

HOUSE OF COMMONS  
ORAL EVIDENCE  
TAKEN BEFORE THE  
ENERGY AND CLIMATE CHANGE COMMITTEE

**ENERGY PRICES, PROFITS AND POVERTY**

THURSDAY 9 MAY 2013

PROFESSOR JOHN HILLS, DR NICK EYRE and JAN ROSENOW

GERVASE MACGREGOR

Evidence heard in Public

Questions 295 - 375

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## Oral Evidence

Taken before the Energy and Climate Change Committee

on Thursday 9 May 2013

Members present:

Mr Tim Yeo (Chair)

Dr Phillip Lee

Albert Owen

Sir Robert Smith

Dr Alan Whitehead

### Examination of Witnesses

*Witnesses:* **Professor John Hills**, London School of Economics, **Dr Nick Eyre**, University of Oxford, and **Jan Rosenow**, University of Oxford, gave evidence.

**Q295 Chair:** Good morning. Thank you very much for coming in. As you know, there is a lot of interest in this inquiry—although perhaps not intellectually in your session—and when we had the energy companies in the other day there seemed to be a particular amount of interest, for some reason; I cannot quite work out why. Perhaps you could start off by telling us whether you think the Government is on track to eliminate fuel poverty by 2016.

**Professor Hills:** I don't think the Government is going to eliminate fuel poverty by 2016, however you measure it. Those of you who have seen the summary of or read the whole of the report I wrote last year will see that, in the way that I suggest that fuel poverty might be measured, and with the focus on the measure which I think captures the scale of the problem best, which I call the fuel poverty gap, given the central forecast that DECC was producing for fuel prices over the next few years—some of those increases have already happened—I was suggesting that that measure of the scale of the problem would increase by as much as half, from where it was back in 2009, by 2016, rather than being eliminated. As you will have seen from the report, I thought that was a profoundly disappointing projection.

**Dr Eyre:** No, I don't think the Government is on track to eliminate fuel poverty by 2016. I don't even think it is on track to do so as far as is reasonably practicable, which I think is what it is obliged to do.

**Q296 Chair:** Why do not you think it's doing that?

**Dr Eyre:** Because it is reducing the amount of resources that are being committed, particularly through Government funding—for fuel poverty measures for England—and the affordable warmth programme in no way substitutes for that and the parts of CERT devoted to low-income customers.

**Jan Rosenow:** I would agree with the previous speakers. I think ECO is going to take about 125,000 to 250,000 households out of fuel poverty; these are the DECC projections. I think, currently, we have about 5 million households in fuel poverty; with a new definition it is a bit less than that, but it is still nowhere near the figures that DECC are projecting for this. I agree with Nick. The fuel poverty spending, according to ACE—the Association for the

Conservation of Energy—has been reduced by about 29% from previous fuel poverty budgets. So there is a quite significant cut.

**Q297 Chair:** Professor Hills, if the Government adopted your new definition of fuel poverty, should they set a new fuel poverty reduction target?

**Professor Hills:** That is for Government and Parliament—given that the original Act originates from Parliament—to make those decisions. I think that giving people clear objectives to deal with serious national problems can be a helpful device.

**Q298 Chair:** Of course it is for the Government and Parliament, but what would your advice be about whether we in Parliament, whether we as this Committee, should recommend that they do that?

**Professor Hills:** My advice would be that there probably should be a system of rolling targets, taking account of changing situations, that keeps officials' and Government's nose to the grindstone in delivering the greatest possible action to deal with a problem of this kind. Where I would probably part company from the original specification in the Act would be the use of the word "elimination." If you look at the history of the child poverty target, which was originally announced by the former Prime Minister, Mr Blair, as having the objective of eliminating child poverty, that language was modified to talking about becoming among the best in Europe, for instance. We do not have that kind of comparator as far as fuel poverty is concerned.

To be honest, what matters is what happens over the next five or 10 years and the scale of action. I would much rather see meaningful targets that lead to a more rapid pace of change, directed at what can be done over the next 10 years, than to focus on something in 16 years' time or whatever it is. When we get closer to it, I am very happy to argue about whether we have eliminated the problem, or reduced it to extremely low levels, which is what I think the objective should be in practical terms. We are so far away from that at the moment, that I am not sure that it matters. We are going in the wrong direction and we need a scale of action that takes us in the right direction.

**Q299 Sir Robert Smith:** I should probably declare that I am an honorary vice-president of Energy Action Scotland, which has argued that your new definition, Professor Hills, makes it much more complicated to work out whether a household is to be classed as fuel poor because it requires a great deal of data to be gathered on an individual basis. Is that a fair point?

**Professor Hills:** Well, the proposal I put forward for measuring the scale of the problem is based on precisely the same data as are used to create the existing fuel poverty statistics. I have suggested some tweaks to that, which, in terms of the use of the surveys, could improve the way in which we allow for particular household situations, but it basically uses exactly the same information that we have at the moment. There is a big difference between the information you use to see how you are doing nationally and whether you are going in the right direction, and the information you use on the ground to see which households need assistance and action fastest. The existing measure is not that helpful on the ground. It requires quite a lot of information about people's income, and to measure it precisely would require a full survey of the house, in the same way that the sample properties are done.

I actually think that the reverse could be true. The way I suggest we focus on the problem—as the original Act suggested, we look at households that have low incomes and high need to spend on energy, and we look at the way that that creates the worst problems for

the people who are furthest away from being out of fuel poverty, the ones who have the biggest fuel poverty gaps—allows you to think about the characteristics of the people themselves and also of the houses they live in, which you can then use as some form of proxy. You do not do a full survey of every house in the country; that would be prohibitively expensive.

However, we do know—I set out in the report the information that I had available to me then, and I hope the Department has done more work since. That information allows you to say what proportion of the problem is accounted for by particular kinds of houses. It is that information—looking at people who are off the gas grid or people who are in pre-1940s properties and so on—that allows you to home in on the people you want. It is that kind of information that matters, rather than the precise calculation that is used from the sample service, either now or possibly in the future.

**Q300 Albert Owen:** In the remit you were given by the Government, did they say that the original indicator was too crude and that you should look deeper into it? What was the remit that you were given?

**Professor Hills:** No. The first part of the remit was to ask whether fuel poverty was actually a problem because, after all, there are all sorts of other aspects of hardship for people on low incomes and we do not have particular targets or measures for those. The first part of my remit was to look at that, and I reached the firm conclusion that fuel poverty is a serious national problem.

The second part of my remit was to look at the existing measure. I was not given any instructions as to what conclusion I should reach. I wasn't pushed in any particular direction, but looking at the way in which the existing 10% indicator works it seemed to me that it had some problems and led to misleading identification of who the priorities for action should be. It also gave some misleading impressions that in the past led to complacency in what the trends were in the scale of the problem. That was my own conclusion, and I then thought through different ways of trying to get at the problem as it hits people in terms of hardship, health and climate change, and came to the conclusions I did.

**Q301 Albert Owen:** I respect that. I asked the question because Ministers indicated to us that it was too crude, and used the headline that multi-millionaires, including the Queen, could be described as being in fuel poverty. So there was no pressure put on you to look at that because of the circumstances and the crudeness?

**Professor Hills:** I don't remember anyone using the word "crude" to describe the existing measure. Many aspects of the way it is calculated are sophisticated. The conclusion I reached was that it did not deliver what people thought it delivered. You have mentioned the potential for people on high incomes to be caught by it sometimes. That is true, and obviously you would not normally expect a measure of fuel poverty to capture people—you quoted the *Financial Times* story about the Royal Household—

**Albert Owen:** I'm repeating what Ministers said.

**Professor Hills:** I think they're probably repeating a line I have repeated from a front page of the *Financial Times*.

That is just not helpful because it leads to conclusions—as some assessments of the Warm Front programme did, for example—that a lot of money was going to the wrong people. That happened because the assessments were being done at a time when energy prices were particularly low, and the effect was that apparently we had almost licked the problem. According to the official indicator, the problem had fallen by three quarters between the late

1990s and 2003 or thereabouts. None of the people I spoke to—I did quite a lot of consultation for my report—believed that the underlying fundamental problem had been reduced by three quarters over that period, yet that is what the numbers were saying and I think that fed some complacency in Whitehall about the overlap period. Those sorts of problems led me to think that we were possibly not using the data we had to capture the problem in the right way.

The second thing that struck me was the focus. It is very nice to have a single number to focus on—the number of households—particularly if you are lobbying on something. It is particularly nice to have a number that is going up rapidly, but that focus on the number of households caught, which moves around rapidly with energy prices, can lead to you thinking that some people are out of target when they should be in it, and others are now a problem when they shouldn't be, and also possibly to focus on action that tips people just across the line, because the easiest thing to do is to give someone who is just on the edge a bit of loft insulation so that they are on the right side, which reduces the numbers.

The problem is the people on low incomes who have to pay £800 or £900 a year out of their very small incomes over and above what a typical household has to pay for their energy bills. Those are the people we need to focus action on—the people who are furthest away from the line—and that is why I suggest a focus on the fuel poverty gap, and that the depth of the problem is the best thing to focus on, however you set up your programmes and whatever targets you set, because that will focus your energy on using your resources to make the biggest difference.

**Q302 Sir Robert Smith:** You mentioned that the swing in energy prices made a huge difference to the statistics. Do you think that it goes too far, though, to ignore energy prices as part of the problem?

**Professor Hills:** I think, if you look carefully, that that is not what the framework I have suggested does. There are two different aspects to that. One is that as energy prices rise, more people are pushed into a position where the income they are left with after paying necessary fuel costs would push them into poverty. Some people are dragged into poverty by the particularly high level of their fuel prices, because the retail prices index or the consumer prices index does not capture the cost of living to them as their energy prices are so high.

On the one hand, the number of households or individuals captured by my measure varies as energy prices vary, but the thing that really changes is how big a problem that is for the people affected by it. That is the fuel poverty gap. I can give you a copy of the summary of the report, if it will be helpful. You will see from the graphs in the report how that measure of the seriousness of the problem has gone up and down. That is why I project that the problem will worsen over the next few years as energy prices rise.

**Q303 Sir Robert Smith:** Another statistical concern is that using the median figure means that you would never be able to eradicate fuel poverty.

**Professor Hills:** I don't think that is strictly true, but it is certainly very difficult. We are using the figure of median costs for the whole population, that is, "What does a typical household have to pay to keep warm to a certain degree?" We are then focused on low-income households who would have to pay more than that to keep adequately warm. It is possible—it would be very hard—to ensure that everyone on low income was below the level. You cannot get the whole population below the median, even in Lake Wobegon, where, if you

remember, all the children are above average. You could theoretically get all people on low incomes below it, but that is not the issue.

The issue is whether you can get most people on low incomes below that level. After all, people on low incomes live, by and large, in smaller houses than people with higher incomes. Then, when we get there, we can have an argument about the people who are left near the line and are just above those median costs, but we are so far from that at the moment. We have so many people who have costs way above that level. It would be very nice to have that argument in 10 years' time—I would welcome it—when we have got the problem down to the level where some people on low incomes have costs that are still £50 or £100 higher than the median, but let's get close to that level before we worry about that.

**Q304 Dr Lee:** How much equality do you want to see, Professor Hills?

**Professor Hills:** In what respect?

**Dr Lee:** Equality means equal. I notice that you chaired the National Equality Panel. Human beings are not equal, and I am trying to understand what your definition of equality is.

**Professor Hills:** Oh, well, you could have a definition of equality, and someone could set an objective that everyone in the country should have the same income, the same energy costs and wear the same suit or whatever.

**Q305 Dr Lee:** Is that your objective?

**Professor Hills:** It is certainly not my objective. I cannot think of any political philosophy, apart from the most extreme, that would set that objective.

**Q306 Dr Lee:** My point is that your judgment of equality is subjective, is it not?

**Professor Hills:** I think my job as an academic is to try to report on the extent to which, as a society, we vary from that position.

**Q307 Dr Lee:** And what is an acceptable amount of variance?

**Professor Hills:** I think that is something that society makes decisions about, and politicians like yourselves make decisions about what you feel is acceptable and right. Different countries make different decisions, and at different points in time we have been a more equal society than we are today, but that is—

**Q308 Dr Lee:** But you keep saying “more equal than before”. I am trying to bear down on what is an acceptable level of equality. Equality for me is that I should be the same as Alan, the same as Albert and the same as Tim. Equal is equal; two equals two. If we are getting into the realms of subjective assessment of what equality is, and indeed what reasonable is—I notice your definition is “reasonable costs”—I wonder what it is. The 1980s are blamed for the gap between rich and poor, but not much difference occurred, I notice, under the previous Government. There has been a problem between the richest and the poorest, but it is a subjective judgment about what is an acceptable difference between the rich and the poor.

I am not saying that there is not a problem between the rich and the poor; I am just trying to work out what you think. Underlying your report will be a sense of grievance: “I don't think it's right that the top 10% have x amount more than the bottom 10%.” The same applies to fuel costs. Unless we come up with some wonderful invention in the next 10 years,

fuel costs will continue to go up, so by definition, the proportion of people's income being spent on fuel will go up. Does that mean that they are increasingly becoming fuel-poor, or does it mean that they will have to make decisions about what they spend their money on in future as a result of the changed reality?

**Professor Hills:** Can I separate that out into two issues? I will be very happy to talk to you if the Committee wants to carry on talking about equality in general, income inequality and wealth inequality. I would be very happy to do that, but in fact, given what the issue of fuel poverty is about, what happens to the top 10% is completely irrelevant. The reason why I suggested that if one is taking a threshold, it should be based on what a typical or median household is doing, is that that number is not affected by what plutocrats are doing with their large ranches or multi-million-pound residences. I am looking at the position that people with low incomes are in by comparison with the mainstream of society.

The issue, then, is whether we think it is acceptable—you may or may not—that somebody who has a low income would face very high costs to keep their home at a temperature that allows them to protect their health. The evidence I reviewed in the interim report suggested that there are good reasons for thinking that living at low temperatures damages health, and that the scale of the problem is such that people who are already facing hardship in different ways will have that hardship exacerbated by what they must spend to try to keep warm.

You say it is inevitable that fuel poverty will rise. I do not think that is true. What one is looking at is a product of both energy costs and the energy efficiency of the building that they live in, and that is something that they can make a difference about. One of the conclusions of my report was that when you look at the evidence on what happens if you invest money in energy efficiency measures in the homes lived in by everybody, but particularly people with low incomes, there are measures you can take that are very good value for money according to the kind of cost-benefit analysis that the Treasury, for instance, does. It is a good national investment, and that is the focus of the report. That has nothing to do with what has happened to the incomes of, the top 1%.

**Q309 Dr Lee:** Following on from that, one short question. I have long thought that the winter fuel allowance should be scrapped. Would you agree that we could invest that money in social housing that is energy efficient, with insulation and everything else? We could take that money and perhaps add to it. One thing Government could do is get rid of the tenement blocks that John Robertson often goes on about, which cannot be insulated. If they were to decide to invest in and build new social housing, that is probably the most that a Government can do to address fuel poverty in the way you have defined.

**Professor Hills:** Again, there are several things there. First of all, you will see in the analysis that we did in the report, using the framework I set out, that spending more money on the winter fuel allowance is one of the least effective ways of tackling this problem. There are many other reasons why you might want to have a winter fuel allowance, and the current Government are committed to keeping it, but with those resources there are more effective ways you could spend that money that would deal with fuel poverty. That is the very clear conclusion of the report.

There is then a second issue that you brought up, which is precisely what you do with it. The one point I would make there is that my biggest priority for action would be taking measures with existing property—retrofitting existing property. The centre that I am part of recently published a report, which you might be interested in, called “High Rise Hope”, about the programme that has been insulating a series of energy-inefficient tower blocks in west London and how that has worked out. I think examples of that kind show what can be done,

rather than using a great deal of resources to demolish something and then rebuild it. In terms of cost-benefit analysis—the benefit you get for each pound spent—renovation and retrofitting is probably much more effective than demolition and rebuilding. It seems to me that using the money we have got in the most effective way, whether it comes from abolishing the winter fuel allowance, or from somewhere else, is the top priority. There is a lot that can be done at very good value for money.

**Q310 Dr Phillip Lee:** You could say that, but I am just saying that the winter fuel allowance is actually in place to try and prevent fuel poverty. My point is that, if you are going to try and prevent fuel poverty, or address it, I do not think it is—

*Professor Hills:* If you look in detail at the report—

**Dr Phillip Lee:** I have not read the whole report.

*Professor Hills:* I can point you to the precise pages where we make a comparison between the different measures. I am afraid that the winter fuel allowance comes out very badly on all those grounds.

**Q311 Chair:** I should disclose an interest, as I am old enough to receive the winter fuel allowance myself. I have never expressed a view on its desirability or otherwise. I have listened to the arguments with great interest and the attack by my colleague.

*Jan Rosenow:* If I may chip in, there seems to be a difference in the principle of how you address the problem. One is a long-term investment, where you invest in energy efficiency measures, and the other one is short-term help with rising energy prices. From a long-term perspective, the former—the long-term investment—seems the wiser investment. That is my view on whether we should invest in short-term financial help or long-term energy efficiency measures.

**Q312 Chair:** Moving on a bit, do you agree with the NEA that environmental and social levies are regressive?

*Jan Rosenow:* I do agree that the revenue-raising side of social and environmental levies, if raised by energy prices, is by definition always regressive. However, on the spending side, the provision of measures can be progressive, and CERT and CESP have made attempts to deliver a large proportion of the measures to low-income households, to offset some of the regressiveness on the revenue-raising side of things. So I think you have to distinguish between the revenue-raising side, which will always be regressive in the current system, and the spending side, where you spend the revenues on energy efficiency measures. But broadly, I would agree with the analysis that NEA put forward.

**Q313 Chair:** Age UK suggested it would be better to levy those costs on a per unit, rather than a per household, basis. Would that be better?

*Jan Rosenow:* We had a discussion yesterday between the two of us and the standing charge for electricity is, I think, about £15, probably, for most households, and the cost of CERT and CESP was more than £50 per year. Some of the cost will be passed on a per unit basis and some of that will be passed on in the standing charge, but we have no insight into what the proportions of that will be and how much is on the unit and how much is on the standing charge. On average, we would probably agree that putting it on a per unit or per consumption basis is less regressive. However, there will be fuel-poor households who

consume quite a lot. For example, elderly people who live at home 24/7 need to heat their homes. So I think you have to be quite careful with these sort of proposals.

**Dr Eyre:** Can I just add something? I think that what you quoted was about environmental and social levies in general. It is important to distinguish those levies that support energy efficiency and fuel poverty, and to look at whether it is possible, as Jan has explained, for revenues that are raised in a regressive way to be used in a progressive way and for the overall balance to be positive, both in being generally progressive and, in this context, in actually addressing fuel poverty. That is not generally true for all environmental levies. Where we are raising environmental levies to fund new low-carbon supply, for example, with proposals to put very significant amounts of money into contracts for difference, which are laid out on the same basis, you are going to get all the regressive effects and none of the progressive ones. I sometimes find it a bit odd that this debate focuses on the levies for energy efficiency and not on the levies for nuclear power, for example.

**Professor Hills:** Could I add to that? There is a tension. If the costs are passed on per kilowatt-hour, or whatever, that will be less regressive in general. It will hit lower-income households less hard, because on average they use less energy. However, the cost of that is that the people with the worst problems—the most fuel-poor—will be the worst hit. It seems to me that that then makes the case for a dual strategy: yes, you probably would rather have more emphasis on the per-unit side than on standing charges, for environmental reasons as well, but the corollary is that you absolutely need to be taking action to help eliminate the problems of people who have low incomes and are living in G-rated or F-rated properties, because they will be hardest hit by that.

The other side, which follows on exactly from what Nick has been saying, is that it depends entirely on how the revenue is used. It makes it very important that a large slice of the action comes back to people on low incomes, and it makes the case for a large scale of the affordable warmth component, for making sure that the CSCO part of the ECO is hitting the right people and that we are not in a position where people on low incomes are paying higher fuel bills in order to subsidise the energy efficiency of people on high incomes.

**Q314 Chair:** Could we use rising block tariffs to address this problem?

**Dr Eyre:** You could do, but that would mean regulating prices. That is the caveat that I always put on that. Yes, if you are prepared to tear up the whole of the liberalised energy market, which I might be prepared to do, that could be made to work. However, people should go into talking about rising block tariffs with their eyes open in that way.

**Professor Hills:** And you should also be aware of exactly the problem that we were just talking about—the people who would be hit hardest would be the people paying the very high unit costs who had the worst problems to start with. There is a little bit of a chicken-and-egg situation here. At the moment, we have these people with low incomes with very energy-efficient homes who would be hard hit by that, even though in general people on low incomes would benefit from RBT.

**Q315 Chair:** It depends how you do the formula, surely. If you had a free allowance, someone living in a very energy-efficient home might be getting their fuel for free.

**Professor Hills:** But only up to a certain level.

**Chair:** Well, up to the level that a two-person household would need. I can see the difficulties of designing the formula, but I cannot see that the concept is open to the objection that you have put forward.

**Professor Hills:** The problem is that couples live in a vast variety of properties.

**Chair:** Yes, absolutely. That is their choice, of course.

**Professor Hills:** Well, it may be a choice, but they may not easily be able to do something about it. If you are living in a rural area, off the gas grid, in an old property, in theory you do have an option of moving into somewhere small in town, but that is a very costly option in terms of the disruption of your life and abandoning the property you leave behind.

**Q316 Chair:** It is always easy to find an extreme example that about 0.01% of the population might encounter and say that that is a reason for not doing something that is generally desirable.

**Professor Hills:** Unfortunately, it is not 0.01% of the population who are living in extremely energy-efficient properties at the moment.

**Dr Eyre:** The broader point is that a rising block tariff is essentially trying to use the price mechanism to dissuade people from using large amounts of energy, and they may be people who are more or less poor, as John indicates. If you are going to charge people more than the marginal cost for high uses, the real trick is to use that revenue back in direct energy-efficiency programmes rather than simply relying on the price mechanism. Marginal block tariffs will financially achieve something, but it is much better to invest where you need the investment.

**Q317 Dr Whitehead:** One of the enduring issues of the whole fuel poverty debate is that all the figures are based on extrapolation of the household condition survey, which I think covers about 8,000 homes. We have never known where anyone in fuel poverty actually is, yet we have a system of effectively requiring energy companies to find out where people are and then lavish devices on them to alleviate fuel poverty. As Citizens Advice pointed out to us recently, people may not be aware that energy companies are about to lavish goods on them. Indeed, last year, £50 million from Warm Front was unspent as a result. Bearing in mind that that is what we are stuck with, what lessons might be learned for future policy from that record of identification and take-up concerning fuel poverty?

**Professor Hills:** Could I say two things on that? First, reiterating the distinction between how we measure as well as we can the scale of the problem at national level, whether we are going in the right or wrong direction, and what we do on the ground, I think the trick is to take one's best understanding of how you would measure the problem if you had perfect information, and then translate that into relatively simple-to-measure indicators on the ground that you know capture most of the problem, with the important proviso that this is an area where we probably do not mind if we get it a bit wrong to start with. If you think about it and take seriously the carbon budget, climate change and where the country must be by 2027 or whatever it is, we must go round most of the housing stock. That is one of the most important things we can do to tackle climate change.

In a sense, we are talking about the order we do it in. If we do someone a bit early when we would have had to do them later on, that's not such a big problem. If you are treating stock where someone has an income that is a bit above the poverty line, incomes vary and people move between properties. We must work our way round the whole housing stock eventually, so I would not be too nice about exactly how we set the objectives on the ground. We want things that by and large hit the right people in the right order, but if we can find relatively simple proxies that get us to the bulk of the problem, that is where we should start.

**Q318 Dr Whitehead:** But that is a bit of a “which is to be master” problem from “Alice in Wonderland”. You may consider tackling all properties on the basis that they should be energy-efficient and thereby scoop up people who are in fuel poverty and eradicate fuel poverty. Alternatively, you may target those in fuel poverty and incidentally make considerable strikes towards the energy efficiency of properties.

**Professor Hills:** You do the best you can, but you don’t get too hung up if somebody turns around afterwards and says, “Well, that person wasn’t really in fuel poverty,” because their income was £10 too high or their property was not quite as bad as somebody else’s. We will need to get there eventually, but yes, you do want to set a priority order, and you want to look at anybody on a low income who is living in a property with an energy efficiency certificate rating of E, F or G. Those properties need to be brought up to standard. You do not need to do a lot of calculation to see whether somebody fits those characteristics.

**Q319 Dr Whitehead:** But previous schemes missed by 40% or 50%.

**Jan Rosenow:** Yes. If you look at the proxies that have been used under CERT, they are mainly income and age. The same will be the case under Affordable Warmth, like many income and means-tested benefits. Only about 30% of households on means-tested benefits are actually fuel-poor under the current definition, and only 19% of all pensioners. The proxies we are using to identify fuel-poor households are not that precise. I think, however, that Affordable Warmth is more targeted than previous schemes. I have seen some analysis from York university saying that about 37% of all the beneficiaries will be fuel-poor households under the current definition, compared with about 20% to 25% under the CERT priority order.

So it is an improvement, but we are still quite a long way off. The main reason for that, as John pointed out, is that we are not looking at the energy efficiency of the property under the current indicators. We are focusing on income, benefits and age, but not the actual properties and their energy efficiency ratings.

**Q320 Dr Whitehead:** I am trying to get a better feel for this. Is it effectively being suggested that that level of inaccuracy is okay for future schemes, inasmuch as that is about the best you can do?

**Jan Rosenow:** I don’t think it is. I think area-based approaches achieve a higher targeting efficiency if they are done properly, not just by focusing on income. I think CESP was also based on income, looking at the bottom 10% of the income deciles. Again, that doesn’t achieve a very high targeting efficiency. I think you have to design area-based approaches in a way that captures low efficiency and low income. By that you achieve a very high targeting efficiency.

**Dr Eyre:** I think that is in the spirit of what John was saying about doing well rather than perfectly. Ideally, we would know the fuel poverty status of every household and go through them in order, starting with the deepest, but in practice, we are not going to be in that position. Rather than looking for low-income, high-cost households, looking for low-income, low-efficiency areas is probably a reasonable way to do it, and it has the outcomes you suggest. The targeting is not perfectly efficient, but it is better than a nationally based approach.

**Q321 Sir Robert Smith:** If it is area-based, does it also make roll-out and delivery more efficient?

**Dr Eyre:** Certainly, for some measures like external wall insulation. If you could go up my street and do a block of 30 at a time, it would be more effective. It also says something about the delivery agent. Large multinational energy suppliers actually don't know very much about the housing stock. That is one reason why they have struggled with parts of CERT, I think; they don't know much about their customer base in terms of its income characteristics, or about the housing stock in particular areas. That would indicate that we should be looking to more trusted and more local organisations for delivery, whether that is local authorities or the third sector.

There are many options open. I am not convinced that fuel poverty is best done through the big six energy companies, and I actually think the big six are not convinced it is best done through them either. There is perhaps a degree of agreement that often does not exist on these issues.

**Q322 Dr Whitehead:** SSE has suggested, for example, a central register or clearing house agency to match customers and presumably allocate them to energy companies in some way. Would that work better? Would that work?

**Dr Eyre:** Well, if you're going to do it through an energy company obligation, yes, you need some mechanism like that. I guess I am saying that in the longer term, maybe an energy company obligation is not the right way to address fuel poverty delivery.

**Professor Hills:** In terms of delivery, I think there is an opportunity here, which I think some housing associations are taking up, but one of the great unsung success stories of the recent period has been the huge improvement in the energy efficiency of the social housing stock and the success of the decent homes programme, under the last Government. But what that means is that social landlords have actually got experience of doing this stuff in their own property—they need to do more; we need to push further on that—and they also have local knowledge. Some of them are quite dispersed and quite large, but a lot of them do have local knowledge and, to some extent, are those trusted agents. It seems to me there is a big opportunity here for social landlords who have been doing this to become—whatever mechanism you have for financing—the intermediary that helps people do all of this. I hope that is something the sector takes up.

**Q323 Dr Whitehead:** Returning to Nick's point about ECO and the way that might take up the torch, certainly there is a fair amount of evidence suggesting that, as far as the individual approach is concerned, energy companies, in discharging their obligation, are not likely to go for people in fuel poverty living in solid wall homes and would perhaps prefer to do a partial arrangement with a "better level" of customer, who would be partly taking the green deal up and partly doing ECO.

**Dr Eyre:** Yes, I think it is important to distinguish—ECO is essentially there to replace both Warm Front in England and the CERT super-priority group approach. It is actually two things. It is important to distinguish between the affordable warmth bit of ECO and ECO in general. I am sure you are right. For ECO—the ECO carbon saving—the energy companies will be looking to factor in Green Deal money or customers' money generally. That is the only way they are going to deliver that cost-effectively. Affordable Warmth, I suspect, will look more like the CERT super-priority group approach.

**Q324 Dr Whitehead:** Yes, but that will be one way. An energy company will go to a local authority and say, "Can you please discharge x percentage of our obligation by doing up all your system-built homes? Thank you very much. We will then leave the area."

**Dr Eyre:** I think that is our best guess at the moment, yes.

**Professor Hills:** Affordable Warmth itself I don't think applies to social housing. Others will probably know better than me on that. CSCO probably could cover it, but the Affordable Warmth part does not. There is clearly a crucial issue in the administration of all of this, which is that the potential of there being, effectively, a market in all of this through ECO is that you get the most cost-effective delivery. So you do want people to be catching the low-hanging fruit and to be doing this in the most cost-effective way. You then get more done for the money that is being put on people's bills or, if it was tax-funded, from people's taxes—but in this case through their bills—but the rules and the monitoring of those rules have to be set up in a way that does not allow the energy companies, or the people who have the obligation on them, effectively to cheat by doing things that don't really meet your objective.

I have, still sitting in a drawer, a whole load of light bulbs that a former energy company sent to me—not even one I was still using—because it met one of their obligations. That kind of extreme game playing has been ruled out, but it will be a continuing tension all the way through—and this is maybe Jan's area in particular: making sure that the rules that apply to the obligation are in line with, and can only be met by, measures that really achieve your objective will be crucial.

**Q325 Dr Whitehead:** But are we not back to the “who is to be master” problem? Let us say you are doing an area envelopment scheme and you are keen to get value out of that, obviously, in terms of reducing the unit cost, and you might then deal with a lot of properties in an area. You might then, depending on what part of ECO you are working with, work with a housing association and go out into private properties in the area and get the whole scheme working, at which point you have completely gone off the question of the extent to which fuel poor households might in any way be identified. The DWP is increasingly sharing data, is it not, on identification? Are there ways in which that DWP data sharing could be allied with those schemes to target better? If the target were better, would that be at the cost of the efficiency of the operation?

**Jan Rosenow:** I think the response rate to the letter that the DWP sent out was very low. They sent a letter to all eligible households, but few of them responded to that. It is a problem of self-identification, I guess, and people voluntarily saying, “I would be interested in receiving measures.” There might be some data issues with the DWP providing energy companies with those data. That is why it sent out that letter, but the letter did not lead to the desired response rates. There is an issue about data protection and about getting uptake from eligible householders who are not responding to the offers.

**Professor Hills:** We have two problems. One is that with the warm home discount there is matching of data between the DWP and the energy companies. Some people get a reduction off their bill if they opt in. Obviously, a lot of people in that kind of situation do not take it up, so you miss some of the people who you want. There is also a problem that not all of the people on low income who you are worried about are receiving means-tested benefits. There is a group that you are worried about that the DWP does not even know about. The people you are most worried about are those who are entitled to means-tested benefits of one kind or another and do not claim them, because they are the ones left furthest below the poverty line.

Again, you would not want to have a system where you counted it as a failure that you had not reached some households who had low incomes—you do not have a good way of measuring that—but were not claiming benefits, because it is another of these areas where your targeting is inevitably fuzzy. It is never going to be completely precise. You can monitor

on a national scale how well you are doing, but unless we have vast amounts of data sharing and households reporting more of their circumstances to authorities than they do at the moment, we will never have anything that is perfect. The idea that what you want is something that is good, rather than perfect, is important.

**Jan Rosenow:** May I add to that? The question you raised is very important: how much of the ECO funding will go to fuel-poor households, especially with the carbon saving obligation, although not so much with the Affordable Warmth scheme? The impact assessment that DECC put out last year suggested that most of the activities would focus on the larger properties—wealthier households—and there is a big question mark over whether the private-rented sector will benefit. Under CERT, I think 5% of all the households that received benefits were privately rented, but nationally 13% to 14% of households are privately rented. It was the same with CESP. There is a question mark as to how this important sector for fuel poverty will benefit from the obligation.

**Q326 Albert Owen:** You have touched on many of the points I was going to raise, but I wanted to recap on ECO. There will be less funding for ECO than for the previous Warm Front scheme. How can we maximise that ECO? Are you suggesting that we move away from targeting individual households and go to community-based schemes? Is that the general view of the three of you?

**Jan Rosenow:** It is certainly my view that that would be a more cost-effective approach. There would be a higher targeting efficiency by doing that. How exactly you design the scheme is complex. One would want to look into it. In general that would be a better approach compared with what we are doing now.

**Q327 Albert Owen:** It would be less hit and miss in terms of individual households and the data available. Is that what you are suggesting?

**Jan Rosenow:** Yes, I think looking at the individual household is a strategy that proved quite difficult under the super-priority group in CERT. Suppliers found it quite difficult to identify households. Also, the targeting efficiency of doing that was quite low. We have seen that 30% of SPG customers, or maybe a bit more, were in fuel poverty, so an area-based approach might be more desirable to increase the targeting efficiency and to make delivery more cost effective.

**Dr Eyre:** I broadly agree with that. It is important to bear in mind that there will be households with a big fuel poverty gap who are not in the areas that would be targeted, so keeping a balance between individual entitlement and an area-based approach is probably the right way forward. That is essentially what is being proposed in ECO, and when we see the final evaluation of CESP we may know a bit more about the relative strengths and weaknesses. I do not have a problem with ECO having its different elements; the biggest problem is that it is not big enough.

**Q328 Albert Owen (Ynys Môn) (Lab):** But you did touch on this earlier: will it be a problem that there is less funding available for schemes per se?

**Dr Eyre:** Yes.

**Professor Hills:** I would agree that you are trying to achieve different things, and you therefore probably need all three elements. I would not put all my resources into community-based schemes. Our analysis based on the measurement framework I suggested did not show such a high hit rate on fuel poverty, if you target it by area of deprivation, for example. You have to have some other way of targeting, such as when a property was built and what sort of

property it is, otherwise you might be doing a lot of good, but your hit rate of fuel-poor households will not be so large. Unfortunately, the problem is quite scattered, so some people will always be outside any of the areas that you identify, which is why it is right to have both kinds of targeting.

You want to remember that there is another objective—carbon saving in general. If the carbon saving part of ECO achieves that, well and good. The royal household has very leaky palaces and we should be doing something that anyway, but it is just a different problem from fuel poverty. The issue is the balance between three different parts of ECO, and I think you have to look at the evidence of how well you can use either an area approach as your proxy for getting to the people you are trying to get to, and probably at lower cost because you can envelope things, or—

**Q329 Albert Owen:** You indicated earlier that you felt that local authorities were better placed to deliver it. Yes?

*Professor Hills:* They are not the only people, but many social landlords have experience of doing that, and they have knowledge of the areas they operate in and are more trusted agents than some of the alternatives. As part of the delivery pattern, I hope they will play a big role.

**Q330 Albert Owen:** A large number of people, as you indicated, are off the gas grid. They may have the most energy-efficient houses in the country, yet they have to pay a lot of money for LPG or oil to cook and to heat their properties. How do we deal with them? Would it be better to spend money in those areas on ground source heating and the extension of gas mains, so that they have a more level playing field for their fuel prices?

*Professor Hills:* You have to look at the value for money of any intervention. I have not done enough detailed work on that.

**Q331 Albert Owen:** But there will some very energy-efficient households that are—

*Professor Hills:* If they are in very energy-efficient houses, the problem may not be large, even if they are off the gas grid. The ones I am really worried about are those in leaky old properties that are off the gas grid. There will be cases where different kinds of investment will be more valuable, but that will be on not a case-by-case basis but a type-by-type basis.

**Q332 Albert Owen:** Do you think there should be a special taskforce for rural fuel poverty?

*Professor Hills:* It's an interesting idea.

**Albert Owen:** I think you will find that the evidence is there to show that most fuel poverty is in peripheral and rural areas.

*Professor Hills:* I'm not sure that is quite true. I haven't revised the numbers in the last few days, but I think you will find that the problem is spread between rural and urban areas. What is important is that it is different in different places, so in some areas it is about being off the gas grid and having very high costs, but there is also a very large urban problem. Some people living in tower blocks are not on the gas grid because of restrictions on gas supply.

**Q333 Albert Owen:** But many have the choice of switching to dual fuel, which those in rural and peripheral areas do not have.

**Professor Hills:** Some do and some don't. The people we are most worried about are people who do not have the resources to make the capital investments that can deal with these problems. That is one reason why fuel poverty is a particular problem. Those of us who are in a less energy-efficient property than it might be can afford to make investments that pay for themselves—the green deal, and so on, is supposed to help us do that—but giving somebody a low-interest loan, or a 6.9% interest loan, to deal with a problem when they do not have the money to pay the loan at all does not help. That is one of the reasons why fuel poverty is a particular problem.

**Q334 Albert Owen:** That is important. Regarding the funding being decreased, through ECO, to previous schemes, you are indicating that the green deal is not the panacea to help with that. What else can we do? What other funding streams and extra money can be used to help these people?

**Jan Rosenow:** One of the proposals that have been put forward—I am sure you are aware of it—is an energy bill revolution, recycling some of the EU ETS revenues and directing them into energy efficiency programmes. Broadly, that is an interesting idea that one should look at. But there are, generally, three funding streams that are available. One is Exchequer funding; one is looking at—

**Q335 Albert Owen:** Sorry, but how would that work in practice? It is all right having these headlines, but what can the Exchequer do that will help fuel poverty tomorrow?

**Jan Rosenow:** Warm Front is a prime example.

**Q336 Albert Owen:** So it was wrong to abandon Warm Front. More money should have been put into it and it should have been more targeted.

**Jan Rosenow:** That is one option. Warm Front became more targeted in the later stages. They introduced a SAP rating as one of the requirements in April 2011, if I remember correctly. The targeting efficiency for the proportion of fuel-poor households that received benefits from Warm Front was high—it was more than 70%, if we believe the models. So yes, in theory, that would be one of the approaches that could deliver more on fuel poverty, but based on the proposition that you actually have Exchequer funding for that programme.

**Dr Eyre:** I think there is a case for looking, as Jan said, at the ETS revenues in particular. We all know it would be heresy with HM Treasury, because it counts as hypothecation, but actually these revenues have been raised in a particularly regressive way on people's energy bills and there does seem at least some intuitive logic in applying them back to addressing fuel poverty issues.

**Sir Robert Smith:** I suppose the problem is they are probably being spent at the moment.

**Dr Eyre:** We all know there are problems with the public finances, yes.

**Q337 Sir Robert Smith:** Just one thing. It is fairly obvious to those involved directly, but for those outside, a measure designed to reduce carbon emissions is probably not so effective in a fuel-poor household, because the fuel-poor household, by definition, is living in a cold environment. If you make the house more energy-efficient, they will use what money they have to continue to buy their heating to make better use of it. So you don't reduce carbon, but you improve their health and lifestyle.

**Dr Eyre:** You do not reduce carbon as much in the short term. In the long term, I would hope that everybody would live in a decently heated house and, therefore, in the long term it saves just as much carbon as doing the house that is properly heated now.

**Professor Hills:** I would add that if we do not take action about people with low incomes living in energy efficient homes, we will then get a huge barrier to any measures that use the price mechanism to try to encourage better use of carbon. You have always got this group of people who are, as it were, in the front line and will be the people who suffer most from higher prices. So if you think that having a carbon price, or things that proxy for a carbon price, is part of how we meet carbon objectives in the long run, you have to deal with the problem of people with low incomes who are then hit by that.

One of the biggest things that we can effectively do something about is energy efficiency, both in delivery of people's energy and the energy efficiency and insulation of their home. Those two things go together. I do not think that fuel poverty is a separate problem from dealing with carbon. Dealing with fuel poverty is a necessary part of also being able to do things about carbon.

**Q338 Sir Robert Smith:** Just one other thing that came up. You mentioned people who do not claim benefits. In effect, one of the quickest wins in trying to get people closer to being out of fuel poverty is to have benefit take-up campaigns and to make sure that those who are entitled to them are actually getting the benefits.

**Professor Hills:** Absolutely, and more generally, things that reduce the level of poverty will reduce the level of fuel poverty, so there is a whole series of measures. One of the suggestions that comes through the framework that I put forward is that we have traditionally thought of fuel poverty as being a problem of the elderly; but when you look at it in detail you see there are also quite a lot of working-age families with children who are facing very high costs compared with their income, and compared with the costs that other families face. If those families were out of poverty, the problem would be smaller. For each individual pound tackling this particular problem, energy efficiency is your best buy, but anything you do in general to reduce poverty and the extent of low incomes—getting people into work, or whatever—will also help.

**Jan Rosenow:** These tensions, I think, go back quite a long way, back to 1994, when the first obligation was introduced. People were discussing exactly that: if we just have a market-based instrument that focuses on carbon and low cost, what will happen to low-income households? That is why Ofgem—at the time, it was Offer—put in provisions for targeting vulnerable customers. Those tensions will never go away with an instrument that is market-driven and at the same time raises revenues via prices. There are certain tensions built into that instrument that you will always have to deal with.

I think what is interesting is that for the first time we are actually using the obligation as a deliberate fuel poverty policy, whereas with CERT, EEC and EESoP, as they were called previously, they always said, “We have these provisions in there as social equity provisions, not necessarily in order to target fuel poverty.” Back in those days the Government were quite explicit that this was not a fuel poverty policy, whereas now they say exactly the opposite: it is a fuel poverty policy—and it is probably the most significant one after we terminated Warm Front in this country. So I think it is quite an interesting transition that we have seen, from a carbon market-based mechanism to a fuel poverty policy.

**Q339 Dr Whitehead:** Where do you think the £1.3 billion that is being regarded as the amount that they will come to each year came from?

**Jan Rosenow:** Do you mean, where did that figure come from?

**Dr Whitehead:** Yes.

**Jan Rosenow:** That is the figure that I have seen in the impact assessment that DECC produced, which is based—like previous obligations—on a list of the various measures that are likely to be taken up, and then the cost per measure.

**Dr Whitehead:** I appreciate that it was in the impact assessment, but where did it actually come from?

**Jan Rosenow:** I think this has been modelled within DECC, using various models, and they make assumptions—how many solid walls will we insulate? What is the cost per solid wall insulation? That is how they have come up with that figure.

**Q340 Dr Whitehead:** Yes. The general wisdom, particularly in thoughts from energy companies, is that bearing in mind that that £1.3 billion is explicitly not capped in the levy control framework, costs could spiral up to more than £2 billion, perhaps £2.3 billion, in order to discharge obligations fully.

**Jan Rosenow:** Yes.

**Dr Whitehead:** Is that your view? That surely would represent a very serious impact, for example on the extent to which that cost gets carried over to bills.

**Dr Eyre:** I think it is difficult to tell. I am wary of taking energy company judgment on this. They have a long history of telling us that obligations would cost more than the Government said, and then miraculously delivering them for less than the Government said. But I also think we need to be careful that they may not simply be crying wolf—the nature of ECO, with new and relatively expensive measures, is that actually nobody is very sure how much it will cost to deliver them. So there is a risk that the costs will be substantially higher than £1.3 billion, yes, but I don't think you will find anybody who knows the answer to that question.

**Q341 Dr Whitehead:** Will the competition between energy companies help to keep that cost down, with competing companies knocking on the doors of local authorities, saying “I can do all your system-build houses at half the cost of the other guys”?

**Jan Rosenow:** Of course it will. I think it always has had that effect. That is one of the benefits of having a system with competition; energy suppliers will offer different prices for different measures and different contributions, so I think that it will help. However, I agree with Nick that there are huge uncertainties. DECC itself pointed out that there are uncertainties, ranging from £0.5 billion up to £3 billion per year—that was in the same impact assessment. I could not say where in that range the real figure lies—nobody can—but there are uncertainties attached to this. I also agree with Nick that we have seen that previous obligations have been delivered much more cheaply than the Government thought. I think they were about 20% cheaper than was initially modelled. The honest answer is that we do not know exactly how much it will cost, but there are risks.

**Q342 Dr Whitehead:** The Committee on Climate Change has suggested that one way forward might be to put a cap on individual treatments, so you would say, for example, “You cannot treat a solid-walled property at greater than x cost.” Would that be self-defeating, or would it be a way of maintaining costs? I have to say, first, that I am a little alarmed that nobody knows what the real cost is going to be; secondly, the £1.3 billion figure appears essentially to be made up. Thirdly, what we do know is that since it is an obligation, it will go

on bills and will then be capped one way or another if the alarming truth comes out that we really do not know how much this is going to cost over a period of time. Are there ways in which that might be done less, rather than more painfully? Is the Committee on Climate Change on to something that might work?

**Dr Eyre:** I think you would have to be quite careful about that, because the way you would expect costs to work for newer measures, such as solid wall insulation, is that the costs would come down as the experience of delivering them goes up. You would expect the cost to be lower at the end of the obligation than at the beginning. So, if you capped at quite a low level, you risk nothing happening. You would then have to ask whether it is a quantity obligation or a price obligation. I do not think you can do both very easily. My worry would be that you would be telling people that they have to do something, but that they cannot do it at the cost for which it is available in the market.

**Professor Hills:** You would also have to be a little careful about whether that would then become the norm. You put a cap on, at £10,000 or £8,000 or whatever—I don't know what figure you or they are thinking of—and that becomes the standard.

**Dr Whitehead:** It becomes a tariff.

**Professor Hills:** Yes, and that could be very inefficient; but I don't know.

**Dr Eyre:** You would have to differentiate between different types of property and different types of insulation. I am not saying it's not possible, but it would be a little more complex than saying, "It's £5,000. That's the answer."

**Jan Rosenow:** To some extent it will be driven by the golden rule of the green deal. You have cross-funding whereby part of the solid wall insulation is basically funded by the green deal, so the contribution the energy suppliers make will be determined by how much of the cost is funded by the green deal in that instance. To some extent, it is not a cap on the total cost, but the contribution will be determined by the golden rule, which has been built into the green deal—if that makes sense.

**Q343 Dr Whitehead:** Professor Hills, do you think the Department looked at your report at all when designing the ECO? If not, should it have?

**Professor Hills:** I think there is an issue of timing. My report was completed in spring last year; I think that most of the work on the ECO had been done by then. I very much hope that the Department has been paying attention to the analysis that we did in the report and that, as ECO evolves, they will be able to use the kind of framework that I put forward to help them design it. Given that I hadn't written the report before the Department was doing the ECO and that they didn't tell me what to write, it would have been quite hard for them to have taken account of it; but I hope they are now doing so.

**Q344 Dr Whitehead:** Do you think they should do that in any specific ways? I guess this is a question of redesign rather than design.

**Professor Hills:** Of ECO?

**Dr Whitehead:** For example, in terms of the in-depth fuel poverty cohort.

**Professor Hills:** Whatever action is taken, through whatever form, I hope that what I think is an insight in trying to identify people who have got the worst problems, and trying to think through how you actually find them on the ground, could be helpful to them. I hope that, in the last year, since I did all of this, that people who do that kind of analysis have been pushing it further and that their work on the promised fuel poverty strategy will be informed by that and will be better informed than my report was. So I hope that what we have given

DECC—not just DECC, but other parts of Government as well—is a tool that they can use to get on with it and deal with this really pressing national problem.

**Chair:** Thank you very much indeed for that interesting and useful session.

### **Examination of Witness**

*Witness:* **Gervase MacGregor**, Head of Advisory Services, BDO LLP, gave evidence.

**Q345 Chair:** Good morning. Thank you for coming along and helping us address some of the more complex issues that this inquiry is covering.

Could I start generally? The background, in looking at the accounts, is a level of public distrust now of energy companies, some of which is possibly justified—they have sometimes contributed to it by things they have done—and some of it may just be based on people's difficulty in understanding the information that is available. Were there particular recommendations in the BDO review that you think would have addressed that issue of distrust and would have genuinely improved the transparency of accounts?

**Gervase MacGregor:** Yes, but with time. Shall I give some context as to our approach to this?

**Chair:** By all means, yes.

**Gervase MacGregor:** Obviously, I am an accountant and accountants love figures and data, and if we are trying to make some sort of comparison between one company and another, one wants that data to have a level of consistency across the companies you are trying to compare. The other thing is that you cannot fix something like this in one year—one set of financial statements or one set of CSSs—you have to look at it over a period of time.

The recommendations that I put to Ofgem in view, had they been implemented, over a period of time would have led certainly to more transparency over the performance of the six companies. Of course, more transparency and more data—first, making comparisons and, secondly, looking at how things changed over time—may well have led to more questions. I think that is probably inevitable. But over, say, probably a three-year period at the very least, you would have got more information out of it, and possibly—probably—a greater understanding of people who read these things and what is going on.

**Q346 Chair:** Who do you think does read these things?

**Gervase MacGregor:** Analysts, I am sure; people like yourselves; probably, people like the gentlemen who have been speaking before. I appreciate that there is an interest in the financial performance of the energy companies, and that people trying to understand that will reach a brick wall when it comes to trying to interpret what, these days, are relatively complex documents—financial statements. They become even more complex when you have businesses which are undertaking a number of different activities: generation, trading and supply.

**Q347 Chair:** Ideally, we would like a world in which these sorts of statements are accessible for consumers to understand as well. I am sure the average electricity or gas consumer does not plough their way through the various notes to the accounts of the big six companies. Is there a way in which these statements can be made more accessible and understandable to consumers, rather than their having to go through some intermediary such as the *Daily Mail*?

**Gervase MacGregor:** At the moment it is very difficult. I think, as far as any set of accounts is concerned, this is a debate about education and the extent to which individuals in this country get properly educated in respect of financial matters. Unless you can understand the most basic set of accounts it is quite difficult to understand a set of sophisticated accounts, which means that you are reliant on an intermediary. I don't know about the *Daily Mail*—well, it probably is the *Daily Mail* and some of the other newspapers that look at these things on an informed basis.

**Chair:** I'm one of the few members of the Committee who started life as an investment analyst, and even I find the accounts quite difficult sometimes to penetrate.

**Gervase MacGregor:** It hasn't got any easier. A lot more information is provided these days in respect of business in their financial statements. It hasn't got a lot easier to understand what's going on.

**Q348 Chair:** Is there any way that we can make the bills for domestic and non-domestic consumers a little more instructive and informative about the profits of the companies?

**Gervase MacGregor:** That is an interesting question. A lot of people read their bills with horror, rather than anything else, these days. Putting more financial information on those things would probably scare people off. I have read some of the evidence that some of the big six gave on the transparency of bills and the various regulations that they try to meet when they put information in there. If you want something that fixes it for everybody, it is just not there. I'm afraid you have to do a bit of work to understand what's going on in these things.

**Q349 Chair:** Ofgem suggested some time ago that “retail prices do not always track wholesale costs closely, partly because retail margins act as an internal hedge for generation profits.” You could argue, therefore, that both generation and supply are part of the same overall market strategy, and should be considered together when you are evaluating whether the big six prices are fair and justified.

**Gervase MacGregor:** One could look at that, but then you would have to put trading in the middle. You left out trading, there. Trading, to the extent that it is not included within the financial statements of companies operating in this country, is quite an important part of their overall business model.

**Q350 Albert Owen:** You mentioned your review and Ofgem's response to it, and you identified eight recommendations. After consultation, Ofgem effectively decided not to take them forward in the original form. Why do you think the BDO recommendations were not taken up?

**Gervase MacGregor:** I am going to start by saying that you will have to ask the individuals at Ofgem why that was the case. My view, based on our discussions with Ofgem, is that there was a concern about the ability of the companies concerned to adjust to some of these changes, and perhaps a concern about the costs that would be incurred. I have a particular view about that, but I think that was probably driving some of the thought there. I have some sympathy with that, but not a lot. I saw in one of the companies' letters in response to the consultation that they welcomed the fact that there was not going to be an independent auditor crawling all over this, because they didn't see why they should pass on the cost of the audit to the customer. That seemed to be a strange way of looking at a way of dealing with something like this. I doubt that is the case at all, actually.

**Q351 Albert Owen:** So you think it is to do with the costs? Could you explain to the Committee what the costs and benefits of your recommendations are?

**Gervase MacGregor:** In respect of each of the eight recommendations, I went through and identified what I thought—I wrote the recommendation relatively clearly, and then went through them saying what the benefits are. They are principally what I have talked about before: transparency, consistency and comparability—to give a better insight into what is going on as far as these businesses are concerned.

On costs, the first recommendation, which seemed relatively sensible, was about each company having a coterminous year-end, or at least producing their CSSs on a coterminous basis because the business is seasonal. If you have one—you used to have two—with a March year-end and the other four with a December year-end, it makes comparison a little difficult. You only have one now, and moving SSE to a December year-end will have a one-off year cost. That is how I identified the benefit. The benefit there is greater comparability between companies, and the cost is the cost that one of them has in producing 12-month information to December or changing its accounting reference date.

**Q352 Albert Owen:** In pounds, how much would it have cost the big six to follow your recommendations?

**Gervase MacGregor:** I don't know; I didn't cost that. I don't know, for example, how much it would cost SSE to go from a March year-end to a December year-end. It would have to accelerate one year's audit and financial preparation. Scottish changed its year-end not long ago from March to December, and you could probably find out from it how much it cost. I doubt that it cost a lot given the overall size of such businesses.

**Q353 Sir Robert Smith:** One of your recommendations was an independent audit of statements, and Ofgem came up with the idea of independent opinions. What is the difference between auditing and an independent opinion?

**Gervase MacGregor:** What it got is a review. That is what it ended up with. The Ofgem recommendation said: "We propose obtaining an independent opinion...but not necessarily from an auditor". It has ended up with a review. An audit will look at the information in the CSSs and how that relates back to the underlying financial information. It will give some level of assurance—that is the point of audit—that that segmental information has been correctly prepared and stated. The review does not do anything like that. As I understand it, it is a desktop review with no enquiries made of the companies or their auditors. In some respects, it is the sort of thing that any of us who are suitably qualified could do. What you get is not an assurance certificate from the accountant doing the work but, in technical terms, an agreed-upon procedures report with a series of tests to make sure things add up and that there is a reconciliation, and reciting that that is what has been done. It does not give an assurance.

**Q354 Sir Robert Smith:** How often would you have had the audit done?

**Gervase MacGregor:** Once a year, at the same time as the CSSs came out.

**Q355 Sir Robert Smith:** So it's all about giving the wider consumer market confidence in the information.

**Gervase MacGregor:** Yes, it is. If you look at the work that was done by the independent accountant, it identified issues around—I am sorry to be technical again—differences in GAAP between groups of companies that are essentially non-UK and those that

are essentially UK-based. There were issues in trying to do those reconciliations. There was no overall view of the six as a whole to try to work out whether there was any comparability. Essentially, you continue to have six CSSs which you can only really read on a stand-alone basis, and six separate reports by the independent accountant on those six CSSs.

**Q356 Chair:** On trading, which a lot of people are suspicious about as a way of—well, it reduces transparency and gives companies some flexibility about where they move their profits to, and so on. Your recommendation was that trading activity should be included in the segmental accounts.

**Gervase MacGregor:** Correct.

**Chair:** Ofgem did not require that. They have this checklist. Do you think that their checklist is satisfactory?

**Gervase MacGregor:** No, not at all. My recommendation was including the trading in the segmental accounts, not a checklist. The checklist is possibly open to interpretation. I don't know the value of it. Including the trading gives you a much better idea of the total picture of the financial performance of the companies, if that is what you are trying to get to. The review was—my instruction was—to look at improving the way these CSSs are prepared. Quite frankly, I would much prefer to see numbers, rather than a checklist with some ticks on it.

**Q357 Chair:** Why would the companies resist this? Why wouldn't they do it voluntarily?

**Gervase MacGregor:** Companies don't necessarily do things voluntarily if it requires more work or if it means putting out information into the market. Why would a company do something if it doesn't need to do it?

**Chair:** I was trying to work it out—okay, on the cost factor, you might not think it was an enormous cost to separate that out.

**Gervase MacGregor:** I very much doubt that the cost of producing trading information is that great.

**Chair:** Exactly.

**Gervase MacGregor:** Just think about it. One independent trading entity had, I think, turnover in 2011 of €75 billion. That seems to me to be an awful lot of trading and a lot of positions being taken during the year. I would be astonished if those companies did not have pretty granular information about those trades during the year, and if they did not, I think we should all be a bit worried.

**Q358 Chair:** So we can eliminate cost as being a genuine reason for not doing this. It seems to me that their reluctance to do so voluntarily is only going to reinforce the suspicion that this is an activity which can be used to confuse the whole picture—to obscure what is really going on.

**Gervase MacGregor:** I can certainly see why people would take that view; it is a natural suspicion. I have to say that when I spoke to them—I spoke to a number of the finance directors of these companies in a relatively informal way, as part of the review but just to try to get their views on things—I came away with a sense of their willingness and desire to improve their transparency and to engage properly on these things, but not really knowing how to do it. You cannot expect just one of them to do it. It probably requires a direction that all of them have to do it, otherwise any single one is not going to take that decision.

**Q359 Chair:** Yes. But taking EDF as an example: they have EDF Trading—a subsidiary of the French parent company—which made £513 million in 2011. I am not sure it is the same year, but there was a big inter-company loan. The opportunity to move profits around, if you've got a trading company, is considerable, is it not?

**Gervase MacGregor:** Just a couple of things. As far as that inter-company loan is concerned, all the information which I have been looking at is on a pre-interest basis: EBIT—earnings before interest and tax—and EBITDA, which is earnings before interest, tax, depreciation and amortisation. So really, the CSSs do not go down to that interest level; that is the first thing.

The second thing is that, if there is a loan from the holding company, under the normal rules you cannot be taking penal rates of interest out of one company—one jurisdiction—and sticking them into another company, because the Revenue services are going to challenge that. I have no doubt about that. Yes, in trading and the transfer pricing aspects of trading, as between generation and supply, of course there is an opportunity for profits to be moved around, within certain parameters. There is no doubt about it.

**Q360 Chair:** It seems to me that if Ofgem had accepted your recommendation on this particular matter, that would have been at least a step in the direction of greater transparency and improving the trust which is, at the moment, conspicuously absent.

**Gervase MacGregor:** That's why I recommended it. It was all about improving the quality of those CSSs and the reporting, and that is why I recommended that trading be put in.

**Q361 Chair:** Is the trading done like an investment bank just trying to make money on the market, or is it done as a genuine hedge to reduce the risks that these businesses are facing?

**Gervase MacGregor:** I think it's quite complicated, actually, what you are doing. On one side, you have a generation business; on the other, you have a retail business. My understanding, from going through how the trading is undertaken by each of the companies, is this.

First of all, on the amount of speculative trading—that is, taking vast positions simply by betting that the gas price will go up or down, depending perhaps on the weather—for all intents and purposes we can put that to one side, because not much of it goes on. But we are not talking about that. What we are talking about is the companies themselves trying to work out what the future is going to look like as far as demand is concerned and then coming up with pricing modelling to manage that risk over the period of time. That is what they are doing as far as the trading is concerned. They are basically trying to work out what future demand is and keep their costs of purchase to a minimum, because of course the closer you get to needing power, if you do not have a contract which will give you that power, the more money it will cost you.

**Q362 Chair:** In terms of their reluctance to make these disclosures, if they are all required to do it, there's no commercial reason why they shouldn't disclose the possibility of trading activity separately, is there?

**Gervase MacGregor:** No, not at all. The problem would be if they were required—if I recommended something like this, I think I would get in trouble with the Competition Commission—to disclose their future strategy regarding the market. I am sure that any one of

them would like to know what the others, in particular one of them, is doing as far as its future purchases are concerned. That would be uncompetitive, so I am not in any way recommending it.

**Chair:** I don't think anyone who reflects on it would suggest that; but that objection, of course, does not apply to historical activities.

**Gervase MacGregor:** No.

**Q363 Dr Whitehead:** In the report you not only mentioned concerns about transfer pricing but suggested that further work should be done on that. What sort of further work did you have in mind, and what particular concerns motivated your recommendation?

**Gervase MacGregor:** I am going to come back to the trading point on this, and explain why. My concern is not about transfer pricing as a way of shifting profits between taxing jurisdictions, because actually, when you look at the ownership of these groups—UK, Germany, France—if you are worried about transfer pricing as far as moving profits away from higher-tax jurisdictions is concerned, they wouldn't do that, because the higher-tax jurisdictions are France and Germany. My concern is not about tax revenues being shifted around to minimise tax; my concern is much more about trying to understand the agreements which have been entered into with trading, and trying to work out, particularly where you have brokerage arrangements, whether the price being charged in the centre by the trader is a fair reflection of the risks being borne by that trader, as opposed to the risks which go with the generation and retail sides of the business.

**Q364 Dr Whitehead:** So the fair apportionment of risk down the line where a company is essentially trading with itself?

**Gervase MacGregor:** That is absolutely right; so, if you think about it, the least risky part of the business shouldn't be paying a risk premium at all in respect of any transaction; they should be receiving something, whereas it is the other way round for the most risky part of the business. It was really about trying to go much more in depth—and I didn't get into this at all—to get into some sort of detail as to how that was working in respect of the companies and their trading, what benchmarking they were using, and whether the apportionment of risk was fair.

**Q365 Dr Whitehead:** The relationship between hedging strategies, buying long in the market and churning trading over on a number of occasions—coming up to the day-ahead market, for example—appears, certainly to the outside observer, to give a number of opportunities, shall we say, to transfer price and risk, particularly the three or four churns in trading that may take place between the long position and the—

**Gervase MacGregor:** That is precisely my point—to try to understand the transfer pricing arrangements, to see exactly what is going on, to see whether there is a fair apportionment of risk. Now, as far as that trading over two to three—

**Q366 Dr Whitehead:** It is not just about risk, though, is it? It is about the question of the extent to which, as it were, you are buying ahead because of your dominant position in the market. You can then retrade as you get closer and closer to day-ahead, possibly on a transfer basis or conceivably to your own or the collective advantage.

**Gervase MacGregor:** Yes, there are two very good points there. First of all, there is nothing suspicious about trading and hedging itself, and thinking into the future. It is a

perfectly rational business activity, especially for these businesses. It is completely seasonal—the sun's out, the sun goes in, that sort of thing—and allows them to try to work out what demand is. Of course, your view of demand is going to change over a two to three-year period. The great thing about being able to forward-buy and forward-sell is that you can change your mind as many times as you want up until the point when you actually have to buy something and deliver something. I don't necessarily have a problem with a company wanting to change its forward-buying on a regular basis if it just starts reading the market differently, which of course it is bound to do.

On your other point, about the dominant position, that is a big competition issue, really, isn't it? I have to say that you have got one very big buyer and retailer of gas. I am sure that everybody else would like to work out what it is going to be doing as far as the market is concerned, because by definition if you are that big a player in gas of course you are going to have some effect on future prices. It must be the case.

**Q367 Dr Whitehead:** So the big six, collectively, make the market as well as deal with the market, as it were.

**Gervase MacGregor:** They do, but they don't act, really, as a coherent group. I think what is probably happening is that each of them is trying to guess what the others are doing and five of them are trying to guess what Centrica is doing, just because of its market position.

**Q368 Dr Whitehead:** You also have the development within some companies that are effectively offering their service as a wing under which smaller companies can shelter. The small company effectively takes on the trading arrangements of the larger company, perhaps from an efficiency point of view buying into its services so that it doesn't have to do it. Is that something that has an effect on that market dominance, or is it a wholly rational device from which everyone benefits?

**Gervase MacGregor:** It is not something I have looked at, but from that description, and from some of the transcripts I have read of previous sessions, I would say that you have a market, which is made up some very big players and some big players. It then gets down to smaller and smaller parts of the market. In a market, you like to have smaller and larger players, so that the market works properly and you have an ability for somebody to take on power, just as others have small amounts of power and just as you have the ability for small generators of power to come into the market and provide it when it is necessary.

**Q369 Dr Whitehead:** But in this market you do not have smaller and larger players. You have very, very large players and very, very small players. The concern that I was raising was that the very, very small players would have to undertake an entire market operation—the whole lot—were they to trade entirely independently. Actually, they come in under the wing, as it were, and track the large company's trades, a little like the Costa Rican economy running on the dollar. In fact, that company is effectively trading for them and then giving them the benefit of that for their subsequent operations. That seems on the one hand to be of benefit to that very small player, but on the other hand it is further consolidation of the way the market works.

**Gervase MacGregor:** It is not something that I know about in detail, but it may well be that small players coming in and doing that essentially means nothing more than that they are acting almost as agents of the big players. Therefore, as you say, there is big consolidation.

Why are the large companies doing this for the small companies? There will be some rationalist, capitalist reason, even if it is just responding to regulatory and media pressure.

**Q370 Sir Robert Smith:** You identify that the EU emissions trading scheme allowances were treated differently in the different segmental accounts. What does that do to the overall presentation, and do you have any thoughts on why it has come about?

**Gervase MacGregor:** They just treat things differently. One of my recommendations—again, I take you to my overall contextual point at the beginning—was that if you are going to do things and look at comparability, you need the information compared on a consistent basis. The carbon credits and things like that are just one of a number of areas where I was recommending that you need to start from the same base point. You need to have a consistent approach to exceptional items, for example. You need to reconcile back to the same starting points—EBIT or EBITDA. Otherwise, as I said before, you end up with six statements that mean something on their own but do not really mean anything as a group.

**Q371 Sir Robert Smith:** So would you treat them in the same way as trading.

**Gervase MacGregor:** Yes. I would treat them so there was consistency across the piece and so that when one looked at the CSSs, one could see how, on a company by company basis, one could make a valid comparison.

**Q372 Chair:** In the review that Ofgem did of the 2010 segmental accounts statements, it noted that four of the big six had made significant accounting adjustments—in one case, £340 million—which had the effect of reducing the stated profits. Do you think that there should be a good method of presenting exceptional items, so that they cannot apparently be used to reduce profitability?

**Gervase MacGregor:** It is one of the things that Ofgem did take up in terms of getting a consistent approach as far as exceptional items are concerned. As far as reducing exceptional items is concerned, you are going to have, company by company, events that give rise to these sorts of things. They are not necessarily bad things. If you have a massive impairment charge because something has happened, of itself that as an exceptional item is not a bad thing, but you do need the ability to strip it out of the ongoing activities so you can understand what the underlying financial performance has been.

**Q373 Chair:** The existence of exceptional items does make it slightly harder to make consistent comparisons across the industry, doesn't it?

**Gervase MacGregor:** It does. It is certainly true that some companies are a bit more free with their use of exceptional items than others, depending what it is they are trying to show as far as their level of profitability is concerned. One wants to be able to adjust to that. If it has not been stripped out or if it is something that was an exceptional item where perhaps there was an element of judgment over it and it should not have been, you need to be able to adjust for those things across the companies to aid comparability.

**Q374 Chair:** An accounting adjustment is effectively a paper transaction, or a paper calculation by the company. It does not necessarily have any bearing on how much cash the business has generated from one activity or another.

**Gervase MacGregor:** Well, it might do. Your big impairment charges obviously do not have any cash effect at all. If you are going through some sort of reorganisation and you are

paying out genuine money to restructure something then that may well have—it probably will have—a cash impact.

**Q375 Chair:** Is there anything else you think we should have asked you that you have not told us?

**Gervase MacGregor:** No, it has been very comprehensive. Thank you for the questions.

**Chair:** Thank you for coming in. It has been very useful for us.

**Gervase MacGregor:** Thank you.