



HOUSE OF LORDS

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SECRETARY OF STATE FOR ENERGY AND CLIMATE CHANGE

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Witness: Rt Hon Edward Davey MP

Members present

Baroness Scott of Needham Market (Chairman)
Lord Bowness
Lord Cameron of Dillington
Lord Giddens
Baroness Howarth of Breckland
Lord Lewis of Newnham
Baroness Parminter
Lord Renton of Mount Harry
Lord Whitty
Lord Williams of Elvel

Witness

Rt Hon Edward Davey MP, Secretary of State for Energy and Climate Change

Q1 The Chairman: Secretary of State, good morning. It is very good to see you. I know that the Committee has been keen to talk to you and the timing could not have been better. The Government's response to our energy report came out about 10 days ago. I know that we are all pleased both that it was on time and that it was very detailed and engaged with the Committee's work, so thank you to you and your staff for that. We know that there have been a lot of recent developments at Council level and, of course, the Energy Bill is going through this House. While scrutiny of that Bill is not the job of this Committee, obviously our Members are interested in it—I know that a number of Committee Members are very engaged with the progress of the Bill. It is a very good time to see you, so thank you.

You have been given a list of interests declared by Committee Members. This is a formal evidence-taking session of the Committee and a full shorthand note will be taken—it will be put on the public record in printed form and on the parliamentary website. We will send you a copy of the transcript so that you can revise it in terms of minor errors. The session is on the record. It is webcast live and will be available via the parliamentary website.

Perhaps I could kick off with the European Union Emissions Trading System, specifically the backloading proposal. Could you give us the up-to-date situation, following the European Parliament's agreement to the backloading proposal on 3 July? Perhaps you could talk us through the next steps. What do you think the prospects are for agreement in the Council? What are the subsequent negotiations likely to be and what form will they take between the Council and the European Parliament?

Edward Davey MP: Thank you for inviting me and giving me the chance to talk to the Committee. We value your work and are keen to engage, so thank you for your comments, which I shall pass on to my officials who wrote the response. Also, congratulations to you on becoming the Chair.

In terms of backloading, we are obviously very pleased that the European Parliament voted on 3 July in favour of the proposal. That takes us to the next stage, where the Council has to consider it. We want to secure a swift agreement on the Council but we need a qualified majority. While there are a lot of positive views on the Council towards backloading—we have been working with colleagues on that—some colleagues have conditions and at least three Member States have said that they will vote against it: Poland, Cyprus and Greece. We need to keep working with colleagues to make sure that the different views of those who are genuinely supportive can be reconciled and we need to work particularly with those Member States that have yet to take a view—Spain, the Czech Republic and Portugal. To get a qualified majority in swift time, they would need to be supportive.

Colleagues will probably be aware that Germany has, until now, said that it will abstain, because there are disagreements within the German coalition. Clearly, if the Council is considering this after the general election in September, that may put a different light on how a qualified majority could be reached, depending on the views of the next German Government. That suggests that there is still work to be done in the Council. Although we

are still getting a lot of positive noises, we will be engaging intensively with that. I hope that we will get a positive vote in the Council to enable triologue to continue some time in the autumn, hopefully concluding this phase of reforming the EU ETS later this year.

The Chairman: Thank you very much. Are there any questions specifically on the backloading? I know that Lord Giddens wants to talk about the ETS more generally.

Q2 Lord Giddens: Good morning and thank you very much for coming. I, too, would like to say how impressed I was by the detailed nature of the Government's response to our report. I would like to ask two questions. First, everybody knows that there has to be structural reform of the ETS, but could you be a bit more specific about what you have in mind? Do you have in mind a Californian system, in which a price ceiling and a price floor have been introduced to try to stop the kind of fluctuations that have undermined the ETS? What kind of reform do you think should be instituted? Secondly, the Government already have a price floor. What are the implications or consequences of that for EU policy?

Perhaps I can just make a comment on the government response on the ETS. It says that the ETS is delivering what it was designed for—a 21% reduction in emissions. I do not think that anyone thinks that that is a result of the ETS; it is a result of the policies of specific nations and the recession. I do not personally think that the ETS can be treated as a success either in terms of reducing emissions or in terms of fixing prices for low-carbon investment, which is the main basis of reform.

Edward Davey MP: I will take your last point first, if I may—

Lord Renton of Mount Harry: Could I possibly ask the Secretary of State to talk a little louder?

Lord Giddens: As the windows are open, the acoustics are worse than usual, I think.

Edward Davey MP: I will project as best I can. To take you last point first, we should say that the EU ETS started off its life relatively successfully and did make a contribution. We

could have an argument about whether it was the main contributor to the reductions that we have seen, but I think that it has played a role and continues to do so, in the sense that it is still clear that the European Union wants a working carbon market. The fact that we are engaged in reform sends a signal. I know that there is a long way to go, but let us talk about those reforms, because you specifically asked about that in your first question. As you will know, the Commission has tabled a paper with six reform proposals. We are looking at that in detail. The Government are very committed to structural reform; we see it as absolutely critical. We need the carbon market to work as we originally intended it to work. Of the six reforms, we have not come to a conclusion. The first two from the Commission are government policy already: first, we should have the higher target of 30% in the EU for carbon emission reductions for 2020, which would clearly be a good step forward; and, secondly, we already strongly support the proposals for cancellation of allowances, or so-called set-aside. There are four other reforms, which we are looking at in detail. The reform for a linear reduction factor to speed up the cap coming down over the next decade certainly has attractions, but we want to engage with other colleagues and other Member States as we respond to the Commission's reform proposal. We have made it clear today—and at a meeting yesterday with Commissioner Hedegaard I reconfirmed that this is our desire—that we need to see the Commission coming forward with specific proposals for the structural reform of the EU ETS later this year. It is important that it comes forward with them; it has set out the six, to which we will respond, but it needs to come forward with a specific proposal. Your second question was about—

Lord Giddens: Just on that point, one needs for structural reform the agreement of all Member States. That is right, is it not?

Edward Davey MP: I think that EU ETS is under qualified majority voting.

Lord Giddens: That makes a lot of difference in that context.

Edward Davey MP: I am just checking that that is correct. Yes, so clearly we want to engage with those Member States that share our views and those that could be persuaded to go for ambitious reform.

Your second question was about the carbon price floor which the Treasury put forward in the UK and which is now biting in the UK. Clearly, we wanted to make sure that we were not putting energy-intensive companies at a competitive disadvantage, given that they would be paying a higher price for energy as a result of this. That is why the Chancellor came forward in, I think, the Autumn Statement of 2011 with a compensation package of £250 million, which was mainly focused on both the indirect cost effects of the EU ETS and the carbon price floor. We have been through a process of consultation with the industry and a process of engaging with the Commission on state aid. That is proceeding and it is part of the way forward. We have had a carbon price floor in order to send the signals that we had hoped would be sent through the European carbon market—we wanted to send them in the UK—and we have gone some way towards looking after energy intensives. I hope that other things that we have done suggest our commitment to preventing carbon leakage and the unintended consequences of trying to get the pricing of carbon in the right place. For example, we will be consulting—I am not sure whether the consultation has been published yet—on how we help energy intensives to be excluded from the costs of contracts for difference under electricity market reform.

Lord Giddens: I think that the ETS is more shambolic than you are saying.

Edward Davey MP: I disagree with you. It absolutely needs reform. We have been exercising every sinew to try to get that reform. I shall not suggest that it has not been difficult, but we can get it. The EU ETS is being copied in other parts of the world because it had a successful period. We have seen it in Australia. I was in Korea recently at a UK/Korea seminar on how Korea wants to implement something similar. We have seen some pilots in

China, which is particularly exciting. We have seen some equivalents in the US. This approach is being copied. I believe that it can work. The alternatives that other people put forward, such as a carbon tax, while in theory they may be attractive, can prove to be politically quite tricky.

Q3 Lord Lewis of Newnham: You used the term “carbon leakage”. Have we any assessment of how much that applies in this country, where and how we measure it?

Edward Davey MP: I am not aware of a detailed study. There may well be one, but it has not been brought to my attention. We know that it is clearly a possibility and, as we craft our packages around energy and climate change, we need to make sure that we are not hurting our own industries. There are fine judgments to be made, because you are not making energy and climate change packages in isolation. There are other things going on. Energy policy changes around the world in different stages. One has to take account of that and there are other things going on as well. I like to think that in our engagement with, particularly, the energy intensives we have moved the debate on, recognised that it is a problem and are dealing with it.

Lord Lewis of Newnham: Are there measures to measure how you measure carbon leakage? That is what I am not at all clear about.

Edward Davey MP: I am afraid that I am not giving clear answers because I am not aware of them. I am very happy to write to you afterwards to see what measures we have, if we have any. I am sure that they are being developed. Apparently we are doing a study later this year, so we could write to you ahead of that study and then share that study with the Committee.

The Chairman: With one bound you were free. Thank you for that.

Q4 Lord Cameron of Dillington: Secretary of State, I want to ask you about 2030 consensus and agreement. You will be aware that it is really important that we fix some sort of target to encourage investment in the energy industry and the electricity industry, not

only in this country—hence the Energy Bill. If we require £110 billion in this country, in Europe overall trillions are required. EU utility companies are well below par and it is going to be very hard for them to do anything unless there is some degree of certainty. In your reply, you said that you believe that we should “adopt a unilateral EU wide greenhouse gas emissions reduction target of 40% for 2030”. Does that apply just to the electricity generating industry specifically or it is across the board to all domestic economic sectors?

Edward Davey MP: It is across the board. It is not a sectoral target.

Lord Cameron of Dillington: So the electricity target would have to be set within that if we are going to encourage better generation facilities and capacity within Europe.

Edward Davey MP: Let us remember that the EU ETS provides a cap for the power sector because it is within the EU ETS.

Lord Cameron of Dillington: You have already decided that the EU ETS is not very successful at the moment, so these targets are going to be pretty important.

Edward Davey MP: I see this as dual track. I see setting the target for 2030 as critical, but I also see reform of the EU ETS as critical, and both need to happen. Those two policy areas are top priorities for me personally and for the department working with other colleagues across the European Council and outside the Council over the next few months going into next year.

Q5 Lord Cameron of Dillington: You have hinted at various positions of various Member States vis-à-vis the EU ETS. How about the 2030 target? We seemed to get quite a strong impression that they realised the importance of it when we were interviewing various representatives in Brussels, including the energy committee of the Parliament, but no one was clear about how high or low these targets were going to be.

Edward Davey MP: There is a huge debate to be had in terms of the greenhouse gas emission target and we think that there should be other targets in addition. We have come

out with a very strong position, which we think is the best position. It is ambitious; it is the most ambitious of any Member State hitherto. As you rightly said, we suggest that the EU should commit unilaterally to 40% but, in the context of a global treaty in 2015, we should be prepared to go up to 50%. Why 50%? It is because that is where the science suggests we should be. It has not just been plucked out of the air. In order to keep within the two-degree limit that has been agreed by the international community, you would need the EU to get to that level. That is why we think that that is the right thing to do.

In terms of where Member States are, one reason that we wanted to come out early was to encourage others to be equally ambitious. If we had held back, we could not be an influencer. However, we are not just leaving it there; we are engaging. I am not sure whether the Committee is aware of this but earlier last year I set up something called the Green Growth Group, which is a like-minded group of Member States which are ambitious on climate change, and they want to be ambitious whether on reform of the carbon market, the 2030 allowances or the EU's position ahead of the 2015 talks. The Green Growth Group has now had three meetings.

Lord Cameron of Dillington: How many Member States are involved in that?

Edward Davey MP: I think that there are currently 12 but we expect it to grow. France, Germany, Spain, the Nordics, Belgium and Holland—

Lord Cameron of Dillington: Not Poland.

Edward Davey MP: I do not expect Poland to become involved, although I would be delighted if it wanted to be more ambitious about joining. It is very important that Member States which are of the same view work together and work out their differences. Inevitably you can be ambitious but still have different takes on the policy agenda, and it is much better if we work them out together so that when we get to the Council we are not being split off. I am very happy to put on the record for others to read that we are going to be very strong

in preparing for this and very determined. We want to work with other countries which maybe traditionally have been less ambitious and we want to explain to them that actually we believe that this is in the interests of the European economy. That is why we called ourselves the Green Growth Group. That title was not arrived at just by chance. There are people who seem to think that taking measures on climate change must always be a burden. That is not the case and we want to make that argument loud and clear. We are not just keeping this particular group to Ministers; we are liaising with MEPs who are like-minded and with business groups, because the business voice is not being heard in a full and clear way. Some business voices are saying that this is all costly, whereas lots of UK and EU businesses think that this is actually in our interests and that we must do it. We want that voice to be heard alongside political voices.

Lord Cameron of Dillington: I think it needs 100% agreement, does it not? Is it going to be the lowest common denominator that applies as to what the target ends up being?

Edward Davey MP: You are right. We expect that this would have to be taken at European Council level with heads of state—that is, by unanimity. We need to make the argument and engage with Member States so that we get a large number clearly in favour, and there will have to be some discussions with others who are less keen.

Q6 Lord Giddens: I support that very strongly but I would ask you to recognise that we are in the middle of the deepest recession that Europe has suffered for many years. You have to presume that there is going to be economic recovery. You are probably going to get 20% or 30% more output as a result of that recovery, which is going to produce more carbon emissions. So increasing targets is a good idea but the practical difficulties of achieving them are going to be truly formidable against what we all want, which is a return to prosperity. It is largely because of the drop-off in production that emissions have declined.

Edward Davey MP: Certainly the recession has been a big factor in the decline in emissions and I do not think that anyone would gainsay that. Therefore, we have to be realistic about what has been achieved by policy to date. However, a huge amount of policy that has already been agreed is being implemented now. It is not like we are starting from a blank page.

Lord Giddens: I wanted to point to the huge nature of the task, given that loads of countries remain heavily dependent on coal. With industrial recovery, a country such as Poland is not in a position to introduce shale gas overnight, or anything like it.

Edward Davey MP: I agree but I do not see why we cannot reach agreements that recognise—this has been the case in the past—that countries start from a different position. Just as other countries are adapting, we could help them to do so. I met my Polish counterpart, Marcin Korolec, on numerous occasions. Indeed, at Doha, when we finished the agreement on the AAUs, I invited him to join the British negotiating team on the budget, given that he was such a fierce negotiator. Marcin Korolec will take some persuading, as will the Polish Parliament and Government. However, by engaging with them, we can make it clear that we want not to force this on other Member States but to work with them so that they can adjust over time. I believe that this will be in Poland's interest over time and in the interests of the Polish people. Clearly, Polish politicians and the Polish Parliament must make that decision themselves—they are a very strong democracy. However, if we engage with them on everything from energy efficiency to nuclear to shale gas to renewables, we could see a Polish energy policy that is very compliant with the EU requirement to be at an ambitious level. It is a question of the timescales that you work on and whether you are prepared to engage and work with colleagues to show them that energy policy can actually change significantly over relatively short time periods.

Q7 Lord Whitty: To go back to Lord Cameron's points, all the time that we were doing this study, investors or companies seeking investment were saying that we needed some

degree of certainty and stability in our policy framework. That was why we were so insistent that a 2030 target or something well beyond 2020 was necessary to provide that certainty and stability. We recommended, as Lord Cameron said, a target for renewable energy for 2030, as we had for 2020, which had some considerable success. It was not entirely a surprise that you rejected that. However, anticipating your rejection, the alternative that we proposed was that there could be a power sector decarbonisation target that would not be so technology-specific but would drive what must be the largest-scale investments required in order to meet the overall decarbonisation target of 40%. Your reply did not go into why you rejected that alternative. I put it to you again that, if we are to drive this scale of investments, industry and investors need to know where they are aiming at.

Edward Davey MP: I agree strongly with that and with your overall point that we need certainty, stability and predictability. These are critical things that we need for investors who are making very big investments that take many years to pay off. We need that at a political level, a legal level and a fiscal framework level. That is what the Government's policy is trying to deliver in the UK and why we have taken powers to set a statutory 2030 decarbonisation target for the UK rather than a UK renewables target for 2030, because we want to be technology-neutral but promote low-carbon electricity.

It is worth pointing out that at the European level there is a cap on carbon emissions for the power sector, as I said earlier. It is called the EU ETS. Reforming it is a very big part of our agenda. Reform is critical in itself and provides a longer-term level of certainty in the price signal that we need to see. I know that colleagues will quite understandably—Lord Giddens implied this—be sceptical about whether the carbon market can be reformed. It is essential to reform it and I am not going to give that up. I like to think that because we have been strong on the overall economy-wide target—the greenhouse gas emissions target, where we are coming with a very ambitious target—investors will look at it and say, “Well look, the

UK has argued for a strong greenhouse gas emissions reduction target for 2030; it is arguing for ambitious reform of the EU ETS; it is prepared to set a 2030 target itself for decarbonisation and it is therefore sending as clear a signal as any Member State about where it wants policy to be on reducing carbon emissions". That puts us in a good place for the negotiations.

Q8 Lord Whitty: I am slightly more optimistic about the EU ETS than some of my colleagues, but even so it is a pretty low level of immediate delivery. Even if we move quite positively on the EU ETS, the point at which it would set a cap that relates to 2030 is some way off. Given the long-term nature of these investments, would it not be better to have some sort of target for the power sector in anticipation of the EU ETS being revived and delivering?

Edward Davey MP: We now have on the table a backloading proposal and proposals for structural reform, so we have to engage with those. If we fail, it may be that in a few years' time we will have to come back to it, but I think that we have to engage with what is there and which is tried and tested. Personally, I think that if we cannot get a carbon market to work, that would be a very backward step. That is quite important because at the European level one has to look at how these different things interrelate. We do not have it at the national level because the interrelationships are not quite so severe. We have seen in phases 2 and 3, and particularly in phase 3, of the EU ETS the interaction of the energy efficiency policies with the carbon market. There have been some perverse consequences, so you need to design these things very carefully. If the EU ETS is already working and is thus effectively a cap on the power sector, you want to think very carefully before setting another target. You have to look at the interrelationships. We are studying those ahead of the 2030 discussions to ensure that what we put forward is based on evidence and a proper

analysis of how these different things interrelate. It is a little more complicated than people originally thought.

Lord Cameron of Dillington: There is only one question here: what is going to make businesses and banks invest? How are you going to get the investment? I do not think that the EU ETS is going to provoke anything. In my view, as you will have already gathered, I think that the EU ETS is dead. As Lord Whitty said, how are you going to attract long-term investment into the generating industry? I do not see it, I am afraid.

The Chairman: I want to park it there, because we have quite a few questions around investment. I want to move away slightly from the agreed agenda because I know that Lord Bowness has to leave.

Lord Bowness: Thank you, but I do not have to leave yet.

The Chairman: Good. I am sorry to have interrupted Lord Cameron in full flow, but I know that Lord Renton also wants to ask about investment, which will give the Secretary of State a chance to reply at that point.

Q9 Lord Renton of Mount Harry: I am totally on the Secretary of State's side because I very much want this to work, but you said in your answer that the funding would be split between traditional grants and more complex forms of financing, including project bonds, debt instruments and equity instruments, with a view to leveraging private sector investment in energy infrastructure projects in the EU. Is there not a danger that we here, even more than in other countries, will find this very difficult to do? Many of those whom you might consider as possible investors will say, "We don't know if it is going to work or not. It is up to the Government and perhaps to the big banks. We are not going to touch it yet because whether it is going to work is too questionable". I do not want to appear to be pessimistic, but given the size and the number of countries that must join in, is that not going to be a real difficulty?

Edward Davey MP: If I may, let me separate the two investment challenges so that I am clear in my answer about what I am addressing. There is a UK infrastructure challenge and a pan-European cross-border energy infrastructure challenge. On the UK side, we have a whole range of policies—whether it is the Energy Bill right at the centre, the Emissions Performance Standard or the carbon price floor, all are directed at providing as much certainty as we possibly can that the UK's electricity market in generation and transmission has what investors need. While these are early days, I can tell the Committee that the deadline for applications for projects for final investment decisions enabling the CfDs—these are the go-early CfDs before we go into the enduring electricity market reform CfDs—closed recently. We have had 57 applications, 31 of which came in after we published our draft strike prices. I am sure that not all of them will get CfDs and that not all will go on to construction. However, were they to do so, that would be over 18 gigawatts of low-carbon power—and we are in the very early days. There is at least a suggestion here that our reforms are bringing forward investment in the UK.

Because this is a European Committee, Members may well be focusing more on the cross-border issues. I think that you are right to say that we need to ensure that European policy provides clarity for the long term. I have been engaging with northern European colleagues in something called the North European Energy Dialogue. This was an idea that came from a discussion with my Danish colleague, Martin Lidegaard, who led on this. We had the first meeting last year in Copenhagen, where we discussed how we could put the energy infrastructure, particularly the grid networks, in a better place. A lot of work is being done, but we wanted to see if we could give it more of a political push. A follow-up meeting with the same participants will be held in London on 10 October. At the original meeting we looked at what else we could do. Those things range from the 2030 framework that we have been discussing, to better planning of the European grid, to the energy infrastructure

regulations which have now been put in place. That was a particular issue because at the meeting we had not just Ministers but investors and industry, so the question of unbundling the provisions of the third package arose. We have taken action on that and at the end of May the Commission published a working document to show how it goes about unbundling issues in practice. This may seem a bit off the point, but it is absolutely critical if we are to stimulate investment in the European infrastructure. The unbundling proposals had been worrying financial investors, particularly pension funds, because if they invested in the grid network, they would not be able to invest in generators. There is now a lot more clarity coming from the Commission, something that we had been asking for. We will check with investors whether they have the extra clarity that they requested. It is hoped that that will provide reassurance. This is a long answer to the question, but there are two parts to be clear on. At the European level, there is work to do, but we are making real progress.

Lord Renton of Mount Harry: In what you are doing at the moment, it is clear that you are not too, if you like, frightened of not being able to get project bonds and debt instruments to the markets where they will be needed.

Edward Davey MP: Project bonds are an interesting idea which we are very keen on, but they are in the pilot phase. The Treasury is working with the European Investment Bank for potential UK projects for that pilot stage. There will be an evaluation of all pilots in 2015, and then we will see where that can be taken. It is an important initiative, but we should not put all our eggs in that basket. There are other things that we can do. We already have the Connecting Europe fund and the projects of common interest that could apply to that Connecting Europe facility. That list of projects of common interest is being developed and will be finalised later this year. The Committee will be pleased to know that there are UK projects within that list.

Q10 Baroness Howarth of Breckland: This is a question of rather large detail. In your reply to us you mentioned that, unless we have advances in technology, we will not meet the targets, certainly not at current costs. You say, “The government expects to invest in excess of £800m in this spending review period to directly support a broad portfolio of innovative low carbon technologies”. When is that programme likely to be announced? If you are going to be investing in those sorts of jobs and expertise in that sector, how will that be monitored to ensure that you reach the outcomes that the money is supposed to produce?

Edward Davey MP: I am very happy to write to give some detail of how some of that money is being spent. Clearly, there are decisions to be taken later about how some of that money is to be spent. Allocations have already been made with CCS, for example, and within innovations on energy storage, which is a really important technology to develop. There is money for looking at how we can reduce the cost of offshore wind. There are targeted spends already announced from that money, but we can send more information if the Committee wants it. There are some decisions to be made about how that money is spent. We have to do two things to get costs down and to deliver. We have to do innovation, R&D and very practical innovations about how these technologies will be deployed and how some can be brought on, but we have to do deployment as well. Let us take offshore wind. When you talk to offshore wind developers, they are learning through doing. Some of the cost reduction will come through process and how they get that process more efficient rather than through making the turbines more efficient. Deployment is needed to get costs down as well as research and development.

Q11 The Chairman: On the subject of innovation, one of the recommendations in our report was using reform of the ETS to raise revenues through auctions that could be reinvested into innovation. I note that the government response was not supportive of that. Will you say a little more about why you did not feel that was an idea that you could

support, given that it would be quite a good sell to other Member States if they thought that they could auction them off to raise revenue for innovation?

Edward Davey MP: Let me first start by saying that I am strongly in favour of investing in these new technologies and in pushing our agenda. The question is whether one should do that through hypothecation—through ring-fencing the revenues from the auction. I think that the Committee will know that, over many decades and many Governments of all different colours and hues, the Treasury has resisted hypothecation. I can also confess to the Committee that I once wrote a paper as the Liberal Democrat senior economic adviser on hypothecation and its many different forms. I can explain why I think there are some problems with hypothecation. Some hypothecated taxes, like the licence fund, are actually relatively regressive—sometimes you can have regressive hypothecations—though that obviously would not apply in this case because it is corporate. Nevertheless, one of the other disadvantages of hypothecation is that you can actually limit the amount of funds that are spent on what you want to spend on, because people say, if it is pure hypothecation, that you cannot spend any more than the money that is coming from that particular source of revenue.

At the moment we are spending quite a lot on low-carbon issues. We have talked about the innovation funds, but we could talk about the £1 billion that we put up for carbon capture and storage, or the money that we have given to the Green Investment Bank—£3.8 billion—for it to leverage in private money, or the money that we will be supporting, from the taxpayer, for renewable heat incentives. So if we did hypothecation and allowed the Treasury to say, “Well, that is the hypothecation, that is the fund, don’t come to us for any more”, there is a danger that we might end up with less.

The Chairman: That probably says more about the Treasury than about energy policy, but there we are.

Q12 Lord Bowness: The recommendations in the Committee's report stated that we urge the UK Government to examine the potential for a regulatory framework to increase gas storage. Your response talked about "considering interventions which encourage gas storage development" and the possible announcement of a decision in the coming weeks. Can you tell the Committee what progress you are making with that initiative? Do I read "interventions which encourage" as a rejection of a regulatory framework?

Edward Davey MP: We have not published our response yet and therefore I will have to choose my words with a little bit of care, but perhaps I can give you some background. We have been looking at this in a lot of detail and we are not that far away from publishing our response and explaining to your Lordships and others where we think this needs to go. I want to say that all the work that we, and others, have done shows that, in broad terms, the gas market works very well. We have a highly liquid market. We get our sources of gas from many types. Obviously we have our own from the North Sea. We have pipelines from Norway and from the continent. We now have a lot of import infrastructure to enable us to import LNG from around the world. So we have a very diverse market and that should reassure people. The reason we are looking at this is because you cannot say there is no risk at all and, given how important it is, it would be completely wrong to be complacent. That is why we are looking at this.

In our thinking, we have noted that we have other forms of gas supply—the ones that I have talked about—in addition to storage, and this is why, when we have seen tightening gas markets, we have not actually had a problem at all. We have never been near a problem in this regard. We also have other things happening. Ofgem is looking at the so-called cash-out reforms, to sharpen the incentives to wholesale gas suppliers. Ofgem believes that that will create incentives for investment from the market in gas storage. We have also seen regulatory changes at the European level, everything from remit to harmonised gas codes to

European infrastructure package. That will help across Europe to make sure that gas flows to where prices say it should be. It should make the single market in gas work far more effectively. In our analysis, we have had to take those into account. It is also important to note that the market often is investing in gas storage. In the debate people seem to forget that. We have had new gas storage come online recently, including Aldbrough in Yorkshire in November last year and Holford in Cheshire in February this year. There are two more fast-cycle gas storage plants being built at Hill Top Farm and Stublach in Cheshire. I think that there are 12 major projects with planning consent. So it is not as if the market is not delivering some gas storage and in our analysis we have had to take into account those factors as well.

Lord Bowness: Can I follow that? There is a lot of comment that we have many fewer days supply than other countries. Are you saying that diversity of supply justifies that situation?

Edward Davey MP: Yes. Few other countries have domestic production. We have the North Sea and pipelines from a very secure supply country, Norway. You cannot always compare and contrast these figures. We have to look at the whole picture and, for supply of gas in the UK, we are not reliant on the gas that comes from storage—far from it.

Q13 Lord Giddens: You mentioned storage more generally earlier; it is fundamental to the future of renewable energy. Do you see any significant technological innovations on the horizon for storing electricity in the medium term? For example, there are now concentrated solar panels which use salt to store the electricity so that they deliver a fairly regular output over a 24-hour cycle. Since you have more access to these things than me, I wonder whether you know of any other innovations on the horizon. It would transform the renewable energy future if you could find even medium-term storage, let alone longer-term electricity storage.

The Chairman: In the interests of time, we will perhaps take some questions together.

Q14 Baroness Howarth of Breckland: In the evidence that we heard from a number of witnesses, there was great concern that the speed of the new storage and innovation across the board was not equal to the amount of power that we are losing by closing power stations. The big question is how sure the Government are that lights will not go off in 2017 because they have a strategic pathway going through the whole that says that these things will come in at the right time as other things disappear.

Edward Davey MP: Those are both big questions, but I will try to answer them as briefly as I can. I had not heard about the salt innovation with solar panels. It goes to show that there are quite a lot of people working away there. We are trying to support them although there is quite a lot of entrepreneurial activity. The ones that I have heard about relate to everything including using renewable power that cannot be saved or consumed when it is being produced to produce hydrogen to go into batteries, whether car batteries or specific storage batteries to go into heating water. We are seeing the development of more intelligent storage heaters. People will be aware of the storage heaters that have been in many people's homes over a long period; they are known as "dumb" storage heaters, but we are now looking at smart storage heaters that could store energy for use later on. There is a lot of innovation in storage. I do not pretend to be an expert, but there is an awful lot and it can play an important role. It is potentially a critical step forward. I am on the optimistic side that we are going to get there, given the level of innovation going on.

Lord Giddens: Someone could make a fortune.

Edward Davey MP: People want to make their fortunes all the time and this is an area that is ripe for that. I would very much welcome them doing so because they would have helped to tackle climate change.

Energy security is a massive question. Are we confident that we can keep the lights on? Absolutely, we are. When the announcement that we made on 27 June was covered in the

newspapers the next day, they covered half the story; namely, they reported on the latest figures from Ofgem and their assessment of what would happen if we did not do anything. The headlines therefore suggested that there was a real problem. If they had reported the full story, as some newspapers did, although sometimes belatedly, they would have pointed out that two other announcements were made on the same day. One was made by Ofgem and National Grid and one by ourselves. Our announcement talked about the medium-term issue—the back end of this decade—where we took the decision to initiate a capacity market that we will run towards the end of next year for delivery in 2018-19. We believe that it will stimulate new generation and encourage some generators to stay online for longer than they otherwise would have done. We think that the capacity market addresses the questions around towards the end of this decade.

In the immediate future, we had to decide whether we would run the capacity market for early delivery, as some people have urged on us, or whether we would go for something called the strategic reserve, or whether we would use the existing balancing powers that National Grid holds under the Electricity Act and which are regulated by Ofgem. When we looked at this in detail, it seemed to be less risky. The combination of the risk and value-for-money option was to use the existing powers, so Ofgem and National Grid made an announcement on the same day that they would look at developing something called the Supplemental Balancing Reserve, which would pay for mothballed plants to be ready at the peak should National Grid want them to come online if there were any concerns. There was also a demand-side response. We already have a lot of demand-side efforts under way and the decision by Ofgem and National Grid was to look at doing more in that area. They have a plan, which we knew about, of course, because we had been working with them on it, and they are now consulting on it. That is the answer in the short term and we think that it measures up. The combination of what Ofgem and National Grid have announced and what

we have announced means that I can say with a degree of confidence—a huge degree of confidence—that we have answered the energy security challenge.

The Chairman: I know that there are other questions about capacity mechanisms, but in view of the time perhaps we should move on to Lady Parminter.

Q15 Baroness Parminter: You will know from our report that we believe passionately that interconnection is a fundamental means by which we can respond to the trilemma. We understand why the Government, like the French, are looking at introducing a capacity mechanism, but given the commitment in the Energy Bill to the capacity mechanism and clarity on demand-side reduction, there has been no third statement about a strategy for interconnection. Would you be so kind as to elucidate clearly today what the Government intend to do to boost interconnection between the UK and other Member States?

Edward Davey MP: First, I share your passion for interconnection. If the energy markets are more integrated, that is a good thing for security of supply and competition. I am strongly in favour of this and it is one of the reasons why I helped to initiate the North European Energy Dialogue, which I talked about earlier. Your Lordships should be aware that we looked at bringing interconnectors into the capacity market at the start. A huge amount of work was put into that. Unfortunately, when we talked to our European Commission colleagues, there was a feeling from them that at this stage it would be difficult, in the schemes that we came up with, which were quite ingenious, to devise a role that interconnector capacity could play in the capacity market that would be compatible with the internal market, particularly the target mechanism. We had to say that we would start up the first capacity market without including interconnector capacity, but that we had not given up. Since you run a capacity market more than once, if we can find a solution, there is no reason why we would not do that in the future. I hope that the Committee is reassured that we are committed to interconnectors.

In terms of the broader policy, Ofgem is developing a new cap-and-floor approach to replace the merchant-only approach that we have at the moment as an option for regulating interconnection. The idea is that that might provide more revenue certainty to interconnector developers and thus facilitate investment. I have kicked off some work in the department to look at interconnector policy more generally to see what else we can do. A lot of work has been done at the European level, which was referred to in earlier answers: the Connecting Europe Facility, the projects of common interest and so on. However, there may well be more that we can do. For example, the Committee may be aware that we have engaged in a memorandum of understanding with Iceland to look at whether we could have an interconnector for geothermal energy. That may prove not to be possible, but we are looking at it, and feasibility work is under way. We are certainly working with the Norwegians. Last year, the Prime Minister committed to support the development of an interconnector with Norway and I have had similar conversations with Ministers from other countries. I hope that in my answer I have reassured the Committee that we share its enthusiasm. The question is more one of “how” rather than “whether”.

Q16 Lord Whitty: On the connection between capacity mechanisms and interconnection, informally, at the beginning, we thought that the Commission was pretty sniffy about capacity mechanisms—and you can see conceptually why it might be, as against developing a more integrated market through interconnection and greater approximation of regulatory regimes. I understand that the Commission is about to discuss capacity mechanisms; obviously, all 27 countries have different capacity mechanism. The danger is that we have a sub-optimal situation with potential over-supply of generating capacity. Are you engaged with the Commission on this strategic area and, if so, how far have you got?

Edward Davey MP: You are right to bring me back to first principles and I am happy to answer that. The UK has been the champion of the single energy market. The problem with

the capacity market—and, as you said, the Commission is quite sniffy—is that it is an intervention into that single energy market. You might ask why the UK is interested. We have made it clear that we want to do it in as market-friendly a way as possible, accepting the point that it is an intervention. We do not want to upset the single energy market policy and priority, so we welcome the engagement that we have had with the Commission and the fact that the Commission is looking at this. So far, Commissioner Oettinger has been shown to be very pragmatic. He understands that countries like the UK, France and others have to ensure security of supply. Given that we are in transition in the electricity market, particularly with the transition to low carbon, and that that creates other challenges—and the UK itself has massive challenges as coal plants come offline and old nuclear is decommissioned—people have understood why a champion of the single energy market like the UK should consider this. We are engaging the Commission; we welcome the fact that it has been very practical about this. We want to ensure that, at the European level, this is looked at in a way that prevents Balkanisation of the market.

The Chairman: You may be interested to know that I raised the question with the Lithuanian ambassador last week, when she was before the Select Committee to talk about the priorities for the presidency, and we urged on her the need to take a pragmatic approach. She was absolutely supportive of that and immediately understood why this might be an issue. So clearly you have some understanding from the current presidency at least that you may feel able to build on.

The Chairman: Baroness Howarth, you wanted to ask about CCS.

Q17 Baroness Howarth of Breckland: It is a quick question and I will not ask it at great length. Another thing that we are all passionate about is carbon capture and storage, because that will make a difference across the whole piece. You talked in your response about the UK position, but you did not say what action you thought should be taken at the EU level.

Can you tell us whether it is just because we mentioned the word “regulation” that you did not respond to us, or whether you have a view about what should happen about carbon capture and storage at EU level?

Edward Davey MP: I am sure that it was an error and I apologise for that. There are a number of things to be said. I hope that this will be received in the best possible way. Reform of the EU ETS is probably the most important thing that you could do for CCS. Having a strong carbon market and a strong signal from that would be welcomed, I think above all, by CCS developers and innovators. Clearly, the funding from NER300 makes a contribution. We should see it in context from the UK position, because we are putting rather more money into carbon capture and storage than would be available from NER300. However, we have made an application and the White Rose Project is our preferred CCS project for obtaining NER300 funding for the UK. Let us be clear: it is much smaller than what would be coming from the UK taxpayer, but that could help. We could potentially see a review of the CCS directive, which could facilitate CCS projects. There are a number of things that we could do. Again, without wishing to increase controversy, having a 2030 target that was only on renewables would send a bad signal for CCS developers, so 2030 targets that are technology-neutral—like the decarbonisation target that we were arguing for in the UK in the Energy Bill—are the best way to send those sort of long-term signals for CCS and others.

Lord Whitty: Given that some countries are not that keen on CCS—Germany in particular, for reasons that are obscure to me—we have the largest potential storage for it. Have we thought of offering this in some terms to the rest of Europe as an incentive, because there is plenty of storage there for a good few hundred years?

Edward Davey MP: It is a very interesting idea and I think that it would potentially even be a profitable one. We would need to make sure that we can show that CCS is commercially

viable. Maybe if we do that, we would get another source of revenue that I had not considered.

Lord Whitty: Feel free.

The Chairman: We heard it here first. Secretary of State, thank you very much indeed both for today's evidence and for the general engagement with the Committee, which is much appreciated.