure what your business will be doing four years ahead, so it might be harder for you to commit. We have had some evidence from demand-side that says that they are more able to bid in the year-ahead auction when they have greater certainty about what they will be doing in subsequent years.

Q223 Sir Robert Smith: If someone is confident they can bid in a four, why should you—
Mark Ripley: There wasn't a prohibition on them bidding, so some people have bid. There was something like a 30% conversion rate of demand-side pre-qualified into contracts, but we do expect to see more in the T-1. It is not an either/or, it is just where we think people will show up.

Q224 Dan Byles: Can I ask a supplementary to that? When you say there was a 30% conversation on demand-side, are you counting diesel farms and diesel generation as demand-side?
Mark Ripley: Demand-side.

Q225 Dan Byles: Yes, but we have already had this problem in the past where the definition "demand-side" seems a bit hazy sometimes in DECC and National Grid. Does that include turning on a generating asset precisely?
Mark Ripley: No. Well, not diesel farms. What we don't know is whether a demand-side player has turned their demand from the network and turned their back-up generation on. That is very difficult for us to—

Q226 Dan Byles: But you can categorically say it excludes diesel farms?
Mark Ripley: Yes.

Mark Ripley: But that is 30% of those that pre-qualify, not 30% of the volume delivered.

Dan Byles: Thank you.

Q227 Sir Robert Smith: Finally, how do you think Tempus Energy's challenge will affect the process?
Mark Ripley: I am not a lawyer so I won't pretend to claim I know the ins and outs of that process. What I do know is that the Secretary of State felt able to go ahead with the auction and is confident that the design is robust. I can do no more than endorse that, based on my own knowledge.

Q228 Chair: To pursue the conflict point a little more, it is nevertheless the case that National Grid benefits if there is a need for more generating capacity in the long-term. You make money on your regulated business, and make more money if there is more generation and, therefore, more transmission. Is that correct?
Mark Ripley: We don't control the amount of generation that connects our network. Generators can apply for a connection to our network and we are obliged to provide them with an offer for a connection to a network. We provide them with an offer within 90 days. With our network and the Scots network, we provide offers for both of them, and then there is a lead time to connect to that generation. If they connect, that gives us what you might call load-related growth. We build assets for that for which we earn a revenue stream. That in itself is unrelated to the capacity market.

As I said, the design of the capacity market is designed to bring forward generation, demand-side and in the future interconnectors. It is purely a price-based decision. So that is not something we have an ability to influence. Although I accept your point, Mr Yeo. Load connection to our system adds to our asset base.

Chair: That was a very long way of saying yes to a very simple question.

Q229 Sir Robert Smith: Because you set the volume?
Mark Ripley: We make a recommendation to the Government and the Government sets the volume. We don't set Government policy. Matters such as the security standard and how much volume to buy are reserved to the Secretary of State.

Q230 Chair: If we try to peer into the future a bit, maybe into the 2020s, it seems to me—and I think to one or two members of the Committee—that it is possible that the way in which demand-side response may develop could cut some consumption. It could make a meaningful contribution towards preserving enough capacity. In other words, the total amount of capacity in 2025 may be much less than we currently expect. To get to that, we are going to need to try to nurture this new technology. We have accepted that we subsidise new forms of generation when they are new. If you have some new solar thing we give it a CFD, a feed-in tariff and so on. Unfortunately, from National Grid's point of view, supposing through some other policy the Government succeeds in nurturing demand-side respondents, we might find that the total amount of capacity on the grid and therefore the total amount of transmission is much lower. That would not help National Grid's asset base on which its regulated business earns its profit. Is that a correct analysis?
Mark Ripley: We are into the mechanics of price control products here. What that would mean was that we wouldn't be adding new infrastructure to our grid and, therefore, we wouldn't be adding to the asset base, which would have an impact on the organisation, yes. But we would continue to earn returns on the investments we have made, given the length of those investments and what those investments have made in good faith in the interests of the consumer.

Q231 Chair: But it would only be humour on the part of National Grid to think that, if we nurtured the demand-side technologies very successfully, that will mean that our shareholders in this part of our business get a smaller return. I am simply trying to establish what the facts are. I am not suggesting National Grid has done anything wrong here.
Mark Ripley: No.

Chair: These are simply the framework in which National Grid is operating.
Mark Ripley: I think there is an assumption that the framework remains exactly the same. The world is evolving. We are doing things now that we weren't doing a number of years ago. There is a slide I used to use to demonstrate the rationale behind EMR. First, we are decarbonising electricity through to 2020 and then we are electrifying energy through to 2050 for the emissions target. So if you are successful in doing that, and I sincerely hope we are, then the danger is that you create an enormously large peak demand, much bigger than you are now. People come home from work. They put their electric vehicles on and they have much more in the way of their energy use being electricity, so the world is changing and we will come on to different incentives to manage that, and demand-side will be a very, very powerful way to manage those issues going forward, which we would expect would be reflected in our regulatory regime.

Q232 Dan Byles: I want to explore some of the costs of the capacity mechanism. We have had evidence that the capacity mechanism may end up being more expensive than it needs to be, for a variety of reasons. Do you have any thoughts on how we can make sure that the capacity market costs are controlled and that we do get the best value for money?

Mark Ripley: The way the capacity costs can be managed are that you attract as many people as possible to bid in the auction to create liquidity, and as I say there was a successful result in attracting 65 GW of capacity for this year's auction. As I mentioned before, we will look again at the way we engage with our customers and stakeholders to try to maximise that. Then the auction process, the descending clock auction, was designed very much with driving the lowest-cost consumers. A lot of work was done—particularly with reference to the US—to mitigate the risk of gaming. So a number of provisions were in there, the price taker being one in particular, to mitigate any risk of manipulation by portfolio players. I think the fact that we got down to under £20 and were able to go up the demand curve indicates that there was a reasonable degree of success on that.

But as I say, Mr Byles, we will continue to look at ways in which we can stimulate more people participating in the auction. I would expect Ofgem to look to us to do that in the future as part of our incentive process.

Q233 Dan Byles: Is there a danger at the moment, though, that suppliers, and then by extension customers, are carrying the risk that forecasts for future market share are inaccurate?

Mark Ripley: When you say "forecasts for future market share", I am not sure I quite follow the question.

Q234 Dan Byles: This was evidence we had from E.ON, who were concerned that it could be more expensive than necessary. They said that they did not believe the methodology to recover capacity costs from customers was the most effective approach. Suppliers are required to forecast their market share at certain times in the year. Costs will be shared among suppliers based on these forecasts and, therefore, suppliers—hence customers—will carry the risk if the forecasts are inaccurate.

Mark Ripley: Yes, I believe there is a reconciliation process for that. As part of the development process, there are, as you might imagine, a number of ways that you can cut the cake. We have to allocate the cost of the capacity. Ultimately it comes to consumers. I think we all accept that. We looked at peak energy. We looked at portfolio. There was a lot of discussion and consultation on the methodology that was used.

Again, it is a bit early to say whether that is right or not. We have not seen that work in process but, as with everything else, if we feel the Government feels that that creates unintended consequences, I would expect it to be looked at. I think it is a little early to say at this stage in the process whether it is right of not.

Q235 Dan Byles: How did we come up with T-4? Obviously there were a lot of uncertainties in future wholesale prices and capacity margins.

Mark Ripley: Yes, T-4 was largely about the fact that there will come a time when you will need reasonably sized new plants built. We haven't seen a huge amount of new build in the '18-'19 auction. I think that reflects the fleet we have. I would imagine as you get into the 2020s, when some of the coal plant that is on an IED exemption closes, you would see more capacity being built.

By and large, a combined cycle gas turbine that has its planning consent takes about three or three and a bit years to build. That is what the four years is designed for—so that I get my project and my contract and, provided I am ready to go and shovel ready, I have sufficient time to build it with a little bit of contingency, given the fact that weather can affect some of these large projects. So that is the balance you strike—giving enough time that new build plant can be built and commissioned without imposing too much risk, which of course gets priced into bids, versus that long-term certainty.

Q236 Dan Byles: It was suggested again by E.ON that if too much capacity has been procured, National Grid could be allowed to sell over-procured capacity on the capacity market. Do you think that sounds like an interesting suggestion?

Mark Ripley: I have not heard that suggestion. This is part of the reason why the number of long-term contracts is relatively limited to reflect the fact that things will change. Four years out, I think it is—

Q237 Dan Byles: You think that is when it gets harder?

Mark Ripley: That is probably a reasonably good view. Although, as we have discussed with this Committee before—we have provided written evidence—our view of the world in 2007 was quite different to our view of the world in 2008, but we weren't the only person who got that not quite right. When you look from where we are today and at demand growth, four years out it is not that variable, and that is why we will continue to review every year and iterate that.

Q238 Dan Byles: Is the prospect, though, of National Grid selling over-procured capacity something you could look at?

Mark Ripley: I think the arrangements for trading capacity are something that will evolve, whether that involves us I couldn't say at the moment.

Q239 Dan Byles: You would not rule it out?

Mark Ripley: I would not rule it out, no.

Q240 Dan Byles: There is also some concerns around—just changing track slightly—the buying power of the Levy Control Framework. As I am sure you are aware, obviously the wholesale price makes a big difference to how much is going to be—CFDs will be there for how much is left in the Levy Control Framework. How do you think DECC can best address the impact of the carbon price floor freeze and likely, therefore, lower wholesale prices on the buying power of the Levy Control Framework?

Mark Ripley: One of the things DECC has done in setting the Levy Control Framework is it can be reviewed. There is the scope for additional moneys. What I would say is that we need to see how things play out. We have not paid out any CFDs yet. We are trying to think what prices will be at some point in the future. But some of the sensitivities we modelled when we were providing evidence to DECC about strike prices were high and low wholesale price, to see whether, scenario-wise, you got to 2020 within the 7.6 billion.

That has formed part of the analysis. On an annual basis, that analysis will be reviewed to provide information that Government is able to make decisions upon.

Q241 Dan Byles: Do you think future CFDs should include clauses to claw back excessive returns if wholesale prices are significantly lower than expected?

Mark Ripley: I think the CFD prices are set bearing in mind the costs of the technology. Many of the technologies are high capital cost, low short-run marginal cost. So to an extent, a wind farm's only interest in the wholesale price is its ability to be in merit, so it still needs its strike price. The protection method is in the fact that the CFD is around the strike price. If in fact the wholesale price goes beyond that strike price, there is the clawback for the consumer, so I think that is where the protection comes for consumers with CFD.

Chair: I think we may have come in five minutes ahead of time, so thank you both very much indeed. That was a very helpful session.

Examination of Witnesses

Witnesses: **Rt Hon Matthew Hancock MP**, Minister of State, and **Jonathan Mills**, Director of Electricity Market Reform, Department of Energy and Climate Change, gave evidence

Q242 Chair: Welcome. We will crack straight on and I will start with a general question. Are you happy with the way the implementation of EMR has gone over the last year?

Matthew Hancock: Yes. You would expect me to say that, I hope, not only because I am the Minister responsible, but also because of the fact of the outcomes. Over the last year, the implementation of EMR has involved two absolutely mission-critical moments, both of which have been successful. There are many, many other details, but if you boil it down there are two core things. The first is that, in the summer, we successfully gained state aid approval for the structures and the processes, and that was very important for implementing it. The second was the execution of the capacity market auction over Christmas and in the run-up to Christmas. This is the auction to ensure that we essentially pay what you could see as an insurance fee to make sure that capacity is available and, therefore, to avoid price spikes. We decided to conduct that auction on a competitive basis rather than on an administrative basis, in terms of how we worked out the costing.

I was very happy with the outcome because the outcome had a clear price of £19.40, which was cheaper than we anticipated, and because there was a good balance between supporting existing generation, supporting refurbishment and supporting new build. You may recall that, in the run-up to it, there was a debate about whether there would end up being too much support for existing and not enough support for new build capacity, or whether we would have it the other way around. In the end, we had a good balance, which I think reflects well on the structure of the auction. It turned out that auctioning capacity market contracts in this way was successful and good value for bill payers.

Q243 Chair: We will come back to the capacity market in a moment. On the implementation, which obviously has taken place at a reasonably swift pace, one of our witnesses suggested that that sometimes has meant that, to meet the timetable, some corners have been cut. Do you share that view? That was expressed to us by the Solar Trade Association.

Matthew Hancock: No. I don't think that is fair. In Government, I think that getting criticised for doing things too quickly is an unusual pleasure. Of course, it has been implemented at pace. There has been an awful lot of work, and I want to pay tribute to the work of the officials in DECC.

This has been one of the best teams that I have worked with in Government. It has moved fast and the electricity market is a complicated market, but I don't think it has been rushed, no.

Q244 Chair: I think the criticism related to the period allowed for some of the consultations. There was a view that they did not give some of the businesses much time to react.
Matthew Hancock: There were a very significant number of consultations because we have done it in a highly consultative way. The businesses engaged are incredibly expert in their areas, and so it is perfectly reasonable to expect them to be able to respond fairly quickly to the implementation of something that affects their business.

What also matters in any implementation when it comes to consultation is not just listening to the voices of those concerned—important as those voices are—but also listening to wider stakeholders and making sure that they express a view. It matters that you can successfully untangle the interests of those who reply to consultations. I do not think that asking for people to respond in good time to a consultation is unreasonable at all.

Q245 Chair: How do you think National Grid and the LCCC are getting on with their roles in all this?
Matthew Hancock: Well, my summary would be that they are executing the process effectively and appropriately. The Grid advise on many elements and execute other elements of the process. They have been doing that rigorously and bringing their experience to bear. The LCCC, which is new, of course, and is much more involved on the CFD side, has been putting in place its processes and making sure the contracts will be high quality. What really matters is getting the CFD auction right, which we expect in the next few weeks.

Q246 Chair: The Grid has quite a big role in this and, in addition to implementation, there is almost a policy element in it as well. Do you think that it is scrutinised effectively for the potential conflicts it might be facing and other aspects? Is that scrutiny sufficient?
Matthew Hancock: Grid does not have a policy role, but it does have a very important execution role and the two are often closely interlinked. So, for instance, in questions of electricity margins, Grid's analysis is critical to the decision that we take on policy and so, of course, the analysis that it does is a very important input to policy. I am not planing that down, but they execute policy. In the same way on the auctions, they execute the auctions but ultimately it is a policy decision for Ministers as to whether the auctions are proceeding properly.

Q247 Chair: But those decisions are likely to be influenced by the advice that Ministers are getting from the analysis conducted by Grid?
Matthew Hancock: Of course, because they are at the coal face, so to speak. Did they get enough scrutiny? I am sure they feel that they get enough scrutiny when they appear in front of your Select Committee.

Q248 Chair: We are not the only body that is supposed to scrutinise them, of course.
Matthew Hancock: No, of course, but again, as with any other player in the market, we consider their expert advice, and they have statutory duties on advice as well, but we also take the big picture policy view. That is why it is vital and appropriate that we take the policy decisions, and they in some cases advise and often execute.

Q249 Chair: But their role is a unique one. They are not like other players in the market. They have this quite wide-ranging function that, at least potentially, gives rise to a conflict.

Matthew Hancock: Potentially, but that has to be managed as part of the policy process. Transmission is a natural monopoly but we have decided as a country over many years that it is best executed in a regulated private setting. I think that is right.

Q250 Graham Stringer: You are satisfied with the processes that have been carried through. Have you had time to think about the actual design of the process? Could it have been designed differently, in a superior way?

Matthew Hancock: We will go through this process over this summer to make any decisions on whether there needs to be changes. I would say that the overriding central goals have been successfully achieved on the capacity market, and all looks well set for the CFD auctions, but they have not happened yet, obviously.

That does not mean that you can't have changes. However, if you think about the central design, there are two or three principles in the way they have implemented that really matter at the core of this. The first is this: should we have a capacity market set up or should we rely on the electricity market to ensure that we a security of supply? Given the value for money that we got in the auction, which was below half what our central expectation was—as a former economic forecaster, I know how uncertain those pre-market expectations are—that demonstrates that this is good value for money for consumers because it mitigates, but does not totally eliminate, against the risk of price spikes. That is an insurance that is worth paying. I am very happy to pay it and we, through policy, are ensuring that the country pays it.

So that is the first thing: should we have a capacity market? Yes, we should. Should we have the CFDs? So long as those auctions go okay, especially if we get the same sort of reaction as we have had in the capacity market, the idea of auctioning rather than just doling out subsidies is a very good step forward.

Second, has the auction been designed in such a way that it gets value for money? There are loads of different ways to design auction processes. This was designed before I arrived in this post, and I am very satisfied—to the point where I wish I had designed it this way myself. The proof of the pudding is in the clearing price. There it is. Within that the outcome is not just the price, but also the allocation among different types of generating capacity—existing, refurb and new.

The third area is specific questions about how specific technologies interact. I am thinking here in particular about demand-side, which we have had a discussion about before, and whether you can tweak things around the margin to improve the way it functions. We will go through a process of reviewing those over the summer, but I think the principles of whether it should happen and whether the auctions are designed right have been resoundingly answered in favour. On the third one, we will look at all that, and if there are technical changes that need to be made, of course we will consider making them.

Q251 Graham Stringer: It is interesting in the design that you talk about specific technologies, because the Solar Trade Association were very disappointed that a lot of the solutions they came up with were not absorbed. Do you recognise that as a criticism and do you have any response to it?

Matthew Hancock: There were lots of proposals that would have made the auctions slightly more favourable to every different technology involved, and every trade association would have been failing in its duty if it had not pushed the design to be slightly more favourable to their particular technology. So, of course, there were proposals that we did not take up because we wanted the overall design to be as fair to all technologies as possible. I would have been amazed if that had not been the case.

Q252 Graham Stringer: I do not want to put words in your mouth, but the implication is that the vast bulk if not all the criticisms and suggestions for an improved design were just self-interested from the different technologies.

Matthew Hancock: No, what I am saying is that you have to bear that in mind. It is entirely understandable and reasonable. You have to look at whether a suggestion will have an overall positive impact on the process as a whole. So we will look at all of those over the coming months ahead of next year, and work out whether any of them would have made a positive difference, hence looking at all the technology-specific issues at the margin.

Q253 Graham Stringer: The CFD appeal process is causing further delay and therefore uncertainty. Can you overcome that in any way to make sure the contracts are awarded as quickly as possible?

Matthew Hancock: A good question. We remain within the expected path as broadly set out. It is just that we knew that, if there were appeals, then we would end up on the back half rather than the front half of that time period. Does that make sense? We are within the bounds of the expected timings, it is just that, because of appeals, we are at the back end rather than the front end of that. I think that band was only about three months wide. I do not think the difference between a December settlement and a March settlement is enormous in the grand scheme of things.

It is worth asking the question of whether we get the incentives around appeals right, because you would not want a situation where the appeal is the no-cost option and therefore becomes an automatic option, because that undermines the decision-making process in the first place in terms of participation in the CFD. Again, we will consider the question that you asked after the CFD round this year to see if we can tighten up on timings.

Q254 Graham Stringer: Do you think part of the problem that has led to appeals has been poor communication about the process and eligibility? Is that one of the factors where there could have been better communication?

Matthew Hancock: There always could be better communication. Especially in a first round process, you are always going to get people learning about the process. Even if communication were perfect, good communication is about being able to get the message out in a way that is fully understood. So you are always going to be able to improve that communication. I think it is inevitable that a second round will be communicated better than a first round because people know the parameters that they are dealing with. So, of course, there could always and in all circumstances be better communication. There is no perfect communication in this world. But I think we did a pretty reasonable job.

Q255 Graham Stringer: Back to solar, if we may. Solar projects are going to be particularly badly affected by the delay because they may not know until March, which is just before the renewable obligation closes to large scale solar PV. Can you do anything alleviate that problem and those concerns?

Matthew Hancock: Well, we fully expect the outcome and the notification to happen before the closure of the RO, so it may be that large scale solar PV has to be on a twin track before deciding on which route to go down. That is an inevitable consequence of changing a system over.

Q256 Graham Stringer: There have been some concerns from the financial sector that they were not involved enough or engaged early enough when drafting the details of CFDs. How confident are you that the CFDs are going to be bankable?
Matthew Hancock: What do you mean by bankable?

Q257 Graham Stringer: That they can be used to raise funds, and that they are recognised on balance sheets by the financial sector.
Matthew Hancock: Yes, they will be English common law contracts. That is why we set up the LCCC, to ensure that they are standard English common law contracts. It also means that they are not statutory, so they are protected against the whim of a future Government by being guarded by hundreds of years of contract law. That was the purpose of setting up the LCCC, in order to protect them in that way. That is a good bulwark against that.

Q258 Graham Stringer: You think that is an unfair criticism? How much contact was there with the financial sector before the design?
Matthew Hancock: I will ask Jonathan to answer that. I would not have expected there to have been contact with all parts of the financial sector—it is a pretty big sector.

Q259 Graham Stringer: No, the relevant parts.
Jonathan Mills: We worked with the financial sector in a number of ways. In our formal consultations, we received responses from a number of either group of financiers or individual financial institutions. We had informal contact throughout the process of policy development with all affected parties, including again potential financial investors. Then in the process of moving the FID enabling contracts towards closure, we had more direct contact with projects that were looking at investment. I would note that we have several large-scale renewables projects that have taken up the contracts available through the FID enabling contract, and several of those have taken the final investment decision and so have made the financial commitments that demonstrate that they believe this to be bankable. So we consulted with them, both formally and informally, throughout the process.

Q260 Graham Stringer: Just a final question that you have touched on. How concerned are you about the level of risk to developers of less established technologies as a consequence of the move to competitive auctions?
Matthew Hancock: I do not think that question could be considered on its own because the move to auctions is an allocation mechanism that allows us to get better value for money out of the subsidy that we choose that bill payers ought to pay. The deeper question is how much should we choose that bill payers ought to pay, which is set by the LCF. So the fact that we have a competitive process for allocating that subsidy leads to better value for money, and it means that we can make sure that we choose to subsidise the projects that are going to give us the most bang for the buck. It means that there is not an infinite amount of subsidy available, but there is not an infinite amount of subsidy available anyway and quite rightly so. This is an allocative decision.

Of course in any project, in any business, there is risk attached and the risk of whether or not you attract successfully taxpayer subsidy is a perfectly reasonable risk for us to introduce, because it is an inevitable consequence of having a limit on the amount of subsidy we are prepared to put on taxpayers' bills, which is something that is a perfectly reasonable democratic decision.

Graham Stringer: Thank you.

Q261 Chair: As it happens, I think the design of the CFD contracts and the role of the LCCC reflected concerns expressed by this Committee when we looked at the draft Energy Bill in 2012. I think we had some influence on the outcome, which is broadly speaking satisfactory.

Matthew Hancock: Yes, Jonathan told me to say that in the pre-brief and I forgot. Can we put that in as my answer? You are quite right. I was supposed to, at that point, flatter and charm you but I completely failed.

Chair: As you were not here earlier on, I should draw attention again to my entry in the Register of Members' Interests and my interest in the energy industry, including the nuclear sector.

Q262 Sir Robert Smith: I suppose I should remind the Committee again of my entries in the Register of Members' Interests, in particular oil and gas. Just on appeals for review, you are saying it might be too easy to appeal. Surely in the early stage, one of the key things is to look at how successful the appeals are and therefore getting the decision right first time.

Matthew Hancock: Yes. That is absolutely right, that has to be part of what we think about over the summer. By the way, you put the wrong words into my mouth, you said, I think, "more difficult to appeal". It does not necessarily need to be more administratively burdensome to appeal. If an appeal is risk-free, you would expect it to become the norm as opposed to people thinking about whether they have a good chance, like appeals in all things, both business and sporting.

Q263 John Robertson: Minister, the complexity of the CFD allocation process has created additional difficulties for SMEs. How have you helped smaller participants to compete equally for CFD contracts?

Matthew Hancock: Again, the proof of the pudding here will be in the eating, when we have the auction in the next few weeks to find out how successful SMEs are. If we are signing up the bill payers to a very long-term contract to provide energy, we have to be sure or have a reasonable certainty that the businesses on the other side are going to be able to deliver on their piece. That does mean that we have to do some serious due diligence. It means that, in order to make that practicable, we have to have size limits. I am also the Minister for Small Business, so I bow to no one in my support for small businesses, but the practical consequence of signing up bill payers, which is what we are doing, to these long-term contracts means you have to be pretty sure the other side will see it through.

Q264 John Robertson: Leonie Greene of the Solar Trade Association complained about the fact that you have to typically sink around £200,000 to meet the pre-qualification criteria before you even get a bid in. There is a risk to that kind of money to very small companies. Is it going to be worth it to them to do it, and therefore has it become a hindrance to companies to do it? But what happens if you do not win the bid? How can a company like that afford £200,000?

How can they stay afloat? I think you have to agree that the risk to SMEs in comparison to large companies is disproportionate.

Matthew Hancock: I do not think that is fair. These are multi-million pound, and sometimes billion-pound, contracts. There is a huge amount of bill payers' money at stake, and I feel keenly the fact that, when I am making ministerial decisions over how this works and the design of it, I am making decisions where we are forcing bill payers to part with their hard-earned cash. We have to remember that throughout the whole of this process. This is regulating the way that people pay for their energy. As far as the small businesses are concerned, we have feed-in tariffs, so especially on the renewable side, feed-in tariffs are precisely there to have a much lower cost, much smaller cost of entry renewable systems. This is designed for the big stuff and that is expensive. Then we have a simpler, much-cheaper-to-apply-for subsidy system for the little stuff.

Q265 John Robertson: The question has to be then, Minister, is DECC serious about getting in more competition and new entrants, particularly from the smaller companies?

Matthew Hancock: Yes.

Q266 John Robertson: Because it would appear to me, what you are saying is, "It is not our fault that they can't afford that and we are not willing to try and help you in any way." We have had lots of complaints about the workshops themselves that are supposed to give them advice. DECC does not come out very well in this.

Matthew Hancock: I think that is pretty unfair and, again, you have to look at the outcome of the auction. We had 77 capacity market units bid for new build. The large part of that was independence, which means that we have expanded the range of players in the market through this process. That is on the award side but, of course, there are even more on the application side. This has had the effect of allowing new entrants into the market, of expanding the proportion of independence in the market and of broadening participation. I think that is a good outcome. Of course, if you have a very small supplier, then they are going to find it difficult to get through a process that is designed also for vast multi-million pound power stations. I make absolutely no excuses for dealing cautiously with the money that people pay on their consumers' bill.

Q267 John Robertson: It is not a question of consumers' money—

Matthew Hancock: Yes, it is, everything in this is about consumers' money.

Q268 John Robertson: Nobody sticks up for the rights of consumers more than this Select Committee does, but at the end of the day we also have to realise that people's employment is part of the round as well, and the fact that some of these small companies should have at least the opportunity to, first, understand what the bidding process is and, second, be able to have a chance of getting involved.

According to Leonie Greene again, who has complained about DECC, her opinion is that they are not serious about getting more competition. She says, and I quote her, "We know good quality companies are not bidding." Surely that cannot be right, and if it is you need to do something.

Matthew Hancock: Of course we want as many people as possible to bid, and we want as many companies as possible to be able to bid. We have to, therefore, make sure that the due diligence that we do is as light-touch as possible, but it has to be effective. It would be a mistake to reduce due diligence to an extent that means that we make the wrong investment decisions on multiyear contracts with consumers' money. So we have to get that balance right. Of course, there will be very small suppliers who say they would love to be part of the capacity market or the CFDs, but they do not have the money to get going and they do not have a track record, and that presents us with a challenge. The answer is that this is only one part of the suite of solutions. The other part of the suite of solutions includes the feed-in tariffs and other measures to be able to encourage small generation. There is a valuable and much bigger picture question: do we do enough to support small generation to come on to the system? That also goes into connection charges and it goes into how the feed-in tariff works. If a company is watching this and found that the bureaucracy of the capacity market and the CFD was too burdensome, then of course this will be part of what we review over the summer, but I ask the question: should we instead be going in through the feed-in tariffs because they are designed for small players?

Q269 John Robertson: We have had that argument many times in this Committee. What about Dr Nina Skorupska who is with the Renewable Energy Association. Her comment was: "This framework is still geared for people who really understand the market very well and less so for the people who want to enter the market, which is what we want to encourage". Is it not what we want to encourage?

Matthew Hancock: It is what we want to encourage and it is what happened I am delighted—

Q270 John Robertson: Not according to the Renewable Energy Association.

Matthew Hancock: No, but according to the results of the auction.

Q271 John Robertson: I am going with the Solar Trade Association. They do not agree either, so there are people out there who do not agree with you. Are you talking to them?

Matthew Hancock: Yes, of course.

Q272 John Robertson: Obviously not.

Matthew Hancock: Well, we are.

Q273 John Robertson: Okay, let's move on then. The frequency of allocation rounds in auction was complained about by Dr Skorupska. She believed there should be more frequent auctions. I am not saying this is necessarily exactly what she was saying, but more frequency within a year would encourage more people to get involved once they see how the thing works.

Matthew Hancock: Yes, so how frequently to have the auctions is a perfectly reasonable debate and judgment to be made. You want to ensure that the market is not a one-shop game but, on the other hand, we need the auctions to be liquid enough to get the best possible value for money.

Q274 John Robertson: The FIDER, which is a great acronym—why people can't just speak English I don't know, but never mind—was a sort of forerunner for CFD. Have we learned anything from these CFDs, and what changes would you make in future allocation rounds?

Matthew Hancock: Yes, so FIDER was a process to ensure there was not an interregnum between the renewables obligation and the CFDs. I think the single most important thing we have learnt from operating the FIDER and having an auction process is that, in an auction process, you get a competitive value whereas in FIDER you get Government negotiating a contract. Certainly the capacity market has demonstrated that that competitive auction gets you better value for money. So one of the things I hope by the end of March we will have learnt is that having a liquid competitive market is a more effective way of getting the best bang for your buck. The FIDER process was there for a very specific reason, which was to ensure that we managed to get from RO to CFD.

Q275 John Robertson: I appreciate that and I know it was for very important projects, but the larger ones are more expensive—

Matthew Hancock: Yes, it is to keep them moving.

Q276 John Robertson: I appreciate you had to do it. That is not what the argument is about—it is more about whether we can learn from it and whether it has helped.

Matthew Hancock: Yes, undoubtedly the fact of having an auction is something we have learnt. In a sense, we are not going to go back to the FIDER.

Q277 John Robertson: No, I appreciate that. Could you envisage perhaps having more options then? It is quite encouraging that you appreciate it is important and you are looking at it.

Matthew Hancock: Yes. We are not looking at that at the moment. Annual auctions are a perfectly reasonable way to balance those concerns.

Q278 John Robertson: Is it more helpful to large companies than smaller companies? Let's face, small companies need some kind of encouragement to see that they are in the marketplace for it, and to see that it is not just the big guys who can monopolise the process, and who have lots of money at the back of them. When these people bid, I would imagine they are now going almost out on a limb and hoping against all hope that the bid is going to win, so they can go forward rather than go out of business.

Matthew Hancock: I think annual auctions are a good balance. It comes back to the discussion we were having before. I do not accept the premise. There have been loads of independents who have been successful in the capacity market auction. That is good news. We will see what the outcome is on the CFD auction.

Q279 John Robertson: E.ON, which I appreciate is not an SME, has asked the question on the CFDs and the capacity market. What was the reason for developing two different auction designs for the capacity market and CFDs. Why not have just one?

Matthew Hancock: The main reason is that you are auctioning different things. First, you are auctioning essentially an insurance product. Secondly, you are auctioning an option to ensure that renewable technologies are paid for, and to make sure that the subsidy is appropriate. The financial construct of the two contracts is fundamentally different, so I am not surprised that the design of the auction was different. Maybe I could describe it this way. When I arrived in the job and the whole thing was described to me in enormous detail, it did not strike me as a surprise that two different things should be auctioned differently. Jonathan, you were there at the birth of this.

Jonathan Mills: They are doing different things, as the Minister said. In the capacity auction, we are ensuring that there are enough power stations available at times of peak demand. We are not paying for the extent to which they run. With the CFD, we are seeking to reduce the emissions of our generators. That is an instrument that focuses around paying for the energy that is delivered rather than having the power station available for when it is needed. To use an example, under the capacity market, we would expect to be supporting some plant that would be available but would only run very infrequently through the year, and that requires one sort of payment structure, whereas under the CFD, we are seeking to promote low carbon generation that we want to be able to run whenever it is available and economic for it to do so. We are trying to achieve different sorts of aims with the two instruments.

Q280 John Robertson: I understand what you are saying and it sounds very logical, but why would a company like E.ON suggest that that is not right?

Jonathan Mills: There is a debate in the theoretical literature and in the commentators around different models in the world. The emerging model you see in other countries—in the United States and a lot of European markets—is a twin model: having an energy market plus a capacity market. There is a slightly secondary point that some people make about even if you are having different mechanisms, are there ways in which you can align the processes or the timings to make it easier for people to operate within them and I think that is something we will look at in the review.

Q281 John Robertson: Do you think the energy model we are looking at has a European way of looking at things compared to a international—

Jonathan Mills: I am not sure. Even in Europe the twin model has emerged.

Q282 John Robertson: I know how much this Government love Europe.

Matthew Hancock: We look across the whole world to see how we can get the best value for our bill payers.

Q283 John Robertson: How have you dealt with the risk that this sealed bid approach is not going to work? We see the oil price and how it has plummeted, and various people will be worried about how much they should bid. A company, particularly a small company, might bid too low. We have seen this in other areas. Companies came out of early bids for CCS because, in effect, they saw that, at the end of the day, what they said they would pay was too low and they could not finance it. It is a worry for every Government, but at the end of the day, what are you doing to try and ensure that they do not deliberately bid low knowing full well that it is going to cost more?

Matthew Hancock: Ultimately, this is why we have the due diligence that we do. It is a cost of putting an auction process together—making sure you get that appropriate level of confidence on our side that the company is going to be able to deliver.

Jonathan Mills: We looked in detail at different auction methodologies. Having the sealed bids combined with what is called pay-as-clear—you put in your bid, but the price for everybody is set by the marginal plant, which is the difference between being one plant too many and one plant to few—seems to offer the best outcome for bill payers, but also has the fewest opportunities for gaming. Some of the other approaches that people talked about would have been much more prone to larger companies being able to develop sophisticated bidding strategies that would advantage them. Under the sealed bid approach, a small generator knows they can put in what they believe their honest costs to be. That is the minimum they will receive. If the market clears at a slightly higher place because somebody else with better information knows that that was slightly too cheap, they will receive the benefit of that. So it is designed to create the least opportunities for—

Q284 John Robertson: I agree with you. I think two bids is much preferable to any other way of doing it and there is a fairness about it. The risk, of course, is that somebody puts a bid in that they think at the time they can cover, but at the end of the day they cannot. That worries me.

Matthew Hancock: I entirely understand the concern. The due diligence is important, but there is also the fact that I cannot see a strong incentive for a business to do that in a sealed bid process because, after all, in the scenario that you are describing, the company goes bust and we are not going to come and rescue any of these companies if they go bust. Therefore it is appropriate to put in the bid that they think they can then follow through on.

Q285 John Robertson: The problem is, Minister, there are many companies that this has happened to. It has happened to many councils—companies bidding for work have gone out of business halfway through the contract. We have seen these things happen. I just want to make sure that, in this case, DECC is going to keep an eye on it and will not necessarily choose the bottom line just because it is cheap. They should choose the right one because it can be fulfilled.

Matthew Hancock: Absolutely. In a way, it answers your original questions about why there is a cost to bidding for the companies. We demand due diligence of them and we want to mitigate against that. You can never completely eliminate that risk but we want to mitigate against it.

Q286 Sir Robert Smith: One of the concerns from the consumer would be that, if there is too much caution, they would be paying for excess capacity. How do you get around the concern that National Grid has an interest in a larger system, and also the criticism of the technical experts that they were being overly conservative?

Matthew Hancock: Of course, getting this balance right is crucial. It does not only rest on Grid, it rests on Ministers. Getting the balance between the amounts of insurance that the system has to pay, that all bill payers have to pay, and the amount of certainty over security of energy supplies is, I would say, one of the most important judgments that an Energy Minister has to make.

Q287 Sir Robert Smith: Do you recognise Carbon Brief's report that the auction has mainly benefited existing nuclear gas and coal-fired power stations?

Matthew Hancock: No, I think the auction has been fair across technologies and we have a good balance of existing capacity, which we want to remain on the system, of refurb. Refurbing capacity is one of the best value-for-money ways of extending the lifetime of our plant, and some new generation as well.

Q288 Sir Robert Smith: You do not think some of the existing stuff would have stayed there anyway without the incentive?

Matthew Hancock: I fully expected that, whatever the outcome of the auction, there were going to be some people complaining that it was the wrong one and that is, indeed, what has happened according to the critique that you just referenced. If there had been much more new capacity, then those with existing capacity would have said, "Hold on, we have to keep our existing capacity open." If there had been no new capacity, people would have said, "Hold on, wasn't this designed to get some new capacity on to the blocks". These things are always about a balance and there are always going to be winners and losers at both ends.

Q289 Sir Robert Smith: How do you think we would get the balance right with demand reduction, because obviously that is a more cost-effective way of managing the system in terms of low carbon?

Matthew Hancock: It can be more cost-effective but we have to be very careful what we mean by demand-side reduction, because often it is localised generation that is not in major plant. Then there is a much smaller proportion of genuine demand-side reduction. I was pleased to see that there was some demand-side reduction successful in the auction, and we had extensive discussions with the DSR fraternity and I met them as well. Some of the concerns that they had will be part of the review over the summer.

Q290 Sir Robert Smith: How are you responding to Tempus Energy's challenge that the capacity market is unlawful?

Matthew Hancock: This is the question about state aid. We are very confident of our case, not least because the Commission are very keen to only grant state aid where it is lawful. We are very confident that it is lawful and the Commission are very confident that it is lawful, so obviously we will fight the case. Very confident is the answer.

Q291 Sir Robert Smith: Looking further ahead, interconnectors are going to be seen to be playing more of role, or want to be seen to be playing more of a role National Grid seems to have two roles because they are actually a player in the interconnector market. How do you remain confident that there is no conflict of interest or the conflict of interest can be managed?

Matthew Hancock: The answer is that we will decide the policy framework within which interconnectors operate, along with Ofgem, who have a very important role. Grid have their statutory responsibilities in terms of connection, but the policy decisions will be taken by us and Ofgem.

Q292 Chair: Just on the demand side, you will be aware of the close interest of this Committee in how that market is evolving. I entirely understand your point that, if demand-side response means that connecting up a few diesel generators that have not been in use is all that may, in the very short term, help to stop there being an enforced power cut, its other consequences are mostly negative rather than positive. Where we are particularly focused is on the opportunity for using the emerging technology to persuade or incentivise consumers to have a voluntary reduction in their consumption at very short notice, the potential for which some of us believe is quite considerable in the future. In the long term, that will reduce costs and cut carbon emissions, so it has all sorts of benign consequences. I hope that when you conduct your review of how this first year has gone, you will look as sympathetically as possible on ways in which the future capacity auctions can, as it were, help that bit of the market to grow, because of the long-term motives. We do accept that a technology that is in the early stages sometimes needs a bit of nurturing. We accepted that in terms of generation. I would like to think we could also accept it in terms of our opportunity to reduce consumption. Again, as Robert has been saying, there is at least a risk that the enthusiasm for Grid for helping to nurture these technologies may be coloured by the fact that, in the long term, in the 2020s, if they are very successful they might lead to a lower level of capacity being needed on a permanent basis, which would of course then reduce the asset base on which Grid earns its guaranteed return.

Matthew Hancock: I think that is a slightly simplistic view of Grid's incentive structure, not least as there are capacity challenges which Grid face that could be mitigated by more DSR. Even if they were acting purely commercially—they do have statutory responsibilities—their incentives are not as clear cut as that, but I agree. We are going to look very closely at this in the review. In respect of both the make-up of the DSR that has been successful and the DSR that bid, we are going to make sure that that is taken into account. We have to also consider the fact that a lot of demand-side response happens because of direct contractual arrangements with suppliers. That is increasing, and I hope it will increase enormously. If you have a time specific or a breakable supply contract, then you do not have to go anywhere near the capacity market in order to have that. You can have that with your supplier.

It is only one part of the answer, but we will certainly take those criticisms on board.

Q293 Dan Byles: Just before we leave demand-side response, I understand you met with the industry. I am also told that they are unclear as to what outcomes might now follow from that, and as to whether they might be receiving some feedback and whether there is going to be some sort of published outcome from that meeting.
Matthew Hancock: It was a private meeting but we have had engagement with them. That will feed into this review that happens over the summer.

Q294 Dan Byles: Do you have a timeframe for that review?
Matthew Hancock: There is every—

Dan Byles: I know there is a small thing happening in May.

Matthew Hancock: I am sure that will be fine. The answer is that, over the summer—we fully expect this to be an annual process—we would need to do things in time to make changes for next year. That meeting and those discussions were too late to influence policy over this year's auctions, so it will be part of the review.

Q295 Dan Byles: Can I just touch on this uncertainty about diesel generation as part of demand-side response? I understand the difficulty of saying we do not know whether a site are genuinely turning down demand or simply turning on a back-up diesel generator in order to draw less demand. I understand that. But can you categorically rule out diesel farms being a part of demand-side response? My understanding is that diesel farm generators were invited to the meeting you had with demand-side response companies.
Matthew Hancock: Demand-side response is defined in the system as reduction in demand from behind the point of the consumer's connection. It is hard for the Grid to be able to differentiate between different types. There was a broad range of demand-side response people at the meeting.

Q296 Dan Byles: Coming back to the capacity mechanism. We have heard some evidence that the capacity mechanism as set up may end up being more expensive than it needs to be. Obviously, we will want to see this get the best value for consumers. How do we ensure that the capacity mechanism costs are controlled and that we genuinely get the best deal for consumers?
Matthew Hancock: That is the absolutely central design question. That is what it is all about really. If you have suggestions on how it could be done in a more cost-effective way, let us know and we will think about them.

Q297 Dan Byles: The example given by E.ON was around the difficulty in forecasting market share in the future. They say the policy states that suppliers are required to forecast market share at certain times of the year, and that costs will be shared among suppliers based on these forecasts. Therefore suppliers, and by extension customers, will carry the risk if these forecasts are inaccurate.

Matthew Hancock: Inaccurate forecasts are a fact of life.

Q298 Dan Byles: They were wondering whether it might be a lower cost to customers overall if the Government were to set a fixed rate to recover costs using its own balance sheet, with lower costs of capital to cover any inaccuracy in forecasts.

Matthew Hancock: We can look at that. The downside of that is that you have a direct Government intervention in the consequences of wrong forecasting by one of the players in the market. I can immediately see a whole series of unintended negative consequences but there is nothing wrong with thinking about it.

Q299 Dan Byles: Okay, marvellous. In terms of the T-4 auction, obviously there are uncertainties about future wholesale prices, uncertainty about future capacity margins. Are you comfortable that T-4 is right?

Matthew Hancock: It is a good question. Again, it is a balance between making sure there is time enough for capacity to be built or refurbed, but also making sure it is close enough that it is within a reasonable time frame of normal business activity.

Q300 Dan Byles: Is this something that will be reviewed going forward?

Matthew Hancock: We are not planning to change that, no.

Q301 Dan Byles: You are not. Okay. E.ON came up with another interesting suggestion, which is that if too much capacity is procured, National Grid could be allowed to sell over procured capacity on the capacity market. Is that something that could be considered?

Matthew Hancock: Is the proposal that they could use capacity and then sell it on again?

Dan Byles: If they over procure capacity, would they would be in a position to then sell it?

Matthew Hancock: I have not considered that. Jonathan, what is your response to that?

Jonathan Mills: No, I am not quite sure how that would work. I am not quite sure to whom they would sell it. We do have very secondary trading arrangements that we are putting in place in order to enable reallocation of agreements once they are awarded. I think the main way in which we are managing the risks of procuring too much or too little are the T-1 auction. We have not bought everything that National Grid say they think we will need in the delivery year at this stage. We left some open to be bought in T-1. Should we find that demand forecasts have lowered or there is more other plant on the system outside the capacity market, then we have the option of reducing the amount that we procure at that stage.

Matthew Hancock: You have to remember here we are buying an insurance to fulfil a certain amount of demand, but that amount of demand is not in itself certain because it depends on the wider economy and people's behaviour and all that.

Q302 Dan Byles: Coming on to the levy control framework. Obviously the levy control framework represents a cap on the total amount of subsidy that is available in the system for quite understandable reasons, but also the value of the levy control framework obviously depends largely on wholesale price. The lower the wholesale price the more gets eaten up in the early stages, and therefore there is less available further down the line. How can DECC address the impact of the carbon price floor freeze, and the potentials lower than the anticipated wholesale prices as a result, in terms of protecting the buying power of the levy control framework over the period?

Matthew Hancock: That is why the levy control framework is set up in that way. We will take into account these recent very significant changes in wholesale prices in the discussions around the next period of the levy control framework, which we expect to conclude after the election.

Q303 Dan Byles: Do you think there is any scope for future CFDs, including a clause to clawback excess returns?

Matthew Hancock: It is not on the table at the moment, not least because the point about the CFD is it gives a set return, and so the return to the energy provider would not be affected by the lower wholesale cost of energy. That would only happen if cost reduction were very significant on the side of the energy provide. We want to incentivise cost reduction.

Q304 Dan Byles: In terms of the FID enabling process, we have had some contributors questioning the transparency of the decisions to allocate so much of the levy control framework so early on in the uncompetitive way you described earlier. Maybe that is not the right word—perhaps I should have said: "the negotiated way that you described earlier." What do you think the benefits were of allocating such a large slice of the levy control framework budget so early on outside the competitive process?

Matthew Hancock: There is still scope in the LCF but the answer, as in the previous discussion, was to make sure there was not an interregnum. We are trying to build an industry to provide at lower cost future energy needs. If we had a period when there was a gap in the ability to commission, we would have had a problem in terms of the whole supply chain or the consequentials. Preventing an interregnum is the best reason.

The investment has been going at a hell of a pace these past four or five years.

Q305 Dan Byles: But do you see any danger that we could see a potential squeeze on investment in the later period of a levy control framework if you have a combination? In fact, the large slice of it has already been committed, plus there could be less available if there is a lower wholesale price due things like the frozen carbon floor price. So we see there may be a squeeze on available investment.

Matthew Hancock: I would not put the carbon floor price in the frame here. I would say that there is undoubtedly an impact of lower wholesale prices, but you have to balance that against how much we are going to add to people's bills. Everything ultimately comes back to how much we want our constituents to be paying for their energy. There are very significant reasons that I am a strong supporter of to try to make that as low as possible, consistent with living with our international climate change requirements and having a secure system of supply. In a sense, it is a technical question, but the answer is the biggest answer that there is.

Q306 Dan Byles: You are comfortable with the balances?

Matthew Hancock: Yes, I am comfortable.

Q307 Chair: Sorry to interrupt, Dan. We entirely understand and support the need for an envelope for the levy control framework, which, if it was to increase, raises consumer bills directly. However, there is a second issue about how you use that money within the envelope to the best effect. It is that early allocation of money to possibly high-cost technology, such as offshore wind. You are getting less bang for your buck in terms of the amount of carbon reduction. Carbon reduction is less if too much of the LCF money goes on very expensive technology.

Matthew Hancock: Yes, I totally agree with that as a challenge. Of course, we have to consider that these decisions were made ex ante before we knew that the capacity market outcome would be as competitive as it was. Making sure we think about the industrial side of it, mains really do not stop an industry and the costs associated with not having this continuous work. But it goes to a much bigger question. If you want to tackle the long-term challenge of carbon emissions and climate change, how much effort do you put into short-term subsidy, and how much effort do you put into R and D in the hope and expectation that you will have better technologies that are cheaper a long way down the track? That is a much bigger question. In a sense, how much of that went on FIDER is a much smaller piece of a much bigger question. There is an argument, as I have put it in the past, that a pound spent on R and D is more powerful than any pound spent on subsidy. That is because this is a global long-term problem, hence the importance of Paris, hence the importance of getting innovation in this area. I for one think that once solar becomes grid competitive—first with a carbon floor price, potentially even without—then the economics of this will change very radically and we will be in a different world. But that is for a whole different hearing.

Q308 Dan Byles: I am conscious that you are time pressed, Minister, so just to draw together what you said, this is a long-term programme. How do we go about assessing how successful this is being through the long term? Because obviously you are signing very long-term contracts, so it is not like you can stop and assess how it is doing every day. The impact assessment suggested EMR would deliver £13 billion of benefits by 2030. Are there any specific indicators along the way that you can monitor to try to assess whether we are being successful?

Matthew Hancock: Absolutely. There is one measurable and one unmeasurable that ultimately are the guide of this. The measurable is how much we pay for our electricity and the unmeasurable is how much we would have paid in the absence of the policy.

Dan Byles: The great counterfactual.

Matthew Hancock: Well, it is true. We have set a baseline for what we expected that counterfactual to be and already we have had a much better result than our first expectations. Obviously, the auction results are going to be the most important indicator of whether we are on track.

Q309 Dan Byles: Are you going to reassess the counterfactual in the light of changing oil prices?

Matthew Hancock: You can reassess the counterfactual. It is more about gas price and coal prices than oil, of course, and electricity. So, yes, you can rebase, but what you cannot do is reassess how much extra you would have been paying for price spikes. As in any insurance product that you are buying, you buy the insurance up front rather than responding to crises as they happen.

Dan Byles: Thank you.

Q310 Sir Robert Smith: On that variability of the carbon price, do you have a working assumption for the amount of levy control that you are targeting, because obviously if the carbon price goes through the roof you could have done more, and if the carbon price crashes you are going to hit the—

Matthew Hancock: Yes, we have a set out carbon price floor trajectory, which is flat for the time being and then goes up. Of course if EU ETS becomes successful and it is EU ETS prices that bite rather than the carbon floor price, you will have a market price. But as with any of these things, if we switch to a market floor price from what is essentially a tax price—an administratively set price—we will have to use a forecast of a market price. We have to do that in all sorts of parts of energy policy making.

Chair: Roll on the day. Thank you very much indeed. A very helpful session.

Matthew Hancock: Thank you.