House of Commons
Committee of Public Accounts

Department of Energy and Climate Change: Offshore electricity transmission–a new model for infrastructure

Twentieth Report of Session 2012–13

Report, together with formal minutes and oral evidence

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Committee of Public Accounts

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The current staff of the Committee is Adrian Jenner (Clerk), Sonia Draper (Senior Committee Assistant), Ian Blair and James McQuade (Committee Assistants) and Alex Paterson (Media Officer).

Contacts

All correspondence should be addressed to the Clerk, Committee of Public Accounts, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5708; the Committee's email address is pubaccom@parliament.uk

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Summary

The Department for Energy and Climate Change (the Department) estimates that offshore wind farms have the potential to contribute 8-15% of electricity by 2020. This will require a large investment in offshore infrastructure, including around £8 billion of investment in transmission assets (offshore platforms, cables and onshore substations) to bring electricity from offshore wind farms onshore to the national electricity grid.

The Department and the Gas and Electricity Markets Authority (the Authority) have introduced an elaborate regime that licences operators of offshore electricity transmission assets following competitions. The terms of the transmission licences awarded so far appear heavily skewed towards attracting investors rather than securing a good deal for consumers.

The transmission operators receive their income from the National Grid which recovers its costs from electricity suppliers and generators. Although all concerned state that no public funds are directly involved, the future payments to licensees, which will amount to around £17 billion, will in fact be passed onto consumers through electricity bills.

The investors' estimated returns of 10-11% on the initial licences look extremely generous given the limited risks the investors bear. Licensees are guaranteed a fully retail price index-linked income for 20 years regardless of the extent to which assets are used. Yet penalties are limited to 10% of expected income in any one year if the operators fail to provide the transmission facilities when required. Despite the lessons from the PFI market the Government has failed to ensure that gains secured, for example, from debt refinancing are shared. The Department and the Authority must also ensure that the offshore electricity transmission market remains competitive and does not become an oligopoly both at the bidding stage and if and when initial investors sell shares to long term investors.

On the basis of a Report by the Comptroller and Auditor General,[1] we took evidence from the Department of Energy and Climate Change, the Gas and Electricity Markets Authority, and industry representatives on the new licensing regime for offshore electricity transmission.

1 C&AG's Report, *Offshore electricity transmission: a new model for infrastructure*, Session 2012-13, HC 22

Conclusions and recommendations

1. **It is doubtful that this elaborate new licensing regime for offshore electricity transmission will deliver any savings for consumers.** The new regime involves the regulator choosing transmission providers. This is more elaborate than alternative approaches, such as that used in oil and gas where production companies make their own arrangements for transmission, or using an existing onshore transmission company such as National Grid. We have not seen convincing evidence to show that there will be savings for consumers from this scheme compared with potential alternatives. Indeed the new system could well lead to higher prices for consumers. In applying the regime for future licences, the Department and the Authority should:

- show clearly how the regime is expected to produce better outcomes than alternative approaches; and
- introduce a rigorous system of evaluation to confirm whether projected savings are achieved.

2. **There are fundamental weaknesses with the model applied to the first licence competitions.** The terms of the licences awarded look too generous for the limited risks investors are being asked to bear. The licences awarded to date did not include any construction risk yet they provide licensees with a guaranteed retail price index-linked income for 20 years regardless of the extent to which the assets are used. At the same time operators can only be fined a maximum 10% of their expected income in any one year if they fail to ensure their facilities are available and working. Furthermore, investors are not required to share any gains made from debt refinancing or excessive equity profits. The Department and the Authority argued that these terms were not overly generous as there was price competition, but did not produce evidence to demonstrate that these are the terms that offer the best prices for consumers. For future licences and, where appropriate, licences already being competed, the Authority should:

- require investors to provide transparency over actual returns including those from sale proceeds, and to share gains from debt refinancing and excess equity profits;
- reconsider whether a revenue stream linked to the retail price index offers better value for money for consumers than alternatives such as a flat or partially indexed revenue stream;
- assess the benefits and risks of continuing with guaranteed income for 20 year licence periods compared with shorter licence periods or more regular price reviews within each licence period; and
- consider higher penalties beyond the current 10% annual cap for failure to make assets available.

3. **The licencing system relies on effective competition to keep down prices for consumers but it is not clear that a diverse and competitive market has been created.** The Department and the Authority are seeking to develop a competitive

market for offshore electricity transmission in contrast to the onshore monopolies. But the first six licences have been won by just two companies. The PFI market has also shown that even where there is a diverse market initially, there may be consolidation as the first investors sell to a smaller group of long-term investors. The Authority should monitor the offshore transmission market and should refer the market to the Competition Commission if consolidation by a few companies undermines competition.

4. **It is unacceptable that HM Treasury have allowed the Department and the Authority to proceed with the new regime without incorporating lessons from previous government experience on PFI.** Lessons learnt from the PFI market, such as the sharing of refinancing gains, have not been incorporated into the new offshore electricity transmission market. HM Treasury's argument of not wanting to introduce any limitations on investors is concerning given that it used a similar argument with early PFI deals, only to reverse its position later. HM Treasury should be alert to any part of government setting up a new market, and make sure they learn from previous experience.

1 Design of the licensing regime

1. The Government has set a target requiring 15% of the UK's energy to come from renewable sources by 2020. The Department for Energy and Climate Change (the Department) estimates that offshore wind farms have the potential to contribute 8-15% of electricity by 2020 to help meet this target. This will require a large investment in offshore infrastructure, including around £8 billion of investment in transmission assets (offshore platforms, cables and onshore substations) to bring electricity from offshore wind farms onshore to the national electricity grid.[2]

2. The Department and the Gas and Electricity Markets Authority (the Authority) have introduced a regime of competitions to award licences to operators of offshore electricity transmission assets. The Authority designed the terms of the licences against which transmission operators bid. The licensees receive their income from National Grid which recovers its costs from electricity suppliers and generators, who seek to pass on the licensee charges in their prices to consumers. [3]

3. These complex arrangements involve the regulator running competitions for services which the market could provide by other means. For instance, offshore electricity generators could appoint transmission contractors, or current onshore transmission companies, such as National Grid in England, could extend their operations offshore. An EU requirement for the generation and transmission of energy to be separated has ruled out the option adopted previously in the North Sea oil and gas industry, of the generators operating the transmission assets themselves.[4]

4. A fundamental aspect of good project planning is to evaluate all viable alternatives before selecting the method which will deliver the best value for money. In this case the Department and Authority have not put forward a convincing case for the licensing regime they have adopted. The consumers' capacity for meeting the costs of these new offshore transmission licences through higher prices does not appear to have been considered. Instead the Department sought to justify the arrangement in calculations which concluded that the licence competitions would bring competitive benefits in line with the PFI market, an argument we question. We have not seen any evidence that the Department and the Authority rigorously assessed the relative value for money to consumers of other alternatives. [5]

5. Ongoing project management should also include rigorous evaluation of whether the project is delivering the expected benefits. The Authority told us that its more recent deals were more competitive than the first four competitions and that, in particular, the returns required by the investors were reducing. This is encouraging but needs to be incorporated in a full evaluation of the benefits and risks for consumers compared to different alternatives. The National Audit Office had reservations about the Authority's earlier

2 C&AG's report paras 1-3.

3 C&AG's report para 5.

4 Qq 18,103

5 Qq 83-87, 190-198

assessment of the benefits from the first four licence awards which included tax savings which may benefit consumers but are offset by loss of tax revenues to the public finances. [6]

6 Qq 200-203; C&AG's report paras 16&3.18

2 Developing the market and the terms of the deal

6. The early evidence of the first four licence competitions suggests that the Authority succeeded in developing the new market in a way which was well received by bidders.[7] However, the Authority appears to have achieved this by offering extremely generous terms to investors which appear out of line with the risks the investors were asked to bear.[8] The licences awarded to date did not include any construction risk yet they provide licensees with a guaranteed income linked to the RPI (Retail Price Index) for 20 years regardless of the extent to which the assets are used, and licensees only face limited penalties if their transmission assets are not available. Furthermore, investors are not required to share any gains made from debt refinancing or from excessive equity profits.[9]

7. The Department and the Authority argue that bidders were in a price competition to secure these terms.[10] We have not, however, seen evidence that the generous terms that were offered secured lower prices for consumers than other less generous terms might have. In response to our concerns the Authority acknowledged the need to learn lessons from the initial transactions and to consider refinements to the terms of the deal for future licence awards.[11]

8. The licensees and their investors benefit from a revenue stream guaranteed for 20 years provided that the licensees meet the performance requirements for electricity transmission set out in the licence. The first four licences guarantee payments totalling £566 million over the life of the licences.[12] It is unusual for a regulator to allow such a long period of guaranteed revenue without periodic reviews. The long fixed revenue stream means consumers could be left paying for assets which become redundant before the end of the 20 year period, and it also may restrict emerging opportunities to enter into deals with North Sea countries to develop an offshore grid. The Authority chose a 20 year licence to match the expected life of the undersea cable, but accepted it was a challenge to assess the likely life of assets far out at sea and told us it would reconsider the licence period in future awards. [13]

9. The Authority's licence terms allow licensees to have all of their annual revenue increased annually in line with the RPI inflation measure over the 20 year licence period. This decision was taken despite the fact that around 80% of the licensees' costs are financing costs which can be fixed at the outset to avoid inflation risk.[14] Consumers will have to fund the resulting costs through increases in electricity prices. The Authority

7 C&AG's report para 3.3, Q81

8 Qq 18,24,36,78-9,100,123

9 Qq 18, 33-38

10 Q 175

11 Q 107

12 Q 22

13 Qq 88,156-7,160

14 C&AG's report para 2.13

defended the arrangement on the grounds that they were seeking to attract finance from high quality pension funds which seek revenue streams rising with inflation to match their liabilities. Two pension funds are now providers of finance to bidders for current licences. However, the four initial licences were all financed without direct pension fund investment.[15]

10. The financial penalties which the licensees can suffer for failing to make the transmission assets available for use are limited to 10% of their revenue in any one year, or 50% of one year's revenue deducted over a five year period.[16] Transmission Capital Partners, which was awarded four of the first six licences, told us that these levels of deductions acted as an incentive to maintain availability as incurring such penalties would quickly reduce the investors' returns.[17] The Authority also requires a bond from the licensees to protect the consumer from unexpected dilapidation or non-performance in the later years of the 20 year licences and could, in extreme situations of underperformance, withdraw the licence. As the licence periods progress we would expect the Authority to monitor carefully whether what appear to us to be limited penalties for poor performance are protecting the availability of the transmission supply in the way that the Authority expects. [18]

11. Our predecessors on this Committee identified that investors in PFI contracts often took opportunities to make large gains from the refinancing of PFI bank loans as the market matured and the initial risks of projects had reduced.[19] In response to these concerns the Treasury introduced arrangements for refinancing gains to be shared with the taxpayer. Despite this clear lesson from the PFI market the Authority did not include any requirement for refinancing gains to be shared in its licence terms.[20] There appears to have been no liaison between the Treasury and the Authority to ensure that the lesson to share refinancing gains was passed on to the Authority. The Treasury told us that in this case the aim had been to get this new type of commercial arrangement up and running without restrictions or limitations. This is the same Treasury argument which allowed early PFI investors to receive large refinancing gains before gain sharing was introduced following pressure from this Committee. There is no evidence that the Authority has achieved much better pricing by omitting a gain sharing arrangement because the impact of seeking such an arrangement was not tested with bidders.[21]

12. A further lesson from the PFI market, on which this Committee has reported, is that initial investors often take opportunities to sell their equity shares to realise early profits. In some cases this may indicate inefficiencies in the way that the equity shares were priced. For the PFI market this Committee recommended that standard contractual arrangements should be introduced to enable the public sector to share in investor returns above defined

15 C&AG's report, Figure 4, page 24; Qq 99-100, 175

16 C&AG's report, Figure 3, page 21; Q 43

17 Q 43

18 Qq 93-94

19 Committee of Public Accounts, *The refinancing of the Norfolk and Norwich PFI Hospital,* Session 2005-06, HC 694; *The Refinancing of the Fazakerley PFI Prison Contract*, Session 2000-01, HC 372

20 C&AG's report, Figure3, page 21; Qq 148-151

21 Qq 150-151

levels. [22] As with refinancing, the lessons from the PFI market do not appear to have been transferred to the Authority's licence arrangements. There has already been an early share sale on one of the four initial licences.[23]

22 Q 12; Committee of Public Accounts, *Equity Investment in Privately Financed Projects,* Session 2010-12, HC 1846, recommendation 8.

23 C&AG's Report para 3.13

3 The response of the market

13. The initial investors were seeking returns higher than investors earn in operational PFI projects at the same stage after construction risks have been dealt with. The 10-11% return they sought may, in part, have reflected the particular risks of setting up transmission assets in a challenging offshore environment and that the initial licences were awarded in a new market where the success of such projects had yet to be established. The attractive licence terms, including the guaranteed 20 year revenue stream, would, however, have been an offsetting factor which should have reduced investor risks and the returns they required. More recent evidence suggests that the returns being sought by investors, who are not bearing construction risk, is decreasing from the 10-11% initially sought. [24]

14. The Department and the Authority introduced competition to the licence awards with a view to improving value for money. There are, however, factors which could limit the diversity of the market and the extent to which competitive benefits will be secured. Competition would be limited if only a small number of bidders are sufficiently credible to be awarded licences. Four of the first six licences were won by one company Transmission Capital Partners. This risks the creation of a monopoly supplier. The Authority informed us that, in three bigger licences which are currently being tendered, there were four bidding consortia competing against each other so it was hopeful that wider competition was emerging.[25]

15. A further risk to competition would arise if there is significant consolidation in the ownership of projects as a result of initial investors selling their shares on to long term investors with a business strategy to build up portfolios of similar projects. The sale of Macquarie's interest in the Walney 1 licence within two months of being awarded the licence indicates the potential for the development of a secondary market in ownership of the projects, similar to that which developed in the PFI market.[26]

24 Qq 17-18, 38, 202

25 Qq 154-155

26 C&AG's report para 3.13; Qq 7, 124-129

Formal Minutes

Thursday 6 December 2012

Members present:

Mrs Margaret Hodge, in the Chair

Mr Richard Bacon
Stephen Barclay
Guto Bebb
Meg Hillier
Fiona Mactaggart
Mr Austin Mitchell
Nick Smith
Ian Swales
Justin Tomlinson

Draft Report (*Department of Energy and Climate Change: Offshore electricity transmission–a new model for infrastructure*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 15 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Twentieth Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Monday 10 December at 3.00 pm

Witnesses

List of Reports from the Committee during the current Parliament

The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2012–13

First Report	The Government Procurement Card	HC 1915
Second Report	Mobile Technology in Policing	HC 1863
Third Report	Efficiency and reform in government corporate functions through shared service centres	HC 463
Fourth Report	The completion and sale of High Speed 1	HC 464
Fifth Report	The Regional Growth Fund	HC 104
Sixth Report	HM Revenue & Customs: Renewed Alcohol Strategy	HC 504
Seventh Report	Immigration: The Points Based System – Student Routes	HC 101
Eighth Report	Managing early departures in central government	HC 503
Ninth Report	Preparations for the London 2012 Olympic and Paralympic Games	HC 526
Tenth Report	Implementing the transparency agenda	HC 102
Eleventh Report	Improving the efficiency of central government office property	HC 288
Twelfth Report	Off-payroll arrangements in the public sector	HC 532
Thirteenth Report	Financial viability of the social housing sector: introducing the Affordable Homes Programme	HC 388
Fourteenth Report	Assurance for major projects	HC 384
Fifteenth Report	Preventing fraud in contracted employment programmes	HC 103
Sixteenth Report	Department of Health: Securing the future financial sustainability of the NHS	HC 389
Seventeenth Report	Department of Health: The management of adult diabetes services in the NHS	HC 289
Eighteenth Report	HM Treasury: The creation and sale of Northern Rock plc	HC 552
Nineteenth Report	HM Revenue & Customs: Annual Report and Accounts 2011-12	HC 716

Oral evidence

Taken before the Committee of Public Accounts

on Wednesday 17 October 2012

Members present:

Margaret Hodge (Chair)

Mr Richard Bacon
Jackie Doyle-Price
Chris Heaton-Harris
Austin Mitchell
Ian Swales

Amyas Morse, Comptroller and Auditor General, **Gabrielle Cohen**, Assistant Auditor General, **David Finlay**, Director, National Audit Office, and **Marius Gallaher**, Alternate Treasury Officer of Accounts, were in attendance.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

Offshore electricity transmission: a new model for delivering infrastructure (HC 22)

Examination of Witnesses

Witnesses: **Maf Smith**, Deputy Chief Executive, Renewable UK, and **Dr Chris Veal**, Director, Transmission Capital, gave evidence.

Q1 Chair: I welcome the group from Bangladesh, who are with us today at the back of the Public Gallery. We have another group at the front. Welcome, I hope that you find our proceedings interesting.
I thank Dr Veal and Mr Smith for coming. I will start with you, Dr Veal. My understanding is that you now own four of the six licences.
Dr Veal: That is correct. Transmission Capital Partners has closed four deals.

Q2 Chair: Presumably, in owning four out of six, you are able to make some savings out of being a rather bigger player?
Dr Veal: Surprisingly, it is difficult to do that to date. The assets are spread around the coast of Britain. We have three in the north-west—two in Morecambe bay and one in the Solway firth—and there is one in the Thames estuary, so they are quite geographically dispersed. We have different contractors on each project. At the moment, I would say that there are not a lot of synergies in owning more than one asset.

Q3 Chair: So why have you gone for four?
Dr Veal: Because the investment opportunity meets the investment criteria of the equity investors that we use for projects. It is an attractively structured regime for—

Q4 Chair: Is your background in this area?
Dr Veal: My background is that I am originally an engineer by training. I worked for the national grid for 14 years. For the latter part of that, I was doing project development—this sort of project, so interconnection projects between Britain and Europe. I then worked for four years developing offshore wind farms—one of the largest offshore wind farms.

Q5 Chair: The generator element of it?
Dr Veal: Yes.

Q6 Chair: And you set this up with equity finance?
Dr Veal: I set this up about four years ago. We set up a company called Transmission Capital with three others, and then we were working with an infrastructure fund and their fund manager. That is where the equity comes from.

Q7 Chair: You say that there is no synergy, but it is a good investment opportunity. What I am trying to get at is that it seems to me that, if you are in there and have decided to become one of the key players in the transmission business, there must be some savings and better value if you are doing it all. I just wonder whether you would be prepared to share that with the Committee, and whether you should be sharing a bit of it with the taxpayer.
Dr Veal: In the four we have to date, I don't think we have seen many synergies from those assets.

Q8 Chair: Why carry on doing them all? Why not diversify into other areas? You and this other company—there are two of you—are becoming oligopoly players in this world.
Dr Veal: We take part in the competition, and we try to be as successful as we can. We feel that we have been reasonably successful, and we are very happy with where we have got to. We won four of the nine that were awarded first—less than half of the first round.

Q9 Chair: Four of the nine?
Dr Veal: Only six have been closed, but three have been awarded in the first round that have still to be closed, and none of them are our projects.

Q10 Chair: So how many have we got? We'll ask the officials. Do you know, David?
David Finlay: What Dr Veal said is correct. Six have reached—

Q11 Chair: Yes, I understand that, but how many players have we got? How many companies?
Dr Veal: There are essentially four consortiums across nine first round projects. We are one consortium and we have four projects. One is called Blue Transmission, which has three. There are two others that have one each, and Balfour Beatty is a common party to both those consortiums.

Q12 Chair: This Committee has quite a lot of experience of PFI, and we have seen considerable profits being made by those who have chosen to invest in the private sector. We are the defenders of the public purse, and the taxpayer's friend in Parliament. We think that in those instances there should have been a fairer sharing of profits between the taxpayer and the partner. I am trying to tease out of you whether it would be better to have a more transparent process here, with some sharing of profits.
Dr Veal: It's a reasonably transparent process from our perspective in that we go through a process that Ofgem runs.

Q13 Chair: It's transparent to the Department, not to the taxpayer.
Dr Veal: I'm not sure what I can say on that. We take part in the competition, we abide by the rules, and we do the best we can.

Q14 Chair: It sounds like Starbucks on the radio this morning—"We play by the rules, but we don't pay any tax."
Dr Veal: I can't comment on Starbucks.

Q15 Chair: I'm not expecting you to. I am not suggesting you don't play by the rules. I am suggesting that this is an untried and untested area of so-called competition to try to eke better value for the taxpayer. Our experience of PFI is that it didn't work very well. Our concern here is that we may be seeing a similar picture emerging, so we think it would be good to have transparency, and perhaps some sharing of profits.
Dr Veal: The profits that are made are at a reasonable level.
Chair: It's a pretty easy business. I would be putting all my money into it if I could get 10% or 11 %.

Q16 Mr Bacon: What profit margin are you making?
Dr Veal: The equity return is 10% or 11%, and I think the National Audit Office report compared that with the PFI sector, on which I admit I am not an expert.

Q17 Chair: It is 8% or 9% in PFI, which we thought was pretty generous.
Dr Veal: So it is slightly higher than in the PFI sector, but you must recognise that we are looking at offshore assets, and there is a premium for the fact that they are offshore. They are in a not particularly benign environment, and it could be said that it is a hostile environment. There are access issues if access is needed to maintain them. There is an availability incentive, which means that you get penalised if the assets are not available. There is significant risk.

Q18 Chair: This is certainly not personal, but after reading all the papers and with the best will in the world, I honestly can't see the value you are adding. You are in a contract whereby you are given a 20-year certainty of income, whether or not the energy from the wind is used. That income is given to you on an RPI basis. In today's world, nothing is fixed to RPI. The only penalty if, for any reason, you just shut shop tomorrow, is that you would lose 10% of your income. It is the customer who will be backing a totally certain investment on your part.
I see absolutely no risks at all, and there is no profit if you refinance, for example, which I imagine you will be doing because you start the financing at a very difficult point. As time gets easier, you will refinance more cheaply and make more money on that. I can't see what value you are adding. I can see that you have a very solid certain contract, and I cannot see what benefit you are bringing. So no value, no benefit—except you are making a lot of money.
Dr Veal: In terms of the value and the benefit that we are bringing, we are bringing lower-cost capital to this area.

Q19 Chair: Lower cost than what?
Dr Veal: Than what the wind farm owners would require if they owned the assets themselves.

Q20 Chair: But they built them, and they are maintaining them.
Dr Veal: They are maintaining some of them, but they are not financing them.

Q21 Chair: It doesn't matter, but they are building, they are maintaining. There is no incentive in the system to cut the costs of building these things. I can't see an incentive for that. If they put in a sum to you for the maintenance, which is below cost, they will just up their costs elsewhere to the supplier so the customer picks up the tab in another way.
Dr Veal: There are a number of different points. There is an incentive to keep the cost of construction down from the generations that are building them because, essentially, they will end up paying 85% of the cost through their transmission costs.

Q22 Chair: But they can pass that on.
Dr Veal: I don't think that they can necessarily. If there is competition in the electricity supply market, they will.

Q23 Chair: But there isn't. We all know there isn't.
Dr Veal: That is an entirely separate issue.

Q24 Chair: From the customer's point of view, I can't see any benefit. What value are you adding?
Dr Veal: The lower cost of capital is one value.

Q25 Chair: Lower cost of capital?
Dr Veal: Yes.

Q26 Chair: Than whom?
Austin Mitchell: The state?
Dr Veal: No, than if the wind farms own them or if an onshore transmission owned them.

Q27 Chair: They did own them.
Dr Veal: They owned them only briefly while they were constructed; they don't own them for the next 20 years.

Q28 Chair: How do you know it's a low cost of capital? At the moment, you are paying 2.5% more than gilts.
Dr Veal: If you look at the cost of financing an offshore wind farm, you will find that it is significantly higher than the rates of return that we are earning on these transmissions.
Mr Bacon: Sorry, can you speak more clearly? I didn't hear any of that.
Dr Veal: I said that, if you look at the cost of financing offshore wind projects, you will see that it is significantly higher than the cost of financing offshore transmission under this regime. By taking out that element of the project and financing it through this regime, you are providing a benefit to the wind farm owners in financing that bit at a lower rate than they would otherwise pay.

Q29 Mr Bacon: What is the difference in the rate? What is the benefit? You say that there is a lower cost of capital. How much lower? What is X compared with Y? How many basis points are you talking about?
Dr Veal: I would be guessing, and I don't think that I want to offer anything on that. I think that it is significant.

Q30 Mr Bacon: I could guess that it is higher, and I would be guessing. If you are going to assert that it is a lower cost of capital, it would be helpful to have a number.
Dr Veal: As I say, I am not going to provide one. I know it is higher.

Q31 Chair: How do you know it's higher?
Dr Veal: Because the risks of an offshore wind farm are, by their nature, higher. The technical risks, the market risks and the construction risks—everything—are higher.

Q32 Mr Bacon: Than the risks of laying transmission?
Dr Veal: Than the risks of owning and operating transmission assets, yes.

Q33 Ian Swales: That is what I wanted to come in on. The report talks about risk and reward. Can you lay out the risks that you think your organisation is running? Not the operators, not people who might be doing physical things. What risks is your organisation running?
Dr Veal: We take over the asset once it is commissioned.

Q34 Ian Swales: So you've got no construction risk?
Dr Veal: No. At the moment under the current regime and the assets that we have taken over so far, we haven't got construction risks. We would like the ability to get involved in construction, but that is not an opportunity open to us at the moment. Essentially, the risks that we are taking are the availability risks.

Q35 Chair: You're not. You just get fined 10%.
Dr Veal: Ten per cent. is a significant amount for the equity.
Chair: You're joking. In Germany, they are looking at a scheme at 95%.

Q36 Ian Swales: You're the expert. I want to understand the risks that you are running, because we can understand the reward only if we understand the risks. You are saying that you have a 10% risk around availability. What else?
Dr Veal: Essentially, our revenue is fixed for 20 years but our costs of operating, maintaining and insuring are not fixed for 20 years. So we take the risk with the operation and maintenance costs and the insurance cost.

Q37 Ian Swales: You only have to beat RPI inflation and you actually make more money out of that than you are making on day one. If you have inflation of your income at RPI, and against that you have to defray the costs, you only have to beat RPI and your profit margin is going to widen and widen. I can't think of a business where the costs don't come down.
Dr Veal: That is not how it works, though, because everybody will bid a revenue stream—that is essentially how the competition works—that basically puts them on the edge of what they think they can deliver, because if they bid any higher than that, the chances are they will not win the competition. So you are always at the edge of what you think you can deliver, and if your assumptions go above that you are going to start losing out on what your base case is.

Q38 Ian Swales: Having said you are on the edge and all of that, you are describing risks that to me sound quite low, actually. You are going to make guaranteed income, which gives you that kind of return. What do you think the value of Transmission Capital Partners Ltd would be if you sold it tomorrow, having won these four licences? How would it compare to the capital that the equity investors put into it?
Dr Veal: I don't know the answer to that question. The investors in these assets have never sold an asset. They don't intend to sell the assets. They are long-term investors. Typically their investor base is pension funds. What they want from the asset is a long-term yield to repay their investors.

Q39 Ian Swales: Perhaps I will rephrase the question. What if one of the main investors, one of these pension funds—I do not need to know who they are—decided to sell their shareholding in your company tomorrow? Would they make a profit or not?
Dr Veal: Again, I can't answer that.

Q40 Chair: You can't or you won't?
Dr Veal: I can't.

Q41 Chair: You won't?
Dr Veal: I can't. I have not looked at it.

Q42 Ian Swales: Okay. I am asking the question because we have had witnesses from other spheres sitting here, who get very, very rich from the fact that the capital value of a company like yours escalates quickly, because people see that they have a guaranteed 10% return from the Government. If they see that, they will pay roughly double what the initial capital is. This is one of the things that we as a Committee are concerned about—that the public sector effectively gives away a lot of value to the private sector as a result of making arrangements such as this. What would your comment on that be?
Dr Veal: I do not think that it is a guaranteed 10% rate of return.

Q43 Ian Swales: What could go wrong?
Dr Veal: A number of things could go wrong. As I say, we are responsible for the operating, maintenance and insurance costs, so to the extent that the insurance premiums rise above our assumptions, that will hit us very quickly and start reducing the equity returns. To the extent that we have an incident in one of the assets that reduces the availability of the assets, we will lose out. You say 10%, but that is 10% in a year; we could have a single event that took the assets out for a few months, and then we actually lose 10% every year for the next five years.

Q44 Ian Swales: You talked about having professional experience in subsea cabling, intercontinental cabling and so on. Can you give us an example of an incident that has happened in the last 10 years, where there is a parallel, that would result in major costs for an organisation like yours?
Dr Veal: You only have to look at the interconnector between Northern Ireland and Scotland, which at the moment has a problem with one of its cables. That interconnector has been running at 50% since January. That sort of incident would essentially mean that we lose 10% of our revenue for five years.

Q45 Ian Swales: How old is that interconnector?
Dr Veal: I think it is between 10 and 15 years old. I'm not sure exactly, but it's roughly 10 to 15 years. That sort of incident would significantly reduce equity returns and possibly wipe them out for investors.

Q46 Chris Heaton-Harris: I have a couple of quick questions. You talked about yield on investment. What do you tell your shareholders your projected yield is?
Dr Veal: Our projected yield for investors in the infrastructure fund is roughly 7% to 8%.

Q47 Chris Heaton-Harris: What about the value of the licences you hold at the moment? What do you pay for those?
Dr Veal: The value in terms of the assets we own?
Chris Heaton-Harris: Yes.
Dr Veal: The total capital for the four that we have closed to date is £250 million, of which some is equity.

Q48 Chair: When did you get the first one?
Dr Veal: At the beginning of March last year.

Q49 Chair: Have you started trying to refinance them?
Dr Veal: No.

Q50 Mr Bacon: So that is what you paid for them?
Dr Veal: The £250 million was the asset transfer price. It is what we paid for them, yes.

Q51 Chair: And when are you going to start trying to refinance?
Dr Veal: We have no plans to refinance them.

Q52 Mr Bacon: You have got a number of institutional investors. How many different investors have you got?
Dr Veal: All the assets that we have acquired to date have one equity investor, which is the infrastructure fund.

Q53 Mr Bacon: So this infrastructure fund is a shareholder in your business?
Dr Veal: It is a bit more complicated.

Q54 Mr Bacon: How does it work? Presumably you have an equity stake in the business yourself.
Dr Veal: There are three companies: the one I am a director of, the infrastructure fund itself and the infrastructure fund manager. The infrastructure fund manager and the company I am with manage the bid process and the assets when we take them over. The equity comes from the infrastructure fund itself, which is managed by the infrastructure fund manager.

Q55 Mr Bacon: The equity comes from the infrastructure fund itself? They supply the cash that is handed over, but who hands over the cash? Do they?
Dr Veal: They do, yes.

Q56 Mr Bacon: They do themselves. So they are the owners of the assets, not you?
Dr Veal: No, we are the managers. We do the management on their behalf.

Q57 Chair: And then you subcontract that to the generator.
Dr Veal: We subcontract elements of it to various parties. On the four that we have got to date, the operations and maintenance on three of them is subcontracted back to the generator. On the fourth, it is subcontracted to an independent body.

Q58 Mr Bacon: So your company, Transmission Capital, does not own any of the assets. Are you paid a fee by the owner?
Dr Veal: We have a management contract, yes.

Q59 Mr Bacon: And how much are you paid to run this for them?
Dr Veal: We have a fee that is made up of a couple of elements. I think it is roughly of the order of 1% of the asset value.

Q60 Mr Bacon: So 1% of £250 million. A figure of £254 million was given in the Report, but I am not

sure we are talking about the same thing. When you say £250 million, do you mean £254 million?
Dr Veal: No. I think that is probably referring to the four assets that were closed when the Report was written. The four assets that we hold are slightly different.

Q61 Mr Bacon: So your annual fee for your business is £2.5 million, roughly?
Dr Veal: Yes.

Q62 Mr Bacon: And that is for managing the process. What do you have to spend that £2.5 million on?
Dr Veal: We have to spend it on staff costs, office costs—

Q63 Mr Bacon: How many staff do you have?
Dr Veal: The £2.5 million is for ourselves and our joint venture partner, the fund manager. We have seven staff and our joint venture manager has roughly the same.

Q64 Mr Bacon: So you have 14 staff between the two. So £2.5 million would go a reasonable way among 14 people. Presumably there are other costs. What are the other costs?
Dr Veal: The normal costs of running a business.

Q65 Mr Bacon: I don't mean post-it notes. I mean, if you need to go out to the site of one of the turbines, by boat, helicopter or however you get there, in order to repair it, where does the money for that come from? Does that come out of your £2.5 million management fee, or is that on top, and you then bill the owner every time you have to do something on top? I would have thought that you could run up pretty big helicopter bills in stormy seas, and that £2.5 million would go quite a long way with 14 staff, but probably not for all the other stuff.
Dr Veal: You are exactly right. It is a bit more complicated than just a straight £2.5 million—there is a base fee in that, and there is a variable fee.

Q66 Mr Bacon: On top?
Dr Veal: No, included within that £2.5 million. I don't have the figures at my fingertips, but let's say, for the sake of argument, it is a £1 million base fee and a £1.5 million variable fee. So, to the extent that we spend more than the expected costs on operation and maintenance of the assets, the incremental value of that would come out of the variable fee that we would get. So, in your example of having to send out—we don't use helicopters, but in having to send a boat out—

Q67 Mr Bacon: If you spend more than expected?
Dr Veal: Yes.

Q68 Mr Bacon: But what I am really getting at is what the expected is, and the expected is a number outside of the £2.5 million envelope, or whatever it is—what is the rough annual cost of maintenance?
Dr Veal: Across the four assets, the rough annual cost, which includes insurance—

Q69 Mr Bacon: Let's not cloud things. Obviously, there will be a premium, and if you want to tell me what that is that is fine, but what is the actual operational cost of making sure that they don't fall over, stay doing what they are supposed to do and rotate when they are supposed to?
Dr Veal: Again, it is a little bit complicated, because it is variable; it is not the same every year, because you have periodic circumstances—
Mr Bacon: Of course, it depends how much wind there is.

Q70 Ian Swales: Let me ask a clarification question. I don't think that you are responsible for the turbines themselves, are you?
Dr Veal: No, not the turbines.

Q71 Mr Bacon: No, it is just the transmission and the platform. So it is the platform, all the cabling from the platform to the turbines, and from the platform to onshore. It is that bit, isn't it?
Dr Veal: Yes.

Q72 Mr Bacon: And it is really the maintenance—I am sorry, you are right, I asked my question wrongly. It is the maintenance of that that we are talking about. What, roughly, is the annual cost of maintaining that?
Dr Veal: I think that, roughly—
Mr Bacon: I'm not asking you to sign your name in blood; I just want some sort of handle on it.
Dr Veal: No, and I do want to be helpful and try to give you a figure. I am just a little nervous because it is variable. If I were to hazard a guess, I would say that, across the four projects, it would be somewhere around £4 million.

Q73 Mr Bacon: Right. You were saying earlier that you have agreements in place as to what it ought to cost, and if it costs more than expected, that could erode your £2.5 million variable top-up of your management fee.
Dr Veal: Yes.

Q74 Mr Bacon: But otherwise, the £2.5 million is, basically, for your 14 people, your post-it notes, phones and whatever else.
Dr Veal: Yes. The insurance would eat into that variable figure as well.

Q75 Mr Bacon: Could you mention the cost of the premiums—what is that, separately?
Dr Veal: The insurance premiums?
Mr Bacon: Yes.
Dr Veal: Again, I'm not signing this in blood because I cannot remember entirely off the top of my head, but I think that we are spending roughly £2 million a year on insurance.

Q76 Mr Bacon: Right, and that is on top of the £4 million maintenance?
Dr Veal: Yes.

Q77 Austin Mitchell: A question to Mr Smith. Is this not really just a complex and, for the firms involved,

profitable way of subsidising wind generation? That is, presumably, the aim of your renewables?
Maf Smith: No, it is not.

Q78 Austin Mitchell: But it is a subsidy, isn't it?
Maf Smith: It is not a complex subsidy. Looking at it from the perspective of the generators, what they need is clarity about what the costs, in terms of transmission, are going to be.
Austin Mitchell: Well, they have got them if they have installed the stuff.
Maf Smith: And in terms of knowing that they are going to be able to, essentially, sell the power—get it back to the mainland, and then the companies that they have contracted with can buy the power.
In terms of the way the market works, the generators receive, obviously, the electricity element and, currently, the renewables obligation certificate—the ROC. They only receive that if two things happen. One, they must generate, so the turbines have to be working, and that is what is managed by the generators themselves and the manufacturers. Secondly, the transmission asset must be available so that they can get that power.

Q79 Austin Mitchell: But it is still a subsidy. The charge is not to the consumer. You make a profit out of it and, at the end of the day, generators don't have to invest in the gear—part of their capital requirement is cut out.
Maf Smith: In terms of the support, the renewables obligation is part of electricity consumers' bills, so it is support, on top of the wholesale market price, for renewables. Consumers pay for that. The generator receives support only when the stations generate, so it is on the unit of energy. It is not on capacity, it is on actual generation.

Q80 Chris Heaton-Harris: This is to Dr Veal. This report is about value for money, and how contracts are designed realistically. With your inside knowledge of your previous job, as it were, and then being on the outside, how was dealing with DECC? Was it on a daily basis, and nice and easy? What was the relationship like?
Dr Veal: Do you mean DECC or Ofgem, or both?

Q81 Chris Heaton-Harris: A bit of both. Those that you signed the contracts with.
Dr Veal: Most of our dealings were with Ofgem, and we found the Ofgem team to be very good. It has been a better experience than we might have expected from what some of my colleagues have said about their experience of dealing with other procurement authorities. They found the Ofgem team to be constructive, well educated and well informed, and it knew what it was doing.

Q82 Chair: I am sorry that it has been a bit disjointed with votes all the time. Thank you. I am sorry we didn't ask you more questions Mr Smith, but we will move to the accounting officer when we come back.
Sitting suspended for a Division in the House.

Examination of Witnesses

Witnesses: **Alistair Buchanan CBE**, Chief Executive, Ofgem, and **Moira Wallace**, Permanent Secretary, Department for Energy and Climate Change, gave evidence.

Chair: Welcome, in particular to Moira. This will be your last appearance before us as Permanent Secretary. We hope that there will not be many occasions when we ask you to come back to account for matters that have taken place during your period of office. We wish you well in the future.
Moira Wallace: Thank you very much.

Q83 Chair: I did not know very much about this before I read the Report from the National Audit Office. I have been picking it up as I go along. It just seems to me that this whole process is just a non-progressive form of taxation, is it not? All the costs are passed to the customer, based not on what they can afford to pay but on what they use or need to use.
Moira Wallace: Okay. We have to pay for our electricity. It has to be transmitted from where it is generated. We have always had to do that. The system is privatised but it is regulated by Ofgem. What I think this Report shows is that as we build out the grid to bring in the electricity from offshore wind, we and Ofgem together have tried to innovate to keep costs down and combine the benefits of competition and regulation. Actually, the Report is quite complimentary about the model.

Q84 Chair: Can you answer the question?
Moira Wallace: It is not a form of taxation, and it is not public expenditure.

Q85 Chair: It seems to be what I said; it is non-progressive taxation. You can be pedantic, but it is the costs and prices we pay, and we do not have any choice.
Moira Wallace: Energy bills are not progressive. They are costs imposed by private companies.

Q86 Chair: The whole of this thing is subsidised by the customer.
Moira Wallace: It is paid for by the customer, but energy bills are not progressive. What the Government try to do is find ways of helping make the system less regressive by helping people to use less energy in various ways that we have discussed in previous hearings, and by helping various people to pay their energy bills.

Q87 Chair: I know all about that. So, in effect, you are accepting that funding people through their charges is not particularly progressive, and also that this is going to be funded through the customer.

Moira Wallace: Yes. This is a privatised industry. Lots of costs that we all pay—all the household bills we have to pay—are not progressive. The scale of energy bills is such that this Government and other Governments have taken the view that they want to do something to help various groups.

Q88 Chair: I am not taking a partisan view here; it is just a fact. Therefore, if we accept that it is non-progressive and that in the end, the customer pays, it feels to me that using terms like markets and competitions in this context is almost a misuse or an abuse of those terms. I don't know if you were here when I was asking questions earlier, but let me put the reason why to you. These licences give a 20-year guarantee of income. Whatever is used, the income is guaranteed. They get it on RPI, which is absolutely astonishing in the context of the current climate. They only lose 10% of their income if they shut the place down because of repairs, and there is no profit share. We find that completely astounding, particularly given our experience of PFI. This is a rotten deal for the non-progressive customer.
Moira Wallace: I don't agree with that at all. To take that point in several bits, first of all, this is a really innovative technology, which the UK is well placed to benefit from. We have one of the best wind resources in the world.

Q89 Chair: That's not relevant.
Moira Wallace: Well, it is, because it is innovative and new. It has not been done in many places in the world, and it is a complex piece of engineering, both to do—to lay the cable out into the middle of the sea—and then to maintain. It is not an easy thing to do. It is quite risky, and it is the first of a kind.

Q90 Mr Bacon: What is the first of a kind?
Moira Wallace: We are in the early stages of the offshore wind industry.

Q91 Mr Bacon: There have been offshore wind turbines off Germany and Denmark for many years. It is not the first of a kind.
Moira Wallace: It is not the absolute first of a kind, but in terms of the scale, and the deep waters that we are increasingly going to be getting into, this is not—
Austin Mitchell: But that's the industry not bringing the electricity ashore.
Ian Swales: The hearing is about the transmission. I do not think laying subsea cables is a new industry at all, is it?
Mr Bacon: People have been laying subsea cables for 100 years.

Q92 Chair: Please answer the question—you can see that there is a collective mood here.
Moira Wallace: I sense that, but none the less, this is quite a new sector in this country and it is growing in scale. I have now forgotten the rest of your question, because I was interrupted so many times, so Alistair will continue.

Q93 Chair: I am saying to you that this seems to be a rotten deal. You are giving them a 20-year guarantee of income, whatever is used. You are giving them RPI, which I find extraordinary. You are only fining them 10% if they shut down the place because they want to repair it, and you have failed to put any profit-sharing clauses in to the contract.
Alistair Buchanan: I'll take those in turn. With regard to performance, you are right when you say there is a 10% issue, but if there is continued underperformance, the licence condition clearly says that we can take the licence away. We also put in place—

Q94 Austin Mitchell: But if there is overperformance, they can flog it on.
Alistair Buchanan: Indeed.
Moira Wallace: But if they fail to perform, their maximum exposure is not 10% of their revenues. Their maximum exposure is that their licence has gone, and all the revenues are gone. There is an ultimate sanction.
Alistair Buchanan: Because this is, to a degree, nascent technology, we will also require from them towards the end of the 20-year period a bond of 50% of our annual revenue to protect the consumer from unexpected dilapidation or non-performance. Performance isn't just the straightforward 10%. There are other elements to give consumers comfort. We consulted on RPI.

Q95 Chair: Who did you consult?
Alistair Buchanan: Widely.

Q96 Chair: Customers? The rest of us are all having to deal with CPI, and I think that you are too.
Alistair Buchanan: The important thing is that the Report has been done early, and I am very glad that you have called us early because there are a number of projects. The four small projects that are party to this are in what is called the transition regime. We are writing the rules for the enduring regime, and we are going out to consult on them.

Q97 Chair: So you will shift to CPI.
Alistair Buchanan: Indeed, we will want to find out views on that, and the views of this Committee will be very important.

Q98 Chair: But did you consult customers?
Alistair Buchanan: We consulted widely. We consult all parties in all of our consultations.

Q99 Chair: Of course, the guys who can make money on it will want RPI.
Alistair Buchanan: Can I explain why we made the judgment? You may disagree with my board's judgment. The judgment on RPI was that we were keen to ensure that debt, which is typically RPI-linked, and swaps that are also RPI-linked, which provide a hedge to the debt, were effectively reflected in the programme. Consequently, that was a very important driver. The other important driver is that we are trying to attract high-quality, blue-chip pension funds. I am glad to say that two such funds are now in that transition round one and are clearly attracted by RPI.

Q100 Chair: Anybody would put their fortune into this. They are guaranteed 20 years of income.
Moira Wallace: Not if they don't follow—

Q101 Chair: Then they get a 10% cut.
Moira Wallace: No, they would have their licence revoked.

Q102 Chair: I await the day when you revoke a licence.
Alistair Buchanan: This is cable. This is wire, and the licence conditions on the offshore players in a way ape the licence conditions of, let us say, the national grid and its licence control over the supergrid. One of the differences is that, on the onshore, we revisit every eight years, as you know. The big difference answers your very first question. Offshore, we felt that to create the right investment climate, we have a competitive tender to win the cable. Onshore, of course, you have a monopoly. You have four active groups currently competing.

Q103 Austin Mitchell: Why bring private firms in to tender for it? When we developed the North Sea oil industry and the gas industry, we didn't say that the pipes were a lot more difficult than cable and that the gas pipes should be brought in by private pipe firms competing for tender. We have the oil companies do it. Why create that distinction now?
Alistair Buchanan: The distinction has been created by Brussels, which has required unbundling. Therefore, the cable—and in your example of the North Sea, the pipe—has to be separate from the generator. Therefore, whether we like that or not, that is what Brussels has dictated throughout the first directive.

Q104 Ian Swales: I ought to declare an interest. In my constituency, Redcar, 27 giant turbines are going up outside my house at the moment built by EDF. As far as I know, EDF is bringing the power ashore, has built the substation on shore and is not subject to the regime at all.
On the giant Dogger Bank development, I have already had meetings with a company that want to bring half the power from that through my constituency. As I understand it, they are the proposed operators or licensees of the wind farm. Following on from Austin's question, you have brought in a new dimension of Brussels but, to me, large though the investment is, the investment in cables is pretty small compared with what we are expecting to do in the actual fields themselves. I just do not understand why we have this complexity and golden egg sitting in the middle of what is a relatively straightforward activity.
Alistair Buchanan: You are absolutely right on spend; 10% of the overall offshore wind spend is cabled currently. Most of the projects that we have got are very close to shore. Sheringham Shoal is close to Norfolk and Gunfleet Sands is close to Suffolk. The very early ones, such as North Rhyl in north Wales, were virtually on the shore, so were using the onshore network. To be technical, they were using 33 kV.
One of the interesting issues, which comes back to Mr Mitchell's question, is that one would imagine that cable is straightforward, but our ambition is far from straightforward currently. In many instances, the technology is nascent or unproven or undelivered. We will have to move to massive DC cables and we have not developed those yet. On your Dogger Bank argument, we will need DC voltage control substations in the middle of the North Sea and we have not developed anything like that so far. In fact, you think cable is dull—it may still be dull—but the technology is profoundly complex at the moment and has not been developed. We have yet to go though this process of developing the cable technology.

Q105 Chair: But we've got six of these things up and running, haven't we?
Alistair Buchanan: Yes, but they're very close to shore. When they start to stretch out, there will be massive complications.
Moira Wallace: On your point about some people bringing their own electricity ashore, in the very early days some did. Some are also below a threshold where that is allowed, where they are so small that they are not treated as part of the major transmission networks. Some of the early projects were under the regime that you described where they brought it ashore themselves.

Q106 Ian Swales: This is being constructed now and it is 27 very large turbines. That is the EDF project. Going back to your comments about DC cables and so on, the company that came to see me, which was talking about bringing half the power from Dogger Bank in near to where I live, showed me photographs from Australia of the types of substations and equipment that would be needed on shore. We kid ourselves in this country that we are leading all these technologies, but we are not. Carbon capture and storage and all these technologies exist all over the world. We kid ourselves and allow ourselves to be kidded by people who say it is all very difficult and expensive. How could they show me photographs of what is needed when you are telling me that it is not developed?
I am also confused by the fact that it was Forewind, which, as I understand, is likely to be one of the operators in the Dogger Bank, that was having discussions with me. Will it do all the work and then have to give a financial deal to some yet unknown player for the cable? Is that how it will work?
Chair: There are two questions there. Can you give quick answers to them?
Alistair Buchanan: Yes, I'll start with the first one. The technology is nascent. You do have a cable, let's say, from Tasmania to mainland Australia. In fact the person in charge of the offshore regime at Ofgem—Chair, you will be pleased to hear this, because I know that it is important to you—was on that project. There is a degree of complexity in what we are looking at now in moving from point to point to what is potentially called mesh, where you are tying them all together and putting voltage control in the middle of the seas. That can be done and will be done, but I do not want to hide the fact that we are on the cutting edge.

One of the problems that has led to a degree of chaos in Germany—it is why Nordsee Ost and Borkum have just been heavily delayed in Germany—is that they are pushing out 100km to 200km into the North sea and they cannot get the kit, and they are developing the technology.
One of the interesting challenges, which was covered in a very good report by Morgan Stanley a few months ago, is that we only have a couple of suppliers of this kit. There is a degree of both bottleneck and control over cable, which is a real concern. The main players, Prysmian, Siemens and ABB are very dominant in the sector. When you look at the wind farms themselves, you see Siemens in a very dominant position on the wind farm turbine. There are some real technology and control issues when we look forward in the sector.
Chair: And the second question?
Moira Wallace: We decided, similarly, to let the developers build the cable. We knew that they could not be allowed to own it, because it had to be owned by someone separate. They could build it, otherwise they would be in the same situation as German wind farm developers, where the system operator has the monopoly and is saying, "We can't cope and you will just have to wait." There are very long delays in Germany, for a variety of reasons. Developers told us that this was going to be a serious barrier to investment and to investors getting a return on it. The flexibility was there in the legislation and allowed, I think in 2010, developers to build it. That is how it started. That may not be how it stays, but that was the quickest way of getting it going while complying—

Q107 Chair: Before I go to the other questions, can I ask whether you are reviewing the 10%?
Alistair Buchanan: Yes, we are. The whole package is under review.

Q108 Chair: The Germans have got 85%, I understand.
Alistair Buchanan: Because they are working on quite a different basis of funding, I would have to go and check that, but things in Germany are not at all comfortable at the moment.

Q109 Chair: I am shocked, Moira, because, across Government, we have known that PFI created assets that have made a lot of money for the private sector at the expense of the taxpayer. I am shocked at that. Therefore I am shocked that we have not got in the contracts a clause that enables us to share in the profits. I am shocked that we have not got it in the first contracts. I don't know why. They will re-finance. You have already had one sell. Why on earth did we not put a profit-share clause into the contract?
Moira Wallace: I'm not sure I can answer that. That would have been a judgment for Ofgem.

Q110 Chair: No—this is the whole point. We know that we got this wrong in PFI. This is a very similar deal, and we got it wrong again. We have made the same ruddy mistake again.

Q111 Austin Mitchell: The answer is that you wanted to give them a soft deal.
Alistair Buchanan: The answer is that when we were looking at this, we felt that for these very small projects at the beginning of the process, the kind of challenges facing PFI—of course, this is private-private—were of a level that, to a certain extent, the construction gain that you can get does not sit with a project like Barrow, but it will sit with the enduring regime projects, and this is why we will take your advice on this.

Q112 Chair: Do you know how much it was sold for? How much did Macquarie pay for the licence?
Alistair Buchanan: I asked my team that question. We do not have those data. That is something that we need to ask under the enduring regime.

Q113 Chair: Did you put in a clause about commercial confidentiality? Are there clauses around commercial confidentiality, placed by either the Department or you at Ofgem?
Alistair Buchanan: Before I answer that, I need to go and check.

Q114 Chair: Because that is another bee in my bonnet, for us following the taxpayers' pound. If public sector agencies put in those clauses, they limit our ability to ensure that we know what is happening.
Moira Wallace: I think it is the case that in the current contracts, you do not have the powers to require that information, but that is something you can look at for the future.
Alistair Buchanan: To give you some comfort—I think we agreed this with the NAOs—we are doing a full review at the end of TR1. I hope I am not selling you a pass here. The NAO will come in and look at that report, and I would envisage that all the information will be available in that report. For example, Grant Thornton has looked at the OPEC savings. PFK has looked at the financial issues. We would incorporate all that in the report for you.

Q115 Chair: I would welcome information from you on whether you have a clause on commercial confidentiality.
Alistair Buchanan: Yes, I will get that for you.

Q116 Chair: We will want to comment on that. Secondly, I'd welcome information on what the profit was in the sell.

Q117 Austin Mitchell: I just wanted to correct Ian's tendency to knock Britain on British achievements. We did lead the world. We put in the transatlantic cable in 1908, and we had a Liberal Government, too.
Ian Swales: Maybe that's where we went wrong.

Q118 Austin Mitchell: I can't see why you did not let the National Grid do it. There is a separation there. They have the ships, the men, and the money, too. Why not let the public sector do it?
Moira Wallace: The National Grid is not in the public sector.

Q119 Austin Mitchell: Why not let the National Grid, which has the ships, men and money, do it, and get an efficient, predictable service?
Moira Wallace: Several reasons. First, National Grid is a private sector company. As a matter of policy, we decided that we did not want to give them a monopoly offshore. We wanted to have a competitive regime.

Q120 Austin Mitchell: But you can have monopolies now with one firm buying several contracts.
Moira Wallace: You can have one firm getting several contracts through competition, but we decided, as a matter of policy, not to say that the whole of the sea or the whole of a bit of the sea is for National Grid. The NAO Report praises that and says that it was a good decision.

Q121 Austin Mitchell: So the alternative to National Grid is other companies making a bigger profit.
Moira Wallace: I don't think there is any basis to say they are making a bigger profit.
Alistair Buchanan: There is nothing to stop National Grid seeking this business and, indeed, they are seeking this business. They have not been successful because they have bid higher than the winners in a number of the early bids. I know they are active bidders in TR2, which is the next round. They now have very strong pension fund partners, too. So they are allowed into this opportunity.

Q122 Ian Swales: Can we clarify one thing? We have seen in our PFI hearings that PFI deals being done one by one are then aggregated by relatively few organisations. I like to think of the salaries of the people who sit at that table, and I think the highest we have had so far is £8.5 million a year for somebody whose only business was aggregating PFI deals. How do you know, and are you interested in the idea, that if you sold all these licences to separate companies, within a few years they would not all be owned by the same company? Are you building any protection, transparency, golden shares, or whatever you want to call it, to protect the position that you say you want?
Austin Mitchell: And any return to the taxpayer on this wheeling and dealing.
Chair: Come on, Moira, this is your last appearance. You can be honest and open about this.
Moira Wallace: I am always honest and open with you, as you know, which is why you like me so much. Putting your two points together, the first step is to award the licences by competition. There has been very lively competition for these licences. Will we know if they are aggregated?

Q123 Mr Bacon: They are fighting like ferrets in a sack for the chance to get to the front.
Moira Wallace: You have evidence from the NAO saying that this has delivered benefits. If you think that is rubbish, so be it, but actually the NAO has just told us that it agrees with our assessment that we have delivered benefits. We can debate the scope, but we have awarded this by competition, rather than by monopoly. I would have thought you might support that. Yes, we will know if they are aggregated; I do not know whether that is a problem in the licence conditions, but, certainly as a matter of policy—we being the policy department—if we thought that, as this regime develops, the goal of competition had not lasted very long and had been subverted, I am sure we would come back and have a look at it.

Q124 Ian Swales: Will you have the power to do it? That is my question. Will the contracts be written in such a way that you will be able to stop, for example, a single company buying up the entire North sea? Will you have the power to do that?
Alistair Buchanan: That is a very interesting point about PFI, but, to give you some comfort, may I take one step back before I answer? We have a centralised team running this at Ofgem. They are now an established team being paid civil service rates. This is very important: the senior team have come from outside. If you take the top three people who took the TR process through, you have someone from National Grid, someone from ABB and someone from Deloitte. They have come together to create this team. I hope they can give you some comfort. And we have proper controls through both the tender and the model mechanism.
On licence selling, as it were, or active competition, it is worth noting that—Parliament will take a view on whether it is right or wrong—if we look at the onshore regime, there have been three active takeovers of network companies in the past year: Pennsylvania Power and Light, which already owned South Western, has bought further network companies in Britain; and CKI of Hong Kong has bought London, Eastern, and Seeboard, and, on the gas side, it has recently bought Wales and West gas. So you have active purchasing in the onshore regime whereby individual parent companies now own two or three, rather than one of 14 or one of eight. A legitimate question to ask me as a regulator is, "Do you find it difficult to regulate them when one parent company owns three subsidiaries?" No, because the three subsidiaries still have to operate in London, Eastern or Seeboard, and they have to deliver their data to us in that form. We are not finding it difficult to regulate. This is a legitimate question that I have asked my board: is there a point where we say they should not do that?

Q125 Ian Swales: In the examples you are giving for comparison, do you insist that such companies, whether or not they are subsidiaries, are UK companies? So, for example, would you insist that our network in the North sea is always owned by UK organisations?
Alistair Buchanan: No.

Q126 Ian Swales: Do you have the power? That is my real question.
Alistair Buchanan: No, we do not.

Q127 Ian Swales: We have already seen one contract change hands. Do you have the power, if you like, to ensure that you can regulate these organisations, which you may not yet know?
Alistair Buchanan: I do not have that power. In other utility sectors Ofcom has a fit-and-proper rule, which

Ofgem does not have; and Ofwat, through the Enterprise Act, has a direct route to the Competition Commission, which, again, is not the case for energy. Different regulators operate within different regimes.

Q128 Chair: Does any of that emerge in the Energy Bill?
Moira Wallace: Has what emerged in the Energy Bill?
Chair: Trying to give us better control to protect the public interest.
Moira Wallace: I think there is no evidence that we need this yet. We are seeing a lot of competition. You may suspect—
Chair: We'll come back to this, because I think a pension fund would be daft not to try to get hold of one of these licences. Absolutely daft. This is the most secure, risk-free investment I have seen in a long, long time.

Q129 Ian Swales: There is a big difference, which is the point of the question: there may be the competition that you desire at the point when the licence is granted—we have seen the same in PFI with massive competition for the next school or hospital—but once they become risk-free and are simply flows of public money, because there is no construction risk, they are traded as virtual Government bonds, and people buy them up and aggregate them.
Alistair Buchanan: If we see anti-competitive behaviour, we can go to the Competition Commission or the CMA, as it will be.
Mr Bacon: If you see anti-competitive behaviour, why do you not use the clause in your contract that helps you deal with it? The answer is that you do not have one. That is our point.
Chair: The Division bells have rung. I ask Members to come back really quickly. Just rush through.
Sitting suspended for a Division in the House.
On resuming—

Q130 Mr Bacon: I would like to ask about the financing costs. On page 24, figure 4 describes the annual payment to the licensees and the value of the assets. Paragraph 3.10 says: "Financing costs averaged 79 per cent of total costs for the four licences that have been awarded." Can I take it from that that, for example, if there is a payment of £28.3 million a year, which is in the bottom-right-hand corner of figure 4 on page 24, 79% of that £28.3 million is paying for the servicing of the debt and the repayment of the loan?
Alistair Buchanan: Correct.
Mr Bacon: I can take that.
Alistair Buchanan: Yes. It is the financing cost.

Q131 Mr Bacon: On page 28, there is a chart showing the total interest rate, including the UK gilt and the commercial premium on top, but if you just take the total, the Robin Rigg is 6.2%, the Gunfleet Sands is 5.8%, the Barrow is 5% and the Walney 1 is 5%. If you take just the debt servicing costs, for the Robin Rigg, which has an asset value of £66 million, assuming you were doing 100% debt, which of course you are not because there is some equity in there, the annual cost of servicing that would be £4.1 million. It would be £2.8 million for Gunfleet, £1.7 for Barrow and £5.25 million for Walney, which is a total of £13.85 million of annual debt servicing costs—just servicing, not repayment—assuming that you had 100% debt, but we know that it is actually only 80% or 90% debt, so you can reduce my figure by 10% or 20%, which makes the debt servicing costs about £12 million. I will calculate it. If it were 10% equity, debt servicing costs would be £12.4 million a year. If it were 20% equity and 80% debt, it would be £11 million. So the debt servicing costs are somewhere between £11 million and £12.4 million a year. However, they are getting £28.3 million, so £28.3 million minus £12.4 million gives you £15.9 million, and if it is the lower figure, you get £17.3 million. So you are left with somewhere between £15 million and £17 million after servicing the debt—paying the interest. Presumably, a significant chunk of that £15 million to £17 million is going on repaying the debt, yes?
Alistair Buchanan: Yes.

Q132 Mr Bacon: And £4 million a year for maintenance costs and the insurance is £2 million a year and so on. Assuming that my calculations, which take the numbers in the Report about the cost of servicing the debt, are accurate—I think they are as it is a fairly simple calculation—how much of that is going on repaying the debt? You are basically getting £28.3 million a year, which has to go in various directions. Some of it goes to servicing the debt, some to repaying the loan, some to paying the insurance premium, some to paying the operation and maintenance—our previous witness said £4 million a year—and some of it potentially goes to rewarding the equity. Of course, you have to have between £1 million and £2.5 million of management fees as well. If you take the £28.3 million, how is that broken up between those different things?
David Finlay: May I add a point of clarification that may help Mr Buchanan? What we say in the Report is that 80% of the amount of money that is paid to the licensee covers all types of financing costs.

Q133 Mr Bacon: You are talking about paragraph 3.10.
David Finlay: Yes.
Mr Bacon: 79%.

Q134 Chair: So the capital repayment comes out of that.
David Finlay: Exactly.

Q135 Mr Bacon: Financing costs average 79% of the total costs.
David Finlay: So if you take 80% of £28 million, which is the total amount paid to the licensees, 80% is about £22 million, and that covers the financing costs of the debt, repaying the debt and the return to equity.

Q136 Mr Bacon: When we speak of total costs for the four licences, that is the total costs to whom—to the people who bought them and bid for them, or what?

David Finlay: That is the amount they would receive.

Q137 Chair: You put an interesting thing in it: you said "and return to equity."
David Finlay: Yes. Total financing costs are 80%.

Q138 Mr Bacon: I assume that the equity wants some reward at some point, if not initially then eventually. What I am really looking at is that my pie is £28.3 million a year, or £566 million over the life of the licence—over the 20 years. But let's keep it on an annual basis. Of the £28.3 million, what I want is a clear picture of what goes where.
Alistair Buchanan: I was looking on the train this morning at the individual projects breakdown. I think I can give you this; I don't see why it would come back to commercial confidentiality. Because each project is different—

Q139 Mr Bacon: And the costs would be slightly different.
Alistair Buchanan: Yes, so what I can do is send you a schedule showing you that breakdown. It is a legitimate question. I haven't got the answer off the top of my head, but I have seen it today, so I can get you that information.

Q140 Mr Bacon: This does not really go far enough for me. I have done my sums: am I right in my thinking about the servicing cost? We are talking about a total value of the asset of £254 million, and between 80% and 90% of that is financed by debt, isn't it?
Alistair Buchanan: Correct.

Q141 Mr Bacon: So somewhere between £203 million and £228 million is financed by debt.
Alistair Buchanan: Correct.

Q142 Mr Bacon: So the cost of servicing that debt—not repaying the loan—is going to be a number that is based on the interest rates illustrated in figure 8, isn't it?
Alistair Buchanan: Yes.

Q143 Mr Bacon: So I am all right so far. And I take those four numbers, and taking the first line, the Robin Rigg, the value of the asset is £66 million. The number I came up with was £4.1 million, but that was based on 100% debt and we know that it is not, so let's say it's 90%, for the sake of argument. That would then be £59.4 million, and £59.4 million multiplied by the 6.2% interest rate means that the cost of servicing that debt is £3.68 million per year. Am I right? Does that make sense?
Alistair Buchanan: I totally understand what you are trying to get. You are trying to get the gap, and I have the answer for you, but I just haven't got it to hand.

Q144 Mr Bacon: Could we have in the chart—in whatever you send us—the annual cost of servicing the debt, preferably broken up by each of the sites, the annual cost of repaying the debt, the insurance payment, the return to equity and the other things? When we get to the bottom it ought to add up to £28.3 million.
Alistair Buchanan: I will send that to you.

Q145 Mr Bacon: That would be brilliant.
I have one other question: Moira, do you accept that if you are the owner of four of these licences, rather than one, there are potential benefits to you, in terms of refinancing, that are not available to you if you own only one?
Moira Wallace: Possibly.
Alistair Buchanan: I am very happy to take the question, but it rather goes back to the conversation we were having previously, which is whether, if you have one company owning multiple cable companies, you get a benefit. Legitimately, there is an issue, which you have raised, and we will put that into the enduring regime consultation, because we need to look at it. This comes exactly back to what Mr Swales was saying, which is: do we need to have some kind of factor in there that says that above a certain level of ownership—however we define that—there is obviously going to be some economy of scale? How do we get a benefit from that economy of scale?

Q146 Mr Bacon: You have not put any refinancing arrangements in this, have you, in the way that started to exist eventually after Alan Williams on this Committee and the NAO were pursuing the matter for a long time? You haven't got those sorts of arrangements here, have you?
Alistair Buchanan: With regard to?

Q147 Mr Bacon: In other words, if the licensee then goes and finds a way to refinance what they have done more cheaply. I know it is not likely to happen tomorrow because the banks are being pretty snotty and demanding fairly juicy premiums, but let's take the example of Robin Rigg. The total there is 6.2%: the 4.1% of the gilt and the 2.1% commercial premium. Let's say that in a few years' time, especially with the Government under pressure to break up the banks, and more new entrants into banking, some bank comes along and says, "Well, actually, we'll take less than 2.1% commercial premium because of the nature of this; we want to get started. It is, frankly, almost like a gilt. We are insured; there is very little downside. We'll take 1.8%, 30 basis points, say, or even more. Maybe we will take 2.1%, maybe we'll take 1.1%. You do not know what the market conditions will be like." If that went from 2.1% to 1.1%, somebody could double their money. In those circumstances, am I right in thinking that you and the Department do not have any clawback to enable you to share in the refinancing gain?
Alistair Buchanan: Currently, we do not. That is something that we are looking at for the enduring regime, which is the projects going forward.

Q148 Mr Bacon: Right. Because it seems to me that if you—this was the burden of my earlier question about bungling—only own one licence, the benefits in the short term are probably relatively limited, especially since they are not financing the construction risk. There is not likely to be the risk premium for construction; well, not likely, it would not have been there. But if you own a whole load of them, the actual income stream is that much larger. So if you own four of these things you are getting the interest cost on—my £13.85 million annual servicing cost on the debt is an overstatement, which we know it is, but let us say we take my lowest number of £11 million, assuming 80% debt, 20% equity—servicing cost of £11 million times 20 years equals £220 million. That is the annual cost of servicing the interest—not repaying the debt; just servicing the interest. Now, 1% of that is £2.2 million.

Chair: It is a percentage of the total interest, so it is 1% of 6%.

Mr Bacon: No, I was saying what I was saying: that 1% of £220 million is £2.2 million. If you were a bank willing to offer refinancing at a lower rate than they have currently financed it at, there is still some honey to go for that would produce a result that could get you into the market as a bank and start lending and displacing the existing lender, and that would also be of benefit to the client. It would be relatively easy to do on that much money over that period of time. Even without the construction risk, there is enough of a premium in there that at some point somebody will promptly do it. So it seemed odd to me, knowing all we know about the experience of PFI, that you did not build in the possibility of sharing in the refinancing gains right from the outset.

Alistair Buchanan: I think we can. What is interesting is that this is a novel approach to financing. The NAO has supported that quite strongly. The first players were the first in class, introduced in very difficult financial markets, which we all know. Here is the encouraging news: I have been told by my team that the latest projects that have come through—this Report is from six to seven months ago; it is not old, but we have moved on—are now highly competitive. We can give this to you privately—it is currently commercially confidential, but I am very happy to send you a private letter, Chair. They are highly competitive with the 8% to 9% listed in this Report on PFI. I am very encouraged that confidence in the regime and competition appears now to be driving it down, but that does not answer your question about the clawback requirement—or, indeed, possibly an affiliate clawback. They are legitimate areas to question. Clearly, we have to say, "Would there be a balance there?", because if we are starting to see rates that are competitive or lower than PFI—you might say, "So they should be"—this is an interesting judgment call as to where the tipping point is. If we start putting in mechanisms—we will think about this very much through the consultation process—where does the price of the bidder start to go up?

Q149 Chair: You could put that in, if I dare say it to you, as part of the competition: at what level of profitability would they start agreeing to share? So you put in an element of competition.

Alistair Buchanan: Indeed.

Q150 Chair: Jackie is waiting to come in, but I just want to bring in the Treasury, because you know about PFI. You have sat through all these endless sessions—from well before time, but in Richard and Austin's time. Why on earth did you not put in these sorts of clauses into these contracts?

Marius Gallaher: Well, I think it was a new type of contract and a new type of business, and I think the aim was to get this up and running, and not to introduce restrictions or limitations on getting the project off the ground—or off the water, so to speak.

Q151 Chair: Well, I have to say it is shocking that you do not learn lessons from one exercise and translate them into the practice of another. The whole point of Treasury—and, I have to say, Moira, you working with permanent secretaries—is that we do have that facility to develop best practice across the Government and stop thinking in silly silos.

Moira Wallace: Okay, I just want to make two points about it. I think it is a valid point you make and, on Mr Bacon's point, if Ofgem is going to look at a gain-share arrangement for a refinancing, I do not see why you should limit it to a licence holder who has multiple licences, because actually you would want flexibility in every contract, wouldn't you? Although you might be more prone to it when there are several, I think it would apply across all this.

I can see how you are approaching this, but remembering it as it played out, there was a lot of concern about this regime, which was different from the one on onshore—and the market conditions at the time—so perhaps people were unduly cautious; I don't know. But there is a lot in this Report that is coming at a valuable stage, when we are designing the next regime, so we need to take it away and work on it.

Q152 Mr Bacon: I think the Chairman was right earlier, because £66 million, to take that as an example, times 6.2%—

Moira Wallace: I am going to miss this. I was wondering whether I would be overcome with emotion at this hearing, and I have to say that you are at your best.

Mr Bacon: If you took £66 million, and you said it was 80% debt, it would be £52.8 million, and if you were charging 6.2% on that, it would be £3.27 million a year. If, on the other hand, you had your £52.8 million and you were charging only 5.2%, you will be £1.32 million a year, so that would be £1.5 million a year just on that one rig, and you've got four rigs. The savings could be substantial. It seems to me that, with everything we have learned, we have to make sure that the taxpayer gets a piece of the pie, otherwise you are just hosing money out the window. Would you like to say something, because your furious nods and gesticulations will not appear in the record?

Alistair Buchanan: I think you are absolutely on to something, generically. We do have to remember that there was an auction in place here. At least three or four players were bidding for this, so to a certain extent they were reflecting the market at the time. This was not a monopoly gift from Ofgem.

Q153 Chair: I think they were reflecting how useless we are at doing the procurement.

Alistair Buchanan: This was a competitive position. Now, that doesn't deny anything that you've just said, and I think we can scoop up a lot into the enduring regime, going forward.

Q154 Jackie Doyle-Price: But what you have actually done is to create a marketplace that is now profoundly uncompetitive, because with one company getting four out of the first six licences, you effectively created a new monopoly, with guaranteed income, with the risk being borne by the public sector, the taxpayer and the consumer, and these businesses are laughing all the way to the bank. That gives you a big challenge, going forward, as the regulator. I was pleased to hear that you said in answer to Richard's questions that you would look at the commercial benefits of that for the companies, but given that you have created a completely new marketplace here, which is very monopolistic, what does that mean for your pattern of regulation, going forward, for this marketplace?
Alistair Buchanan: It's a really good question, if they either dry up or, following Mr Swales' suggestion, one of them starts to eat up everybody else—
Jackie Doyle-Price: More likely.
Alistair Buchanan:—and just becomes the player. The good news at the moment—I don't think I'm clutching at straws—is that for the three big plants that are up for grabs at the moment—Lincs, London Array and Gwynt y Môr—you've got four main bidding consortia competing against each other. I asked my team, "Is there any evidence that they're behaving in concert: that it's yours, mine, and so on?" There is not that suggestion at the moment, but it is something that we need to watch very carefully. If it transpires that we end up with those four groups—they are groups: different players coming in, bringing different skills—just being one, we are going to have to take your point very carefully.

Q155 Jackie Doyle-Price: You say it's four groups, but you already have an emerging dominant player.
Alistair Buchanan: I do not want to be rude to the people involved in Robin Rigg, Gunfleet Sands, Barrow and Walney, but all of them added up are smaller than London Array in itself, so these are very small projects. The big projects that we are looking at are up and under way now.

Q156 Jackie Doyle-Price: One more question: why did you decide to give them 20 years' guaranteed income when it is not clear that we will be using those assets for that amount of time? If we look at figure 3 on page 21, which documents exactly the amount of risk borne by the consumer in this marketplace, there is a risk that the consumer will continue to pay for assets that are no longer in use. Why 20 years?
Alistair Buchanan: We took that decision with a view to how long the kit at the end of the wire is going to last and how long we believe you can get the suitable cable to last. It was based on lifetime of asset. Again, within the enduring regime, we need to look at that quite carefully. To come back to the comments I made earlier, we need to look really carefully, as we start to push out 100 km, 200 km, 300 km or more away from shore, at the quality of the wire. Is degradation going to occur? You've got me off on one at the moment, but this really is new technology. We are going to learn a lot as we go forward. Regarding the 20 years, I think that our judgment call on the inshore is fine. When we are starting to move out further offshore, it is a big challenge for us to get it right.

Q157 Jackie Doyle-Price: Under these contracts, the businesses are going to continue to get their income. Are you confident that the consumer is not going to be paying for redundant assets? How confident are you?
Alistair Buchanan: That is a very good question. One would have to say that under the current regime—the ROC regime, which is in place until '37–38—the wind farm operator would, I believe, continue to operate because of the arrangements in place on the ROC subsidy that will make it economic to utilise the cable fully, but life can change.
Moira Wallace: And the lease that they own on the seabed. Our expectation is that if someone went out of business, it would be quickly sold on, because there is a revenue stream for them to get there, and this is the expected life of the asset.
Alistair Buchanan: It is quite a nice entrée into political risk. Investors are currently looking at energy as a sector across Europe. For example, Spain changed the rules like that, and preferred coal over gas. Germany, as we know, changed the rules on nuclear and made a push for offshore, which actually has currently gone horribly wrong. I am sure they will resolve it, but it has gone wrong. There is a political risk within an investment when changes are made politically that may affect that, but I am sure that that comes into an investment profile as well.

Q158 Jackie Doyle-Price: The thing is that political risk is not being borne by the investor here, in terms of your contracts; it is being borne by the consumer.
Alistair Buchanan: It may be borne by a generator if a generator finds, for whatever reason, it can't generate. Things happen; whatever happens. I find that hard to believe because there are grandfathering rights in place, but the generator is obviously taking some risk.
Moira Wallace: These are very big investments. The point of the regime, both on the renewables obligation—

Q159 Jackie Doyle-Price: With big returns. We are talking about returns that are exceeding PFI, and we thought that that was a licence to print money.
Alistair Buchanan: If I can make a comment. We will send this privately, because we are in the middle of a commercial negotiation, but what we are seeing now for the sizeable projects that are coming through, rather than the small ones, is that we have some very competitive prices.

Q160 Chair: One element of Jackie's 20-year point is that it is my understanding that the Government are trying to get some cross-country deals on managing some of these offshore resources. If you are tied into a 20-year contract, you will then not be able to have the flexibility to take the benefit of a deal with one of

the North sea countries, will you? You have locked yourself out of that.
Alistair Buchanan: At the moment we have anyway, because largely the projects are point to point—from a point in the sea to a point on the British coast. The development of the North sea is some way away, but when we move to a mesh environment, it is a legitimate question and, again, one for the current consultation round.

Q161 Chair: Would you be prepared to tell us this afternoon whether a 20-year contract might actually inhibit? It seems to me it will, because you are tied into a contract that might not be appropriate for cross-country deals.
Alistair Buchanan: It may even be longer. It may be that the quality of the asset means that it appears that the asset life will be longer. That is something we are going to have to make a judgment on, but we are some way away from that. While discussing something like Dogger Bank, the technology both on the cabling side and the wind farm development side is not quite there yet for us to come to any strong conclusions.

Q162 Chair: Are the contracts you are negotiating at the moment 20-year contracts?
Alistair Buchanan: In the current TR1 round, yes they are.
Moira Wallace: Is your point that somehow or other we would regret having entered a contract to send the electricity to the UK if we are trying to send it to somewhere else?
Chair: You will be tied in—
Moira Wallace: In which case I think the answer would be that on the contracts we have at the moment, they are still pretty close to shore, so we are not talking about Dogger Bank. Plus the whole point of things like the North sea grid is to be able to send electricity in both directions, as appropriate, and to increase the resilience of both sides. I do not think that anything that is being done at the moment inhibits that co-ordination that we are talking about in terms of the North sea.

Q163 Austin Mitchell: I was so dazzled by Richard's figuring that I lost the point of the answers. Are you telling us that you will ensure in all future contracts that the profits from refinancing are shared with the taxpayer?
Alistair Buchanan: What I am saying—
Austin Mitchell: Can you give us that commitment?
Alistair Buchanan: I cannot, because I have to consult. I am a statutory body. I must consult on what we are planning to do.

Q164 Austin Mitchell: Would you like to do that?
Alistair Buchanan: There is merit in looking at the refinancing clawback, the RPI situation and the affiliate potential clawback. All those are legitimate areas to be in the enduring consultation.

Q165 Austin Mitchell: We certainly think you should. Isn't the truth that you really want to give these firms a soft deal and soft regulation in order to attract big bucks from America to finance something that you felt British capital could not finance?
Alistair Buchanan: What appears to be happening at the moment is that, for example, one of the key consortia—

Q166 Austin Mitchell: You did give them a soft deal.
Alistair Buchanan: We have got the British Telecom and universities pension funds both aligning with National Grid. That is part of our fund—

Q167 Austin Mitchell: But did you give them a soft deal or not?
Alistair Buchanan: We gave them the deal that we thought was appropriate, but bear in mind that this was a private negotiation within a tender process. We sought active competition for each of these four early, small projects.

Q168 Austin Mitchell: To attract that, you gave them a soft deal.
Alistair Buchanan: They competed for that deal. That deal was the deal that we looked at and thought was appropriate.

Q169 Austin Mitchell: You wrote the deal and it was soft.
Alistair Buchanan: With the tender process, which all the different parties went into for one of those early four players, yes, we wrote the rules, but they applied the price.

Q170 Chair: What was the risk you transferred? I find it difficult to understand what risk they are taking on.
Alistair Buchanan: You are right that the early ones don't have construction risks, so there is operational risk and decom risk—

Q171 Chair: You told us that you are going to look at operational risks again.
Alistair Buchanan: Yes.
Chair: But it is not a big risk. I cannot see why you would not bid for this.

Q172 Mr Bacon: What is the political risk? One normally speaks of political risk as investing in dodgy countries where there is always the risk of a coup. Are we expecting a coup? What is the political risk?
Alistair Buchanan: There has been a degree of concern within the investing community—it is my old community—about having absolute clarity about where investment is going to go. Now, are you going to get that in the rest of Europe? Actually, I think Britain is a very good contrast with investing elsewhere—

Q173 Austin Mitchell: It is because of the softer deal.
Moira Wallace: One of the reasons why we score well on the index of attractiveness for this industry, which we want to have for a variety of reasons, is because we offer clarity and don't go back on our word. Now you could say, "Did you need to offer clarity for 20

years?" That is one of the questions you are asking. However, we are trying to establish a framework for investment to ensure security of supply and meet our carbon obligations. There are plenty of examples across Europe of Governments that have been chopping and changing, and that will not be able to get the investment, or will not be able to get it at as good a price.

Q174 Mr Bacon: I just fear that we are going to be sitting here in few years listening to you or your successor saying, "Well, you know, those were early deals. We have learnt a lot now. Yes, they did absolutely coin it, but then what could you expect because we weren't that experienced?" Yet we have a lot of experience to go on already. We have heard that story before.
Moira Wallace: We may not have made every brilliant decision that we might have made, but one of the decisions that we did make was when we thought, "Shall we give this to one company as a monopoly or shall we compete it?" We decided to compete it. That was a sensible decision to make. You may not think that it was the hottest competition in the world and that there is scope to award the contracts better. There may be scope to finance it better in future, but surely it was an awful lot better than just handing it to someone as a monopoly.
Chair: We do not know.

Q175 Austin Mitchell: We are on the soft parts of the deal, and you are indicating that it might get even softer—I'm talking of risk as you go further out. There is the RPI gearing. What you are saying to consumers is that the price of electricity is going to go up because you have given licensees a guaranteed income rising with inflation. There is no need for that. The costs of financing don't rise with inflation in the same way. The Report suggests you could have eight-yearly reviews of the indexation, so why not do that? Why not make it a tougher deal by taking away this 20-year guarantee of refinancing at RPI? That is a licence to print money. Lord Thomson should be alive at this hour.
Moira Wallace: The—
Mr Bacon: It was Lew Grade who said that?
Austin Mitchell: No, it was Lord Thomson.
Mr Bacon: Are you sure? I thought it was Lew Grade.
Moira Wallace: Talk among yourselves. Is it me now? Fantastic. I need to remind you, as Alistair already has, that this was an auction. The shape—
Austin Mitchell: So was ITV at the time.
Moira Wallace: I cannot compete with you at history. I am on a loser there.
It was an auction. The framework was set and people bid against the knowledge of the way the contracts were going to be designed. If this had not been indexed, we simply do not know what the bids would have looked like. I am sure they would have been less. One of the reasons why it was decided to go for indexation—Alastair will correct me if I am wrong—was that we were trying to attract new investors into the market. Some of them have liabilities over the index and are trying to match them. It is easy for us to say that it would all have been different if we had been able to negotiate better terms or if the terms had been different, but if you offered a different thing, you would have got a different price. Does Alistair want to add to this?
Alistair Buchanan: No, I do not.
To a certain extent, we turn to the NAO, because it is good that it came into our business right at the beginning of this process. Perhaps I shouldn't say this, but it says that we ran the competitions well, in challenging circumstances, to attract new market entrants. We did both and we have got offshore plants off and under way, connected and delivering.

Q176 Austin Mitchell: And the consumer will pay.
Alistair Buchanan: I actually think the consumer probably is more focused—and this is true of all the transmission debates that I have, both onshore and offshore—on £100 per MWh of ROC that is going, which is 90% of the cost, rather than the 9% to 11% differential on the return. That does not mean that I do not take the 9% to 11% differential lightly. I take it very seriously and I am pleased that the latest deals we are looking at are very competitive with the PFI figures in here. I will give those to you privately. Competition has done that and confidence in the regime. We have created a regime that is confident. That does not deny the fact that issues have been raised today that we will very much take into our enduring regime consultations.

Q177 Ian Swales: I have a simple question. Are we too late for this current round? Will anything we say now impact on the new bids?
Alistair Buchanan: I am really glad you asked that. I asked my head of operations, who runs it. His initial reaction was that he was not sure, but I pressed him and said, "Look, if it's quite clear that in the enduring round of consultation we need to make changes—", and he agreed. I am nervous about naming the schemes that might be affected, because there may be commercial confidentiality around that, but if there is a strong view coming out of the enduring round, you have to ask yourself, "Why aren't we moving on to that as soon as we can?"
Ian Swales: Fine. I wanted to explore just another bit of the value chain that we have not looked at, which was a comment you made earlier when I gave my example of Forewind. You said that Forewind would do the construction—I think that is what was said—of the Dogger Bank cable, but it would not be allowed, because of this regime, to be the licensee for operating it. Assuming that Forewind actually does it, talk me through the financial side. Forewind has done all that work. How does it then translate into this regime, in terms of licences and operation? How will Forewind be recompensed for the work that it has done to build the thing itself? Sorry, do you understand?
Alistair Buchanan: Totally. The ambitious view of the generators is 6 GW to 9 GW—a massive power source in Dogger Bank—and Forewind will get paid off the ROCs scheme or off the contracts the differences that the Government are developing. Moira is in a much better position to—

Q178 Ian Swales: I understand the generation. I am specifically talking about the transmission. I think that you said in earlier evidence that it was likely, in most of these fields, that the operator would physically build the connections. So how—financially—will that translate into these new operators who have the licences and are responsible for the maintenance?
Alistair Buchanan: It is a really good question. What is encouraging is that we are now seeing developers not being the generators. Ormonde, for example, which has closed since this has been written, is not being developed by the generator. It may be that the kit—the cable kit and what will also be sub-station kit—will be developed by somebody else.[1]

Q179 Ian Swales: What is to stop them from holding the licensee to ransom and saying, "We want ten times what we paid for this"? How does that work?
Moira Wallace: He disallows them.

Q180 Ian Swales: So you have regulatory powers over that part of the regime. Is that right?
Alistair Buchanan: Correct.
Moira Wallace: And in the first four contracts, after taking advice, you disallowed some of the construction costs they had incurred, so that was their problem.

Q181 Ian Swales: That gives us some comfort.
I got leaflets through my letterbox delightedly talking about the offshore turbines going up off our beach at the moment—27 2.3 MW turbines, so a 60 MW field—which will be enough to power x homes, saving x many thousand tonnes of carbon dioxide and all the rest of it, without any reference to efficiency. With coal, gas and nuclear, you can say what the capacity is as installed. EDF has admitted that 35% is roughly the figure for this field.
When I looked at appendix 3, which we had to look at online, sure enough this wind farm to which I am referring is shown as 60 MW, so I assume that all the figures are for installed capacity. That does not matter for coal and gas—you can work pretty much up to their installed capacity—but these figures are all three times what we are actually going to get from these fields.
I have raised this issue with the Secretary of State and shown him the letter that EDF wrote admitting that that is how it does things. I would like some reassurance that DECC and Ofgem, in all their deliberations, work and public relations, will actually talk about the real capacity of these fields, because I know that I saw something about the London Array recently that did exactly the same thing—multiplied the number of turbines by the capacity of the turbine, which is completely fallacious in this field. Can you give us some reassurance that that is factored into your work and how you talk to each other?
Moira Wallace: We distinguish very clearly between, as it were, the nameplate capacity and the actual generation, so capacity and generation are different numbers. There are different numbers for every technology, actually, but they are particularly different for those that are intermittent. As we have said several times to this Committee before, the renewables obligation pays for what is generated. It doesn't pay for capacity; it pays for generation. Indeed, the transmission regimes are also adjusting to focus very clearly on what is generated—not a theoretical generation, but the actual generation—so we are very clear about that. For example, we measure the renewables target in terra-watt hours, so it is the electricity that is actually generated; not capacity that isn't generating all the time.

Q182 Ian Swales: Do you not think that in terms of the operators and, indeed, the public sector, we should actually talk about that more, given the difference, and certainly not talk about thousands of tonnes of carbon dioxide saved on the nameplate capacity?
Moira Wallace: We certainly calculate the carbon savings on what they generate, not their capacity.

Q183 Ian Swales: Would you not think that it was important for you to talk to an operator who produces that kind of publicity to say, "This is wrong; you are actually overstating—"
Moira Wallace: Actually, I think that it is a shorthand that is used in all electricity technologies, and there is no electricity technology that operates at 100% efficiency. I think gas tends to operate at 60, nuclear at 60 and coal at 41. We don't run round saying, "You say you have just opened a 2GW power station, but actually we know that you're misleading the public." However, I think that it is really important that when we are talking about what things cost and we are looking at how things are remunerated and incentivised, we are really clear about it.

Q184 Ian Swales: You might be surprised to know that I am saying this in a supportive way, because to the opponents of what we are trying to do—and I am a supporter—this is one of the bits of ammunition. I have got constituents who are fighting onshore and offshore wind farms, and one of their weapons is saying, "Look, these people are misleading us. We are not going to get this amount of power off this installation." I think it is important that, in order to promote the agenda, we encourage realism in that kind of reporting.
Moira Wallace: I agree with you.

Q185 Chair: I have two questions, and then Richard has one.
My first question is about governance. Can you help me sort out in my brain what your positions are—who is responsible for all this?
Moira Wallace: We are responsible for the policy. We were very involved in the policy design, so as this technology developed, we had to work out how we were going to get the transmission built. There were no legal powers; there were no public controls; there was no regulation. So we did a huge amount of work, obviously involving Ofgem and other people, to say what the regulatory regime should be. We legislated

[1] Note from witness: We would like to clarify that Mr Buchanan's intention was to confirm that we are now seeing companies other than wind farm developers providing Operation and Maintenance (O&M) services to OFTOs. This is true in the case of the Ormonde project.

for it and we have taken various powers along the way. We also have a very clear interest in how it is working out.

Q186 Chair: Does that mean that you get involved in the details of these contracts—do you see them?
Moira Wallace: No.

Q187 Chair: Do your staff vet them?
Moira Wallace: No. Actually, there is very important independence for Ofgem, which is responsible for this. It is not responsible, contract by contract, to us. We take an interest in the overall regime and how it is going. We are doing a lot of work at the moment on the issue we have touched upon, about how we can encourage co-ordination in the future and how we can encourage the supply chain, but it is an independent regulator.

Q188 Chair: So all these decisions on 20 years and RPI are yours, Mr Buchanan?
Alistair Buchanan: They are. We are responsible for the licensing of the generators—National Grid is the system operator—and all the transmission cable operators. We have been given the responsibility by the Government to run the tenders and the models associated with them. We have placed this business in something called Ofgem E-Serve, which we created about five years ago because we realised that, of an organisation of about 600 people, the majority of my people are actually in E-Serve, which is running all the Government subsidies and running the offshore tender. There is quite a different background and skill needed from the people in what we call Ofgem Orange, which is your traditional economic regulator: analysts, economists and so on. It was very important that while the Government looked at the shape of Ofgem very carefully on coming into office—we had two reviews done for us; the NAO was very involved in the review, as was the DECC Select Committee—they left this under the ownership of GEMA, which is an independent board. But it is also equally important, and I think you would be rather worried if I did not say this, that we have a high-level co-ordination committee, with two of my non-executive board members sitting on it, which meets DECC regularly—once every month or once every other month. The offshore regime and its development are part of that. That is at the top level. Down at the working level, we are talking quite frequently, as you would expect.

Q189 Chair: The savings that come out of the licensing regime—which, according to page 22 of the Report, are £461 million to £1.39 billion, which the NAO says are at best tenuous; I would say a finger in the air—are your figures.
Alistair Buchanan: These are not my figures. This is the CBA IA done by DECC when it was determining high policy. When the high policy was determined—I am just a mere vassal under the table—it is handed down to me to do it.

Q190 Chair: Okay. So, are you having second thoughts about these, Moira, as the NAO thinks they are “tenuous”? To me, that is its polite language for a finger in the air.
Moira Wallace: Where does it say that? I do not remember the word “tenuous”.

Q191 Chair: I saw the word “tenuous”. I cannot—
Moira Wallace: I do not think it said “tenuous”. I think we got a technical ticking off. Did you say “tenuous”?
David Finlay: At paragraph 2.16.
Moira Wallace: I eat my words then.
Chair: I knew I had lifted it. I spent more time doing my homework on this than you did.
Moira Wallace: You did not say that our savings estimates were off the wall, you said that—

Q192 Chair: I said it said “tenuous”.
Moira Wallace: “Implying that” that was “indicative of overall PFI experience is tenuous”, so it is a comment on the NAO’s view of PFI. What you were actually saying to us was that you do not think PFI was the right thing to choose, that we should have chosen a range of things, and that you do not think that PFI made the saving. I think to be slightly—

Q193 Chair: What are these savings? You obviously think they are really there, so tell me what they are.
Moira Wallace: Well, the savings are from applying competition and actually having a regime that, to build on one of Alistair’s points, has delivered far faster than that in Germany. Having an effective regime—

Q194 Chair: Faster is not cash. I keep thinking of the customer; what is the saving to the customer?
Moira Wallace: This was an ex ante estimate of the benefits that we would get from doing it this way. The NAO did not think our methodology was great, and it has ticked us off for that, but it has just delivered a Report that says that it thinks that we have delivered benefits—

Q195 Chair: No, I am just asking about the savings.
Moira Wallace: And what is the question about the savings? Is it where we think they are coming from?

Q196 Chair: Is it true? It does not think that it is. Are you standing by £461 million to £1.4 billion?
Moira Wallace: I do not think that the NAO contests that there are savings; it did not think that our impact assessment was well done.

Q197 Chair: You are trying to avoid this. I will come back to you, Moira, but let me ask David.
David Finlay: Just to go by the wording in the Report, which is obviously an agreed Report, we were indeed casting doubt on using PFI as a comparator. We said at paragraph 2.16 that in our opinion the Department’s final estimate of financial benefits was “inadequate” because of the use of PFI as a basis of measurement.
Moira Wallace: But you also say that the new regime has delivered benefits—

Q198 Chair: No, I am just asking about the savings. You are trying to take it wider. One of the assertions—

the boxes you tried to tick—was that this would save me money in my bill.
Moira Wallace: Yes.

Q199 Chair: Me and the collective we. To the tune of £461 million to £1.39 billion at present value. Where the hell has that figure come from? Are you standing by it? Explain it to us, because it is suspicious of it.
Moira Wallace: Okay. That was an estimate in advance. The truth will be determined as Alistair and Ofgem go through tender after tender. This was an estimate for the overall regime. The truth will be established by retrospective audit of the—

Q200 Chair: Are you finding any savings, Mr Buchanan?
Alistair Buchanan: Yes, we are, in two areas. First, in the projects that we have already looked at in TR1 that we have listed, we have identified £350 million of savings—

Q201 Chair: What do you mean by that? I do not understand the concept; explain it to me.
Alistair Buchanan: The concept of savings we have used, which are not included here, so this is excluding the TR1 savings. We have said that if this is the value of what we have done so far through the competitive tenders, what would it have come out at had we used the return mechanism that we used in the transmission price control onshore? That is effectively the comparator that we have used. Is it the right comparator? It is one of the few that we can use.
Where I am getting comfort about the figure that DECC has used is that I now have evidence that, for the latest two bids for projects, bids are coming in at or below the PFI figures listed here. In other words, we are starting to see the benefits of clarity, consistency and competition coming into the regime. As I said, I will send that data to you, either through the NAO or directly. We are towards the end of some commercial arrangements there. I am feeling quite confident that we are seeing that tension that I think was probably behind DECC's figures.

Q202 Austin Mitchell: For the competition to be showered with money is not a saving.
Alistair Buchanan: We are starting to see rates now—if you assumed that it was showering at the 10% or 11% listed in this Report—that are much more competitive than those first few. The suggestion would be that it is working as indeed the NAO suggested that it would, which is that the more players you get, you get that benefit.
David Finlay: There is an issue going forward to make sure that the measure of savings will be as rigorous as possible. Mr Buchanan and his team are working on that. I want to point out for the record that, at paragraph 3.18, we did have reservations about the calculations that Ofgem had done on the initial licences.

Q203 Mr Bacon: When I hear the words "reservations about the calculations", it naturally makes me think of trains, so can you confirm that whatever methodology you used had nothing to do with estimating passenger numbers?
Alistair Buchanan: No, it didn't—or GDP.

Q204 Chair: You said earlier that Siemens is sweeping up the construction.
Alistair Buchanan: Indeed it is.

Q205 Chair: Are you putting any clauses in there to ensure local labour? Siemens will make the money out of it, but is there anything in there to make sure that we get the jobs out of it?
Alistair Buchanan: This does not feel like my territory.
Moira Wallace: As a matter of fact, you are not.

Q206 Chair: Why not?
Moira Wallace: You will all groan when I say this, but I do not know to what extent it would be legal. The big decision that we made in the policy—I am going to keep coming back to this, and this is the big decision that we are analysing the savings of—was whether we should allocate this to a monopoly provider by right or compete it. We were looking for competition, and that is what we have got. Of course, the Government are doing a huge amount to try and bring manufacturers here and to build confidence in this sector because the opportunities are enormous, but I am not surprised that you did not include a local labour clause—I do not think that that is one of your regulatory purposes, so it would be a surprise.

Q207 Mr Bacon: That is a neat lead into the question that I want to ask, because I wanted to find out not only what your regulatory purposes are, but what your regulatory powers are in the following event. You know that this afternoon the Prime Minister is meeting with other senior Ministers to discuss worries about the impact of high energy prices on households. Indeed, he said at Prime Minister's Question Time—I am reading from a *Telegraph* story that went out on the web this afternoon—"I can announce that we will be legislating so that energy companies have to give the lowest tariff to their customers." The worry, which is reflected in the piece that I am looking at, is that there are fears that this might backfire if companies simply cancel their cheapest deals and force everyone to be on the same tariff. This quotes—but does not say who it is—"Consumer groups have warned that government plans to offer fewer, simpler tariffs will leave many people 'much worse off' as energy companies scrap discounts and cheaper online deals." Should that prove to be the case—of course, I do not know if it will or not—what consumer groups will want is someone to come along with a big stick and hit the energy companies over the head to make sure that they behave. That person is you. What powers would you have in that eventuality to make sure that any attempt by the Government to ensure that the companies were not gouging people so much was not undermined?
Alistair Buchanan: Under my current powers, I will be delivering, and you can appreciate now why there is a stock market sensitivity here. My board meets tomorrow and we will issue our retail market reform

package at 7 am to the stock exchange on Friday. It is probably going to be the most far-reaching change to the retail market in 20 years. I am very interested in what the Prime Minister has said. I find myself in a position in which I have to be extremely careful: first, I have to get my board to confirm what we are going to do; and then I have to ensure that I do not upset our friends in the FSA before I make the announcement. However, it is no secret that we have been looking at a range of things. You may remember that we had a major set-to with the industry 18 months ago, courtesy of its mis-selling, its lousy doorstep selling, its lousy customer service, its lack of clarity in accounts and so on. Over the last 18 months, we have had a forensic review of its accounts. We have seen doorstep selling stop, we have got rid of the hated 65-day rule, and there is a very large package coming out on Friday morning. Whether the Government would like to change Ofgem's powers in the light of that package, I don't know. I will just have to wait and see how people react.

Mr Bacon: We really should have had you next week.

Alistair Buchanan: I'd be delighted to come back.

Moira Wallace: He doesn't mean that.

Chair: On that point, thank you very much for your open and honest responses.

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