House of Commons

Business and Enterprise Committee

Energy policy: future challenges

First Report of Session 2008–09

HC 32
[Incorporating HC 1207 i–ii from Session 2007–08]

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Report, together with formal minutes, oral and written evidence

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The Business & Enterprise Committee

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Summary

In July 2008 the Business and Enterprise Committee completed a major inquiry into energy prices and fuel poverty. Since then, there have been a number of developments within the energy sector, including the publication of Ofgem's energy supply probe, the Government's launch of a £1 billion package to tackle fuel poverty, and the creation of the new Department of Energy and Climate Change, among others. These events have taken place against the back-drop of a global financial and economic crisis. This short Report considers the implications of these developments for the future of the UK's energy policy. Matters we consider to be of most importance include:

- The need for intervention to ensure rapid investment in gas storage;
- The likelihood of timely investment in new electricity generating capacity and network infrastructure;
- Interventions to improve liquidity in the wholesale gas and electricity markets;
- The development of new initiatives to promote small and large-scale renewables;
- The Government's framework for managing its current nuclear liabilities and those arising from new nuclear build;
- Implementation of Ofgem's supply probe recommendations to ensure domestic and small business customers are treated fairly;
- The Government's future strategy on fuel poverty; and
- The effectiveness of the current energy market regulatory framework.

This is the Committee's last Report on energy-related matters, as from January 2009 responsibility for the scrutiny of energy policy will pass to the new Energy and Climate Change Committee.

1 Introduction

1. On 28 July 2008 the Business and Enterprise Committee published its Eleventh Report of Session 2007-08, *Energy prices, fuel poverty and Ofgem*, the output of a major inquiry conducted during the first half of the year.[1] In the cabinet reshuffle announced on 3 October the Prime Minister created a new Department of Energy and Climate Change, combining the Climate Change Group from the Department for Environment, Food and Rural Affairs (DEFRA) and the Energy Group from the Department for Business, Enterprise and Regulatory Reform (BERR). The House has restructured the departmental committee system in response to the creation of the new department, and from January 2009 responsibility for scrutinising energy policy will move from our Committee, to the new Energy and Climate Change Committee.

2. We timed our original Report to ensure that Ofgem could take account of it in its own energy supply probe, the initial findings for which were published on 6 October 2008.[2] The aim of this short Report is to draw on our experience to highlight some of the areas to which we believe our successors will need to pay particular attention.

3. In addition to Ofgem's work, there have been a number of other important developments within the energy sector in the last five months:

- During July and August the 'Big 6' energy retailers raised their gas and electricity prices by double-digit percentages for the second time in 2008;
- On 11 September the Government announced a £1 billion package of additional support for those in fuel poverty. Much of this will be funded by the 'Big 6' energy companies and, for the first time, the independent generators. Subsequent figures have shown a one million increase in the number of fuel-poor households, to 3.5 million in 2006;
- On 24 September EDF agreed a £12.5 billion takeover of British Energy. Centrica has also announced that it is in talks to take a 25% stake in the subsidiary formed by the merger;
- On 25 October Electricity4Business, one the few small suppliers to the SME market, went into administration. They were followed on 3 November by another significant small supplier, BizzEnergy;
- On 26 November the Energy Bill was enacted. It includes provisions to allow banding of the Renewables Obligation by technology and establishment of a framework for funding the decommissioning of future nuclear power stations. Late amendments to the Bill also paved the way for the introduction of feed-in tariffs for small-scale renewables, further incentives for renewable heat, and a national roll-out of smart meters for households; and

1 House of Commons Business and Enterprise Committee, Eleventh Report of Session 2007-08*, Energy prices, fuel poverty and Ofgem*, 28 July 2008, HC 293

2 Ofgem, *Energy Supply Probe—Initial Findings Report*, 6 October 2008

- Since reaching a peak of $147 per barrel in early July, the price of oil has collapsed to around $40-45 as expectations of demand have plummeted.

4. These events have taken place within the wider context of a global financial and economic crisis in which most advanced economies have now entered recession with little likelihood of an upturn before 2010. Accordingly, we have taken oral evidence from Ofgem and the Minister of State at the new Department of Energy and Climate Change (DECC) to gauge the wider implications of these developments for the UK's energy sector in the coming years. We are grateful to those who have contributed to the evidence gathering for this inquiry. We also wish to thank all those who have participated in the various energy-related inquiries conducted by the Committee during the current Parliament.

2 Future challenges

5. The inquiries we have conducted in the course of the current Parliament suggest there will be a number of major energy policy challenges in the coming years, made worse by current economic conditions. We highlight the most significant of these below.

Energy prices

6. All the 'Big 6' energy companies raised their retail prices during the summer, beginning with EDF Energy on 5 July 2008 and ending with Scottish Power and Npower on 29 August. This was the second time they had done so in 2008. The scale of the latest increases was even greater this time round. The price of gas for households jumped by between 22% and 35%, while that for electricity rose by between 9% and 19%. These increases had been widely anticipated as they followed months during which the wholesale price of gas and hence that for electricity had continued an upward trend which had begun in spring 2007.

7. However, July 2008 marked a turning point: the price of oil peaked at around $147 per barrel. Since then prices have fallen sharply to around $40-45—a level last seen in 2004. This has reflected rapidly diminishing expectations of the performance of the world's major oil-consuming economies in the short to medium term in the wake of the global financial crisis. Accordingly, UK wholesale gas and electricity prices have also started to decline, though not by the same extent. Ofgem told us that on the gas side this was partly a consequence of the sharp drop in the value of Sterling, hence making imports more expensive.[3] On the electricity side, concerns over when the Hartlepool and Heysham nuclear power stations would come back on line, having been out of service, have also helped keep prices higher than they might otherwise have been. During the autumn, the Government called on the energy companies to cut retail gas and electricity prices as soon as possible.[4] In response, Scottish and Southern Energy, for example, has recently indicated that if wholesale prices continue to fall it will reduce its retail prices in early 2009.[5] However, no company has yet announced a price cut for its customers.

8. In the 2008 Pre-Budget Report the Chancellor announced that he had requested Ofgem to publish quarterly reports over the coming year "showing the relationship between wholesale prices, estimated hedged wholesale costs and average retail prices for gas and electricity".[6] The aim of this is to help ensure greater transparency over future price movements, which should improve consumer understanding of why their bills are changing, and may discourage companies from delaying passing on lower wholesale prices to their retail customers.

3 Q 77 (Ofgem)

4 See for example, BBC News, *Brown warning over energy bills*, 28 October 2008

5 BBC News, *Energy prices "could fall soon"*, 12 November 2008

6 HM Treasury, *Pre-Budget Report 2008: Facing global challenges: supporting people through difficult times*, 24 November 2008

9. **Given the expectation of recession amongst most advanced economies in 2009, and the absence of a co-ordinated response from OPEC, the price of oil is likely to remain well below its July 2008 peak in the short term. Accordingly, despite the problems with the structure of the wholesale markets identified in our previous Report, we would expect to see a fall in wholesale gas and electricity prices. While recognising that the hedging strategies of the companies means there will always be a lag of weeks or months between falls in wholesale prices and matching reductions in retail prices, we support the Government in calling on the 'Big 6' energy companies to cut prices for their retail customers as soon as possible in 2009, and in pressing for greater transparency on the relationship between wholesale and retail prices. However, we continue to believe that, once the global economy begins to recover, in the long term "the era of cheap energy is surely over".**[7]

Gas storage

10. Our July Report highlighted the slow progress on increasing the UK's available gas storage capacity. We said that: "Significant additional storage, beyond that currently planned, is needed to reduce volatility in the wholesale gas price, which otherwise is likely to increase as the UK becomes increasingly dependent on gas imports".[8] Since 2000, the UK's storage capacity has risen from around 3.5 billion cubic metres (bcm) to approximately 4.3 bcm. Ofgem contrasted this figure with the expectation four or five years ago that total capacity would have reached 10 bcm by 2009.[9] The Minister told us that roughly 1 bcm of new storage is currently under construction, with a further 13.8 bcm proposed by 2015.[10] Yet National Grid's most recent *Ten Year Statement* notes that even if all projects which are at present under construction or have the required consents are developed total storage capacity will rise only to 6 bcm by 2013/14.

11. Only if all *proposed* projects were to proceed would total capacity approach 18 bcm, which would place the UK in a comparable position to many other European countries.[11] Experience, however, suggests that the likelihood of the UK reaching Continental levels of gas storage in the next decade will be slim without government intervention. Two significant constraints inhibit the rapid development of new storage. The first of these is the planning regime. For example, two projects—at Saltfleetby and Fleetwood—that would have provided around 1.7 bcm of additional capacity have recently been refused planning permission. In its response to our July Report, the Government noted that changes to the planning system brought about by the recent Planning Act should in the future help bring forward new projects. Yet we are not likely to see its effect for some time. The Minister told us he expected DECC to consult on a national policy statement for gas storage in mid to late 2009, with final publication likely in 2010. This would then inform the work of the new Infrastructure Planning Commission.[12] Even then, it is not necessarily the case that projects

7 *Op. cit.* para 1

8 *Op. cit.* para 29

9 Q 109 (Ofgem)

10 Q 6 (Minster of State for Energy)

11 National Grid, *Gas Transportation Ten Year Statement 2007*, December 2007

12 Q 5 (Minister of State for Energy)

will receive planning approval that would have been rejected otherwise. Sometimes constraints are local, and may be overridden if national interests take precedence. But even when projects have been referred to central government they may, like the Fleetwood development, be turned down if their impact is too great. The Infrastructure Planning Commission may improve the speediness and consistency of decision-making—it does not, quite rightly, guarantee that every proposal will get permission.

12. Moreover, the economic rationale for companies investing in gas storage is now also a major concern. In our July Report we noted that existing gas storage sites had only recently become profitable enough to demonstrate a commercial incentive to justify major new investment.[13] However, the expectation of recession during the latter half of 2008 and into 2009 is likely to delay some projects as firms struggle to raise financing. Portland Gas has, for example, recently put back its 1 bcm project in Dorset by six months. The Minister told us he had "had no further indication from anyone that [credit] crunch problems are likely to cause significant difficulties".[14] However, we find it difficult to believe the gas storage industry can be immune to the economic downturn, which is prompting most companies to re-evaluate their investment plans.

13. **If the UK is to avoid falling victim to even higher levels of wholesale gas price volatility in the coming years, it requires a level of growth in storage capacity that is an order of magnitude greater than that which the market has achieved on its own to date. The Government's national policy statement (NPS) must set out in detail what level of storage it wishes to achieve in the next decade and the criteria that sites for development should meet. Given that NPSs were announced some time ago, we are very disappointed that the NPS for gas storage will not be available for consultation until mid to late 2009, with final publication in 2010. We call on the Government to bring this date forward. Moreover, given the current economic climate, it must now reconsider the likelihood that investment will take place without some form of regulatory intervention. Given the amount of time that has been lost, and the lack of progress that has been made, we think it likely that the market will fail to deliver. There are many possible solutions. To give two possible examples, some form of storage obligation could be placed on gas shippers or suppliers, or the regulated monopoly role of National Grid could be extended.**

New electricity generating capacity

14. The Government expects that by 2015, 12 gigawatts of coal and oil-fired electricity generating capacity will close as a result of the European Union's Large Combustion Plant Directive (LCPD).[15] In addition, some 7.4 gigawatts of nuclear power stations will have closed by 2020. It will be a challenge to close the resulting energy gap. BERR's *Energy Markets Outlook* report estimated last year that around 14 gigawatts of new conventional (i.e. fossil fuel based) capacity was currently in development, of which around 4.5 gigawatts was under or close to construction. With the exception of a proposed coal-fired plant at Kingsnorth, all of this will be gas-fired. The Minister had even greater expectations of the

13 *Op. cit.* para 28, and Financial Times, *Britain lags behind in gas storage boom*, 10 September 2008

14 Q 10 (Minister of State for Energy)

15 Department for Business, Enterprise and Regulatory Reform, *Energy Markets Outlook*, October 2007

level of new gas-fired capacity anticipated in the coming years, stating that 10 gigawatts currently had consents, while a further 7.5 gigawatts was in planning.[16] Because of this, he gave us the qualified conclusion that: "I think we can be relatively sure that we will get a sufficient replacement for some of the capacity that we will lose …".[17]

15. Ofgem gave a more pessimistic summary of the current situation, highlighting the fact that the current financial crisis and the economic downturn are likely to weigh heavily on companies' investment decisions.[18] For example, its Chief Executive, Alistair Buchanan, told us the required return on equity for new power stations has jumped from 10% to 15%. This potentially reduces the commercial viability of a number of proposed projects, and increases the likelihood of their delay. He also noted that a number of British utilities needed to achieve a significant level of refinancing in the next 18 months.[19] This too could affect their investment plans. However, the Minister told us "we are getting reassurances from the large energy companies […] and they are saying that they are still looking to go ahead with the projects that they have in the pipelines".[20]

16. The outlook appears still more uncertain in the medium to longer term. Whilst the Minister told us there might be up to 13 gigawatts of new coal-fired generation in the future, this is dependent on a number of issues, not least of which will be progress in developing carbon capture and storage.[21] There are also some questions about new nuclear build. Companies such as EDF and E.ON have stated an intention to construct new power stations in the UK. However, the commissioning of the new reactor at Olkiluoto in Finland is already running two years behind schedule and significantly over budget.[22] The Finnish project was widely seen as providing a potential blueprint for the UK's own nuclear programme.

17. **Generating capacity equivalent to nearly a third of current electricity demand will be made redundant by 2020. It will need to be replaced. We believe that in the current economic climate there is a high risk that the energy companies will not be able to raise the finance necessary to build this. It is the Government's job to ensure security of supply. Just as the Government has been quick to respond to the crisis in the banking sector, it must now take action to ensure investment in new capacity takes place as planned. A reasonable level of profit by the big energy suppliers will be a precondition of this investment taking place. The situation is now very serious and we believe that a simple trust in the market's ability to deliver without any intervention will see us facing an 'energy crunch' in the medium term. The social and economic consequences of such a 'crunch' would be disastrous.**

18. **The Government needs to take action to ensure the credibility of its claims that climate change forms as important a part of the UK's energy policy as security of**

16 Q 33 (Minister of State for Energy)

17 Q 30 (Minister of State for Energy)

18 Q 135 (Ofgem)

19 *Ibid.*

20 Q 30 (Minister of State for Energy)

21 Q 28 (Minister of State for Energy)

22 BBC News website, *'Entente nucleaire': What, why?* 27 March 2008

supply. Further action is required if both nuclear power and coal-fired generation are to form part of the electricity mix in the medium to longer term. The Government will need to learn from the recent Finnish experience of new nuclear build to ensure a UK programme is not subject to the same delays and cost over-runs. The national policy statement on nuclear power should be brought forward at the earliest possible date. In addition, much greater levels of investment in carbon capture and storage (CCS) are required than the current single competition for a demonstration plant if the Government wishes to see environmentally acceptable new coal-fired capacity.

Wholesale market liquidity

19. In our July Report we raised concern over the level of liquidity in the wholesale gas and electricity forward markets.[23] The problem is particularly acute for electricity, which contributes to price volatility and poor price transparency, as we discuss below. But there are problems in other markets as well. While there is a high level of churn on the spot market for gas, Ofgem found the percentage of over-the-counter (OTC) gas contracts traded one or more years' forward is relatively small, and has declined in the last couple of years.[24] Ofgem also noted that the forward market for oil showed a similar lack of liquidity for forward contracts further out. However, the regulator has not, at this stage, proposed further work. For electricity, the regulator found that churn on the OTC market is low in comparison to the gas market and again focused on prompt delivery. Exchange-based trading of electricity has also collapsed to near negligible levels in the last year as a result of the credit crunch. In response, for electricity, Ofgem has stated that it will "begin, urgently, a programme of work to identify the underlying causes of low wholesale market liquidity, and explore with the 'Big 6' suppliers how best to achieve a significant increase in liquidity".[25]

20. **We welcome Ofgem's decision to take action to improve liquidity in the wholesale electricity market. This is now more important than ever, as the credit crunch has seen a decline in liquidity from the very low levels that existed in the first place. We look to the regulator to move quickly by proposing reforms in the first half of 2009. These will be crucial for encouraging future new entrants, both in the wholesale and retail markets. Furthermore, we continue to believe the Government and regulator should give greater attention to liquidity in the forward market for wholesale gas, about which a number of witnesses raised concern in our previous inquiry. The Government's response to that Report showed that the last piece of substantive work on the topic was conducted in 2005. It is time for the Department of Energy and Climate Change (DECC) to consider the issue again and without delay. Unless wholesale markets work well there is no chance of achieving a fair deal for retail customers.**

23 *Op. cit.* paras 17 and 63

24 Ofgem, *Energy Supply Probe—Initial Findings Report*, 6 October 2008

25 *Ibid.*

The Energy Act 2008

21. The Energy Act 2008 received Royal Assent on 26 November 2008. It implements the legislative aspects of the 2007 Energy White Paper, including the introduction of technology banding for the Renewables Obligation, and provision of a framework for financing the waste disposal and decommissioning costs required for a new generation of nuclear power stations. The Act also contains provisions implementing past Committee recommendations. For example, a 2007 Report of ours stated that "a feed-in tariff could be used to encourage the development of local energy".[26] The new Act will enable the Government to introduce a scheme of feed-in tariffs to support low-carbon generation of electricity projects up to 5 megawatts.

22. This Committee has also been consistently critical of the lack of attention paid by government to the potential for low-carbon heating.[27] Space heating accounts for 47% of the UK's carbon emissions. Yet the 2007 Energy White Paper dedicated only 5 pages to the issue in a document of more than 300 pages. We are therefore pleased to see that the Energy Act contains provisions that will allow the Secretary of State to establish a financial support mechanism for renewable heat from large industrial sites down to household level. We stated two years ago that: "Renewable low-carbon heat production is the Cinderella of energy policy and this attitude must change".[28] This policy area has finally received its invitation to the ball.

23. Smart meters will play a crucial part in encouraging energy efficiency and enabling retail markets to function more efficiently. Our most recent Report called for the Government to set "a clear and urgent timetable for implementation".[29] DECC has since announced a national roll-out of smart meters for domestic customers and the Energy Act contains the powers it needs to achieve this. The Department intends to spend the next two years resolving technical issues and establishing the detail of the roll-out, which will then take place over a ten-year period.

24. **The creation of the Department of Energy and Climate Change has brought about new policy initiatives on feed-in tariffs, incentives for renewable heat and smart metering, which this Committee has advocated for some time. We welcome these developments. It will now fall to the new Energy and Climate Change Committee to scrutinise the finer detail of how the Department puts these policies into practice. In particular, we hope that DECC will treat the twelve year programme for the introduction of smart meters (two years consultation and ten-year roll-out) as an absolute maximum, and aim to complete it much more quickly. The new committee will also need to pay close attention to other aspects of the Energy Act 2008, such as the implementation of technology banding for the Renewables Obligation and the**

26 House of Commons Trade and Industry Committee, First Report of Session 2006-07, *Local energy—turning consumers into producers*, January 2007, HC 257

27 *Ibid.* and House of Commons Trade and Industry Committee, Fourth Report of Session 2005-06, *New nuclear? Examining the issues*, July 2006, HC 1122

28 House of Commons Trade and Industry Committee, First Report of Session 2006-07, *Local energy—turning consumers into producers*, January 2007, HC 257

29 *Op. cit.* para 90

establishment of a framework for financing waste disposal and decommissioning costs arising from future new nuclear power stations.

Electricity network infrastructure

25. In our 2007 Report on local energy we considered the implications of a changing energy mix for the UK's electricity networks. We noted that much of our existing infrastructure is coming to the end of its design life, and that about two-thirds of the network will need to be replaced in the near future. The current system is optimised for centralised electricity generation, with power flowing in one direction from generating plants through the transmission network to lower voltage distribution networks, from which it is delivered to homes, offices and factories. Ofgem manages the framework for investment in the electricity networks through a rolling cycle of five-year distribution and transmission price control reviews.

26. **The UK's future energy mix will come from a more diverse range of sources, including local energy and larger-scale onshore and offshore renewables, as well as new nuclear power stations. More decentralised generation will need technologies that allow more 'active' management of the electricity networks. The scale of investment required to install them is likely to be huge, but could yield substantial benefits both in terms of security of supply and in reducing carbon emissions. In conjunction with new incentives for decentralised generation, DECC, Ofgem and the new committee will need to consider whether the existing regulatory regime governing network investment is sufficient to meet the demands posed by a more complex energy mix.**

Funding the Nuclear Decommissioning Authority

27. As a consequence of the machinery of government changes in October 2008, responsibility for the Nuclear Decommissioning Authority (NDA) has now passed to DECC. In a Report on the NDA's funding earlier this year we noted that its then sponsoring department, BERR, spent over 40% of its annual departmental expenditure limit (DEL) on the Authority.[30] The proportion of DECC's DEL that will constitute NDA expenditure is likely to be even greater. The Authority's budget was ring-fenced within BERR's budget. This meant that, in the first instance, BERR had to look to its non-ring-fenced budgets to make good any short fall for the NDA—a situation we concluded was unacceptable. As a smaller department than BERR, this poses an even greater risk to the newly formed DECC's non-NDA budgets.

28. Moreover, our Report highlighted that the NDA's funding model is unsustainable in the longer term as a result of uncertain and declining commercial revenues. However, BERR's Permanent Secretary told us that: "the saving grace is I do not think there is a car crash in the next two or three years and therefore we have time to plan the avoidance strategy".[31] **It will now fall to DECC to avoid a potential "car crash" by re-designing the Nuclear Decommissioning Authority's funding model before the end of the current**

30 House of Commons Business and Enterprise Committee, Fourth Report of Session 2007-08, *Funding the Nuclear Decommissioning Authority*, April 2008, HC 394

31 *Ibid.*

spending review period. Agreement with HM Treasury on an appropriate framework should provide full protection of DECC's non-NDA related departmental expenditure limit. This issue should be a high priority for both the new department and the new select committee which will scrutinise it.

Treating domestic and small business customers fairly

29. In our July Report we noted our concern over various aspects of the retail markets for electricity and gas for both households and small businesses. In this section we follow up on some of these areas as well as raising new issues that have come to light since the summer.

Cost-reflective energy pricing

30. Both our own inquiry and Ofgem's subsequent probe highlighted several ways in which the 'Big 6' energy retailers engage in differential pricing. For instance, we both found that customers who pay by standard credit are charged disproportionately more than those who use direct debits. We also expressed concern over excessive charging of pre-payment meter (PPM) users, though the regulator found this problem had diminished over the course of 2008. The regulator also found that five of the former incumbent electricity suppliers were charging their legacy customers on average 6% more than comparable 'out-of-area' customers. Furthermore, Ofgem discovered that the incumbent energy retailers have been consistently earning higher margins on electricity supply than on gas, hence over-charging those 4.3 million electricity customers who are not connected to the gas main.[32]

31. In response, Ofgem has proposed a new licence requirement on suppliers that would require charges for different payment types to be cost-reflective. This would ensure the price differentials for direct debit, standard credit and PPM users are proportionate to the different costs of each means of payment. In addition, the regulator has said it is considering a further licence condition that would impose either a "prohibition on undue price discrimination or introduce a form of relative price control".[33] This would tackle some of the other forms of price discrimination uncovered in Ofgem's probe. Alistair Buchanan told us there were already signs that the energy companies were responding to calls for payment type price differentials to be cost-reflective.[34] Following a consultation on its findings and recommendations, which has now closed, the regulator will decide how best to proceed in the New Year.

32. **In the short term energy suppliers may themselves take action to ensure their charges for different payment types are cost-reflective. However, we believe that in future this requirement should be set down in companies' licences to ensure the issue does not arise again. We also support Ofgem's proposal for a further licence condition that would prohibit undue price discrimination. This would benefit vulnerable groups such as older people who are less likely to switch, or rural customers who are not**

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32 *Ibid.*

33 *Op. cit.* para 1.40

34 Q 76 (Ofgem)

connected to the gas grid. Such a condition would, however, need to make an exception for those households who currently benefit from suppliers' social tariffs. We also repeat that most of those in fuel poverty are on standard credit terms and that, while much is said about pre-payment meter tariffs, too little political attention is focussed on this larger and often more vulnerable group.

Direct debit charges

33. In November 2008 a new concern amongst energy consumers came to light regarding direct debit charges.[35] Many customers who pay in this way believe their suppliers set their monthly direct debit at too high a level so that, in the long term, they gradually build up surplus credit with their company, and effectively provide it with an interest-free loan. The Committee has heard from hundreds of frustrated customers who have had to request either a rebate from their supplier or a reduction in their monthly payments. When we raised this issue with the Minister, he said he had had the same experience.[36] In response, Ofgem told us its "corporate affairs team will take it on and have a look at it and see where we go from there, whether it triggers an enforcement case".[37] Subsequently Ofgem has indicated to complainants that it lacks quantitative evidence and has given the impression of withdrawing from its commitment to our Committee. **We welcome the regulator's initial commitment to look into whether the energy suppliers are using higher than necessary direct debit charges to boost their cash flow, and we look forward to its findings. The level of public concern is high and we urge our successor committee to maintain the pressure on Ofgem to resolve this issue.**

Direct selling

34. In our earlier Report we said: "The industry must consider itself on notice" on the continued use of direct sales as a means of encouraging customers to switch suppliers.[38] We reached this conclusion in response to a high level of public concern over alleged mis-selling practices, and the launch by Ofgem of an investigation into Npower for a breach of its supply licence. Ofgem's probe found further damning evidence on the effectiveness of direct selling. 48% of gas customers and 42% for electricity who switch as a result of a direct sales approach do not achieve a price reduction. This is despite the fact that almost all consumers who switch supplier do so in an attempt to save money. Ofgem has said that it will strengthen the rules governing suppliers' sales and marketing activities to encourage more informed decision-making and to prevent misleading activity. Its probe findings suggest this could include requiring suppliers to provide a written quotation and comparison with the customer's current price before they make the decision to switch.[39] Neither Ofgem nor the Minister was willing yet to recommend the step of banning direct selling outright.[40]

35 BBC News, *Direct debit bills in spotlight*, 25 November 2008

36 Q 37 (Minister of State for Energy)

37 Q 177 (Ofgem)

38 *Op. cit.* para 80

39 *Op. cit.* para 1.37

40 Qq 44 (Minister of State for Energy) and 181 (Ofgem)

35. **We are deeply concerned that nearly half of consumers who switch as a result of a direct sales approach fail to achieve a price reduction. We welcome Ofgem's commitment to strengthen the rules governing direct selling. It should ensure new rules are in place within the first quarter of 2009. If they do not significantly improve the level of service to customers by this time next year, then the regulator should not hesitate to ban the practice outright.**

Supply for small businesses

36. Our inquiry and Ofgem's subsequent probe highlighted a number of abuses in the market for electricity supply to small and medium-sized enterprises (SMEs). These included alleged predatory pricing, delaying tactics to win back customers, and confusing contract cancellation requirements. We recommended that if Ofgem was unable to find a solution then it should consider referring the SME supply market to the Competition Commission. In response Ofgem has proposed a range of remedies including, among others, a code of practice to govern the objections and switching process; an extension of the accreditation scheme for switching sites to cover those dealing with SME customers; and a strengthening of the code of practice for third party intermediaries.[41] Alistair Buchanan told us:

> the 'Big 6' have simply behaved so badly to this group […] that I would be very disappointed if the range of remedies that we have put down does not have a substantial improvement […] for small users. If it does not, it means that something is going very wrong and we will have to use powers that could include going to the Competition Commission.[42]

We are pleased at this new attitude, but we believe that a fully effective regulator would not have allowed things to get so bad in the first place.

37. During our inquiry, it was the small independent suppliers, such as BizzEnergy and Electricity4Business that were most vocal in raising awareness of competition issues in the SME market. Both these companies have since gone into administration or receivership. It is too early to say whether this was a direct consequence of anti-competitive practices by the 'Big 6'. Indeed British Gas recently wrote to the Committee stating, without a trace of irony, that "the exit of the weaker companies shows that competition is indeed working".[43] In reality, it is likely that a combination of factors, including the impact of the credit crunch, lie at the route of the small suppliers' exit from the market.

38. **A consequence of BizzEnergy and Electricity4Business's recent demise is that SME customers have lost two of their most effective advocates. Households are represented by the successor to Energywatch, Consumer Focus, and large-scale energy consumers have two dedicated advocacy bodies in the Major Energy Users' Council and the Energy Intensive Users' Group. Yet SMEs do not benefit from such advocacy, although Consumer Focus is currently looking at its role in representing them. Lack of a**

41 *Op. cit.* para 1.39

42 Q 156 (Ofgem)

43 Letter to the Chairman of the Business and Enterprise Committee from British Gas, 18 November 2008

dedicated advocate may explain why anti-competitive practices by the 'Big 6' have been able to develop relatively unchallenged in the past. Though Ofgem told us it maintains links to SMEs through its Small User Group, we believe the regulator and DECC must ensure there are effective mechanisms for ensuring the interests of SMEs are identified and properly safeguarded.

Fuel poverty

39. On 11 September the Government announced a £1 billion *Home Energy Saving Programme* to help domestic consumers cut their energy bills permanently. Within this, it is expanding the Carbon Emissions Reduction Target (CERT) by 20%. This is an obligation on energy suppliers to install energy efficiency measures in households. It will mean an extra £560 million of investment in housing by energy suppliers. 40% of installed measures must be for a priority group of low income and elderly households. The Government also announced £74 million of additional funds for the Warm Front Scheme; an increase in the Cold Weather Payment for this winter from £8.50 to £25 per week; and plans to work with energy companies and the banks to increase the number of people using direct debits to pay their energy bills.[44]

40. In addition, the package included a new £350 million Community Energy Saving Programme. This will create partnerships between local councils, community-based organisations, voluntary organisations and energy companies going street-by-street, offering free and discounted central heating, energy efficiency measures and benefit checks. Areas where the programme will operate will be selected based on their levels of deprivation, though measures will be developed for both vulnerable households and those in the able-to-pay sector. The programme will be funded through a new and additional obligation on energy suppliers and, for the first time, electricity generators such as Drax Power and International Power.

41. On 2 October, the latest fuel poverty figures for 2006 showed a one million increase to 3.5 million households—2.75 million of which are defined as vulnerable. The figures mark a return to levels last seen in 1998. In our July Report National Energy Action told us it believed actual fuel poverty had now reached 4.5 million.[45] We noted too that every 10% increase in energy prices sends an additional 400,000 people into fuel poverty. This means the round of price increases by the 'Big 6' energy suppliers in the summer could have added another million to the total number of fuel poor.

42. **After two rounds of price increases, we estimate as many as 5.5 million households may now be living in fuel poverty. We welcome the Government's package of measures announced in the autumn, particularly their focus on improving the energy efficiency of the existing housing stock. This will prove the most cost-effective means of tackling fuel poverty in the long run. We also welcome the contribution to the package being made by non-vertically integrated electricity generators, which acknowledges the fact**

44 Department for Food, Environment and Rural Affairs Press Release, *Save Money: Save Energy: Government takes action on family fuel bills*, 11 September 2008

45 *Op. cit.* para 107

that they too have benefited from windfall gains under Phase 2 of the EU Emissions Trading Scheme.

43. **The creation of DECC removes one of the fissures in responsibility for fuel poverty within government, with BERR and DEFRA previously having overlapping involvement. We hope the Department will keep its strategy under review as many of its current measures have a limited lifetime even within the existing spending review period. While there is currently a strong case for the industry's role in alleviating fuel poverty because of the windfall gains it is receiving, these will cease to exist once full auctioning of carbon permits is introduced in 2013. Provided the regulatory framework is sufficient to ensure fairness to all consumers, in the long term the Government will need to consider whether it can continue to expect energy companies and the regulator to be responsible for the delivery of its social policy objectives. We also reiterate our frequent recommendation that much more attention must be paid to groups in fuel poverty other than pensioners, particularly disabled people under 60.**

The role of Ofgem

44. In our July Report we expressed surprise that Ofgem had decided to conduct its own inquiry into the energy markets, having stated only a matter of weeks before that "Britain's competitive market in energy is working".[46] We nevertheless welcomed Ofgem's investigation and adjusted our own inquiry accordingly. Our inquiry revealed that many aspects of the market were not working effectively. While we are pleased the regulator agreed with our assessment in many cases, we are concerned that it appeared to require our inquiry to goad it into action. We are particularly concerned that until recently Ofgem appeared indifferent to the concerns of smaller business consumers.

45. When we asked the Minister's view on the regulator's recent performance, he stated:

> I think it is fair to say that certainly among our many Members of the House there have been some concerns expressed about Ofgem and some issues around confidence in Ofgem [...] I very much hope that Ofgem will be able to restore the level of public confidence that it needs to have. I think there is every indication in terms of the way in which it has dealt with this particular probe that it will achieve the level of confidence the public need. I would not for a moment say that, at least among MPs, it can hold its hand on its heart and say it is where it ought to be. I hope as a result of this probe it will get there.[47]

46. **We were pleased that the regulator's initial findings report and suggested recommendations sought to address many, though not all, of the concerns set out in our earlier Report. Indeed, its probe raised some issues that had not come to light in our inquiry. For this we give Ofgem credit. However, it is clear that in 2008 the regulator has been slow to respond to rising concern over the functioning of the energy markets. We hope that in 2009 and onwards, the new Energy and Climate Change**

46 *Op. cit.* para 4

47 Q 70 (Minister of State for Energy)

Committee will not have to take the lead in setting the regulator's agenda as we have found ourselves doing on too many occasions.

47. **We also express concern that the new consumer representation processes and the plethora of bodies involved—Consumer Direct, companies' complaints procedures, the Energy Ombudsman, Consumer Focus and Ofgem itself—are opaque. Moreover, they risk reducing Ofgem's awareness of issues of concern to consumers, such as the recent complaints about direct debits. Ofgem and Consumer Focus will need to have close and frequent contact. Otherwise, the combination of a regulator which often needs to be prompted to take action, and a lack of effective procedures for bringing shortcomings to the attention of the regulator, will be a recipe for poor representation of consumer interests.**

48. However, we also believe that if Ofgem is to regulate the UK's gas and electricity markets effectively, then it must have the means with which to do so. Alistair Buchanan told us "the Enterprise Act or the Competition Act is quite often a very clumsy tool—using a sledgehammer to crack what may be a big or a small nut".[48] Accordingly, the regulator told us it is pursuing the possibility of acquiring a "market abuse power".[49] This would place a condition in companies' licences that prohibited conduct that amounts to an abuse of a position of substantial market power in the wholesale gas and electricity markets. Ofgem is able to adjust companies' licence conditions as it sees fit, though they can appeal to the Competition Commission (CC). The regulator sought this power in 1999, but it was rejected by the CC.[50] A recent evaluation by the Commission stated: "the CC's decision not to support the introduction of the market abuse licence clause in 2001 seems well-justified by subsequent market developments in Great Britain. Equally, however, Ofgem's view that such powers can be necessary in some circumstances also seems to be supported by subsequent developments overseas".[51] **We recommend the Government now investigates whether Ofgem should have additional powers to guard against market abuses, particularly in the wholesale electricity markets, and how these powers might be granted.**

48 Q 82 (Ofgem)

49 Q 190 (Ofgem)

50 *Ibid.*

51 Competition Commission, *Evaluation of the Commission's past cases*, January 2008

Conclusions and recommendations

Energy prices

1. Given the expectation of recession amongst most advanced economies in 2009, and the absence of a co-ordinated response from OPEC, the price of oil is likely to remain well below its July 2008 peak in the short term. Accordingly, despite the problems with the structure of the wholesale markets identified in our previous Report, we would expect to see a fall in wholesale gas and electricity prices. While recognising that the hedging strategies of the companies means there will always be a lag of weeks or months between falls in wholesale prices and matching reductions in retail prices, we support the Government in calling on the 'Big 6' energy companies to cut prices for their retail customers as soon as possible in 2009, and in pressing for greater transparency on the relationship between wholesale and retail prices. However, we continue to believe that, once the global economy begins to recover, in the long term "the era of cheap energy is surely over". (Paragraph 9)

Gas storage

2. If the UK is to avoid falling victim to even higher levels of wholesale gas price volatility in the coming years, it requires a level of growth in storage capacity that is an order of magnitude greater than that which the market has achieved on its own to date. The Government's national policy statement (NPS) must set out in detail what level of storage it wishes to achieve in the next decade and the criteria that sites for development should meet. Given that NPSs were announced some time ago, we are very disappointed that the NPS for gas storage will not be available for consultation until mid to late 2009, with final publication in 2010. We call on the Government to bring this date forward. Moreover, given the current economic climate, it must now re-consider the likelihood that investment will take place without some form of regulatory intervention. Given the amount of time that has been lost, and the lack of progress that has been made, we think it likely that the market will fail to deliver. There are many possible solutions. To give two possible examples, some form of storage obligation could be placed on gas shippers or suppliers, or the regulated monopoly role of National Grid could be extended. (Paragraph 13)

New electricity generating capacity

3. Generating capacity equivalent to nearly a third of current electricity demand will be made redundant by 2020. It will need to be replaced. We believe that in the current economic climate there is a high risk that the energy companies will not be able to raise the finance necessary to build this. It is the Government's job to ensure security of supply. Just as the Government has been quick to respond to the crisis in the banking sector, it must now take action to ensure investment in new capacity takes place as planned. A reasonable level of profit by the big energy suppliers will be a precondition of this investment taking place. The situation is now very serious and we believe that a simple trust in the market's ability to deliver without any

intervention will see us facing an ‘energy crunch’ in the medium term. The social and economic consequences of such a ‘crunch’ would be disastrous. (Paragraph 17)

4. The Government needs to take action to ensure the credibility of its claims that climate change forms as important a part of the UK’s energy policy as security of supply. Further action is required if both nuclear power and coal-fired generation are to form part of the electricity mix in the medium to longer term. The Government will need to learn from the recent Finnish experience of new nuclear build to ensure a UK programme is not subject to the same delays and cost over-runs. The national policy statement on nuclear power should be brought forward at the earliest possible date. In addition, much greater levels of investment in carbon capture and storage (CCS) are required than the current single competition for a demonstration plant if the Government wishes to see environmentally acceptable new coal-fired capacity. (Paragraph 18)

Wholesale market liquidity

5. We welcome Ofgem’s decision to take action to improve liquidity in the wholesale electricity market. This is now more important than ever, as the credit crunch has seen a decline in liquidity from the very low levels that existed in the first place. We look to the regulator to move quickly by proposing reforms in the first half of 2009. These will be crucial for encouraging future new entrants, both in the wholesale and retail markets. Furthermore, we continue to believe the Government and regulator should give greater attention to liquidity in the forward market for wholesale gas, about which a number of witnesses raised concern in our previous inquiry. The Government’s response to that Report showed that the last piece of substantive work on the topic was conducted in 2005. It is time for the Department of Energy and Climate Change (DECC) to consider the issue again and without delay. Unless wholesale markets work well there is no chance of achieving a fair deal for retail customers. (Paragraph 20)

The Energy Act 2008

6. The creation of the Department of Energy and Climate Change has brought about new policy initiatives on feed-in tariffs, incentives for renewable heat and smart metering, which this Committee has advocated for some time. We welcome these developments. It will now fall to the new Energy and Climate Change Committee to scrutinise the finer detail of how the Department puts these policies into practice. In particular, we hope that DECC will treat the twelve year programme for the introduction of smart meters (two years consultation and ten-year roll-out) as an absolute maximum, and aim to complete it much more quickly. The new committee will also need to pay close attention to other aspects of the Energy Act 2008, such as the implementation of technology banding for the Renewables Obligation and the establishment of a framework for financing waste disposal and decommissioning costs arising from future new nuclear power stations. (Paragraph 24)

Electricity network infrastructure

7. The UK's future energy mix will come from a more diverse range of sources, including local energy and larger-scale onshore and offshore renewables, as well as new nuclear power stations. More decentralised generation will need technologies that allow more 'active' management of the electricity networks. The scale of investment required to install them is likely to be huge, but could yield substantial benefits both in terms of security of supply and in reducing carbon emissions. In conjunction with new incentives for decentralised generation, DECC, Ofgem and the new committee will need to consider whether the existing regulatory regime governing network investment is sufficient to meet the demands posed by a more complex energy mix. (Paragraph 26)

Funding the Nuclear Decommissioning Authority

8. It will now fall to DECC to avoid a potential "car crash" by re-designing the Nuclear Decommissioning Authority's funding model before the end of the current spending review period. Agreement with HM Treasury on an appropriate framework should provide full protection of DECC's non-NDA related departmental expenditure limit. This issue should be a high priority for both the new department and the new select committee which will scrutinise it. (Paragraph 28)

Cost-reflective energy pricing

9. In the short term energy suppliers may themselves take action to ensure their charges for different payment types are cost-reflective. However, we believe that in future this requirement should be set down in companies' licences to ensure the issue does not arise again. We also support Ofgem's proposal for a further licence condition that would prohibit undue price discrimination. This would benefit vulnerable groups such as older people who are less likely to switch, or rural customers who are not connected to the gas grid. Such a condition would, however, need to make an exception for those households who currently benefit from suppliers' social tariffs. We also repeat that most of those in fuel poverty are on standard credit terms and that, while much is said about pre-payment meter tariffs, too little political attention is focussed on this larger and often more vulnerable group. (Paragraph 32)

Direct debit charges

10. We welcome the regulator's initial commitment to look into whether the energy suppliers are using higher than necessary direct debit charges to boost their cash flow, and we look forward to its findings. The level of public concern is high and we urge our successor committee to maintain the pressure on Ofgem to resolve this issue. (Paragraph 33)

Direct selling

11. We are deeply concerned that nearly half of consumers who switch as a result of a direct sales approach fail to achieve a price reduction. We welcome Ofgem's commitment to strengthen the rules governing direct selling. It should ensure new rules are in place within the first quarter of 2009. If they do not significantly improve the level of service to customers by this time next year, then the regulator should not hesitate to ban the practice outright. (Paragraph 35)

Supply for small businesses

12. A consequence of BizzEnergy and Electricity4Business's recent demise is that SME customers have lost two of their most effective advocates. Households are represented by the successor to Energywatch, Consumer Focus, and large-scale energy consumers have two dedicated advocacy bodies in the Major Energy Users' Council and the Energy Intensive Users' Group. Yet SMEs do not benefit from such advocacy, although Consumer Focus is currently looking at its role in representing them. Lack of a dedicated advocate may explain why anti-competitive practices by the 'Big 6' have been able to develop relatively unchallenged in the past. Though Ofgem told us it maintains links to SMEs through its Small User Group, we believe the regulator and DECC must ensure there are effective mechanisms for ensuring the interests of SMEs are identified and properly safeguarded. (Paragraph 38)

Fuel poverty

13. After two rounds of price increases, we estimate as many as 5.5 million households may now be living in fuel poverty. We welcome the Government's package of measures announced in the autumn, particularly their focus on improving the energy efficiency of the existing housing stock. This will prove the most cost-effective means of tackling fuel poverty in the long run. We also welcome the contribution to the package being made by non-vertically integrated electricity generators, which acknowledges the fact that they too have benefited from windfall gains under Phase 2 of the EU Emissions Trading Scheme. (Paragraph 42)

14. The creation of DECC removes one of the fissures in responsibility for fuel poverty within government, with BERR and DEFRA previously having overlapping involvement. We hope the Department will keep its strategy under review as many of its current measures have a limited lifetime even within the existing spending review period. While there is currently a strong case for the industry's role in alleviating fuel poverty because of the windfall gains it is receiving, these will cease to exist once full auctioning of carbon permits is introduced in 2013. Provided the regulatory framework is sufficient to ensure fairness to all consumers, in the long term the Government will need to consider whether it can continue to expect energy companies and the regulator to be responsible for the delivery of its social policy objectives. We also reiterate our frequent recommendation that much more attention must be paid to groups in fuel poverty other than pensioners, particularly disabled people under 60. (Paragraph 43)

The role of Ofgem

15. We were pleased that the regulator's initial findings report and suggested recommendations sought to address many, though not all, of the concerns set out in our earlier Report. Indeed, its probe raised some issues that had not come to light in our inquiry. For this we give Ofgem credit. However, it is clear that in 2008 the regulator has been slow to respond to rising concern over the functioning of the energy markets. We hope that in 2009 and onwards, the new Energy and Climate Change Committee will not have to take the lead in setting the regulator's agenda as we have found ourselves doing on too many occasions. (Paragraph 46)

16. We also express concern that the new consumer representation processes and the plethora of bodies involved—Consumer Direct, companies' complaints procedures, the Energy Ombudsman, Consumer Focus and Ofgem itself—are opaque. Moreover, they risk reducing Ofgem's awareness of issues of concern to consumers, such as the recent complaints about direct debits. Ofgem and Consumer Focus will need to have close and frequent contact. Otherwise, the combination of a regulator which often needs to be prompted to take action, and a lack of effective procedures for bringing shortcomings to the attention of the regulator, will be a recipe for poor representation of consumer interests. (Paragraph 47)

17. We recommend the Government now investigates whether Ofgem should have additional powers to guard against market abuses, particularly in the wholesale electricity markets, and how these powers might be granted. (Paragraph 48)

Formal Minutes

Wednesday 10 December 2008

Members present:

Peter Luff, in the Chair

Roger Berry
Miss Julie Kirkbride
Mr Mike Weir

Draft Report (*Energy policy: future challenges*), proposed by the Chairman, brought up and read.

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

Paragraphs 1 to 48 read and agreed to.

Summary agreed to.

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

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

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

Written evidence was ordered to be reported to the House for printing with the Report.

[Adjourned till Monday 15 December at 2.15 pm

Witnesses

List of written evidence

List of Reports from the Committee during the last Parliamentary Session

Session 2007–08

First Report	The work of the Committee in 2007	HC 233
Second Report	Jobs for the Girls: Two Years On	HC 291
Third Report	Post Office Closure Programme	HC 292
Fourth Report	Funding the Nuclear Decommissioning Authority	HC 394
Fifth Report	Waking up to India: Developments in UK-India economic relations	HC 209
Sixth Report	After the Network Change Programme: the future of the post office network	HC 577
Seventh Report	Keeping the door wide open: Turkey and EU accession	HC 367
Eighth Report (First Joint Report of Committee's on Arms Export Controls)	Scrutiny of Arms Export Controls (2008): UK Strategic Export Controls Annual Report 2006, Quarterly Reports for 2007, licensing policy and review of export control legislation	HC 254
Ninth Report	Construction matters	HC 127
Tenth Report	Post Office finance: matters arising from evidence taken on 10 June 2008	HC 662
Eleventh Report	Energy prices, fuel poverty and Ofgem	HC 293
Twelfth Report	Post Office Card Account: successor arrangements	HC 1052
Thirteenth Report	Companies House	HC 456
Fourteenth Report	Departmental Annual Report and Scrutiny of the Department for Business, Enterprise and Regulatory Reform	HC 1116