

Title: Consultation on raising the threshold at which energy suppliers are required to participate in social and environmental programmes URN 10D/1023 Lead department or agency: DECC Other departments or agencies:	Impact Assessment (IA)
	IA No: DECC0048
	Date: 01/12/2010
	Stage: Consultation
	Source of intervention: Domestic
	Type of measure:
Contact for enquiries: Keith.Evans@decc.gsi.gov.uk Luke.Davison@decc.gsi.gov.uk	

Summary: Intervention and Options

What is the problem under consideration? Why is government intervention necessary?

Ofgem and Government are concerned about barriers to entry in retail energy markets. Ofgem is addressing many of these, but we have identified one potential barrier that is for Government to address, which is the impact of certain environmental and social programmes on smaller suppliers. The programmes of CERT, CESP and FITs place disproportionately greater burdens on smaller suppliers than large ones because they impose significant fixed costs such as setting up new systems. Currently small suppliers with fewer than 50,000 domestic customer accounts are not required to participate. However, Government is concerned that this threshold is too low and proposes to increase it to 100,000 for these programmes plus the new Warm Homes Bonus, to reduce potential burdens on smaller suppliers and promote competition.

What are the policy objectives and the intended effects?

The objective is to improve the level of competition in the retail energy supply market and minimise burdens on small energy suppliers by addressing compliance costs associated with CERT, CESP and FITs that have a disproportionate impact on small suppliers compared to large suppliers. The intended effects are to increase the competitive pressures in the retail energy market to achieve the consumer benefits associated with more robust competition. Overall, increased competition should drive reductions in retail energy prices, efficiencies in suppliers' business activities and increase incentives for innovation.

What policy options have been considered? Please justify preferred option (further details in Evidence Base)

Option 1 is to raise the threshold for FITs, CERT and CESP from 50 000 to 100 000 customer accounts and to set a 100 000 customer account threshold for the Warm Homes Bonus scheme

Option 2 is to raise the thresholds for all these programmes to 250 000 customer accounts.

Option 2 is not considered to generate any additional monetised or non-monetised costs or benefits over the appraisal period. Given the threshold level is due to be reviewed within two to three years, when other measures to promote competition are expected to have taken effect, Option 1 is preferred at this stage.

When will the policy be reviewed to establish its impact and the extent to which the policy objectives have been achieved?	It will be reviewed 2013-14
Are there arrangements in place that will allow a systematic collection of monitoring information for future policy review?	No

Ministerial Sign-off For consultation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister: Date:

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Description:

Price Base Year 2010	PV Base Year 2010	Time Period Years 5	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	High: Optional	Best Estimate: 6.7

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	Optional	Optional	Optional
High	Optional	Optional	Optional
Best Estimate	0	0	0.009

Description and scale of key monetised costs by ‘main affected groups’

Costs related to FITs may increase. More customers are likely to be captured under the voluntary supply of FITs. Suppliers who provide FITs voluntarily currently receive an extra £35 per FIT instalation per year compared to a compulsory supplier. These payments are reflective of the relative costs of larger and smaller suppliers. In our central scenario the growth profile of firms means that there are more small firms offering FITs over the appraisal period so there is a small increase in costs.

Other key non-monetised costs by ‘main affected groups’

No carbon or other benefits will be lost from CERT or CESP as relative to the counterfactual the obligation will merely be transferred to larger suppliers. This is a transfer between scenarios and not over time as large suppliers currently face all of the obligation. FITs is not anticipated to lose any of its impacts either. Whilst fewer suppliers may be obliged to participate in FITs it is assumed that consumers who wish to receive FITs would select an energy supplier that was offering FITs.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	Optional	Optional	0
High	Optional	Optional	13.4
Best Estimate	0		6.7

Description and scale of key monetised benefits by ‘main affected groups’

There are resource costs savings with a reduction to zero in the amount of CERT obligations carried out by small suppliers. In the baseline some CERT obligations are fulfilled by small suppliers. There is some evidence that small companies may face a 50% premium in the cost complying with CERT. As relative to the counterfactual the obligations are transferred to larger suppliers this premium is avoided. There may also be a small resource cost saving from fewer FITs installations being administered by smaller suppliers who have higher administrative costs.

Other key non-monetised benefits by ‘main affected groups’

It is not possible to quantify the benefit arising due to more robust competition. However, we can expect this to contribute towards downward pressure on retail energy prices producing the welfare benefits associated with more competitive markets.

Key assumptions/sensitivities/risks	Discount rate (%)	3.5
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Key sensitivities are the growth rates of small suppliers. The faster small companies grow towards the new threshold the more impact this will have on competitive pressure in the market. The longer that they remain between the previous and new thresholds the more of an impact this policy change will have in reduced administrative burdens for those companies. The levels of administrative payments for FITs are reviewed annually. However, given the lack of estimates of future administration payments it has been assumed that the differential is constant. A further key risk in relation to FITs is how many small suppliers choose to offer FITs voluntarily. If more small suppliers offer FITs voluntarily then there could be a resource cost associated with changing the thresholds in relation to FITs.

Impact on admin burden (AB) (£m):		Impact on policy cost savings (£m):		In scope
New AB: 0	AB savings:	Net:	Policy cost savings:	Yes/No

Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?	Great Britain				
From what date will the policy be implemented?	April 2011				
Which organisation(s) will enforce the policy?	Ofgem				
What is the annual change in enforcement cost (£m)?	0				
Does enforcement comply with Hampton principles?	Yes				
Does implementation go beyond minimum EU requirements?	N/A				
What is the CO ₂ equivalent change in greenhouse gas emissions? (Million tonnes CO ₂ equivalent)	Traded: 0		Non-traded: 0		
Does the proposal have an impact on competition?	Yes				
What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?	Costs: N/A		Benefits: N/A		
Annual cost (£m) per organisation (excl. Transition) (Constant Price)	Micro	< 20	Small	Medium	Large
Are any of these organisations exempt?	No	No	No	No	No

Specific Impact Tests: Checklist

Set out in the table below where information on any SITs undertaken as part of the analysis of the policy options can be found in the evidence base. For guidance on how to complete each test, double-click on the link for the guidance provided by the relevant department.

Please note this checklist is not intended to list each and every statutory consideration that departments should take into account when deciding which policy option to follow. It is the responsibility of departments to make sure that their duties are complied with.

Does your policy option/proposal have an impact on...?	Impact	Page ref within IA
Statutory equality duties ¹ Statutory Equality Duties Impact Test guidance	No	
Economic impacts		
Competition Competition Assessment Impact Test guidance	Yes	12
Small firms Small Firms Impact Test guidance	No	
Environmental impacts		
Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance	No	
Wider environmental issues Wider Environmental Issues Impact Test guidance	No	
Social impacts		
Health and well-being Health and Well-being Impact Test guidance	No	
Human rights Human Rights Impact Test guidance	No	
Justice system Justice Impact Test guidance	No	
Rural proofing Rural Proofing Impact Test guidance	Yes	13
Sustainable development Sustainable Development Impact Test guidance	No	

¹ Race, disability and gender Impact assessments are statutory requirements for relevant policies. Equality statutory requirements will be expanded 2011, once the Equality Bill comes into force. Statutory equality duties part of the Equality Bill apply to GB only. The Toolkit provides advice on statutory equality duties for public authorities with a remit in Northern Ireland.

Evidence Base (for summary sheets) – Notes

Use this space to set out the relevant references, evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Please fill in **References** section.

References

Include the links to relevant legislation and publications, such as public impact assessment of earlier stages (e.g. Consultation, Final, Enactment).

No.	Legislation or publication
1	
2	
3	
4	

+ Add another row

Evidence Base

Ensure that the information in this section provides clear evidence of the information provided in the summary pages of this form (recommended maximum of 30 pages). Complete the **Annual profile of monetised costs and benefits** (transition and recurring) below over the life of the preferred policy (use the spreadsheet attached if the period is longer than 10 years).

The spreadsheet also contains an emission changes table that you will need to fill in if your measure has an impact on greenhouse gas emissions.

Annual profile of monetised costs and benefits* - (£m) constant prices

	Y ₀	Y ₁	Y ₂	Y ₃	Y ₄
Transition costs					
Annual recurring cost					
Total annual costs	0	0	0	0.002	0.011
Transition benefits					
Annual recurring benefits					
Total annual benefits	0	1.7	1.8	1.9	2.1

* For non-monetised benefits please see summary pages and main evidence base section

Evidence Base (for summary sheets)

Policy background

The **Carbon Emissions Reduction Target (CERT)** is an obligation placed on suppliers with more than 50,000 domestic customer accounts. Participating suppliers are allocated a proportion of the total target based on their market share of the domestic energy market. They are required to meet these targets through the promotion of energy efficiency measures to households, for example by establishing schemes to encourage (usually with subsidy) the installation of loft or cavity wall insulation. These schemes can be delivered through third parties but suppliers must monitor the schemes and report to Ofgem. Ofgem both approves the schemes and also monitors compliance. Ofgem has the power to impose a financial penalty of up to 10% of company turnover if a supplier fails to achieve its target. CERT has recently been extended through to the end of 2012

The **Community Energy Savings Programme (CESP)** applies to suppliers with more than 50,000 domestic customer accounts and also to generators producing over 10 TWh/year on average. These businesses are required to deliver energy savings measures to domestic consumers in specified low income areas. Ofgem sets them targets based on their market share, approves proposals, monitors compliance and enforces CESP. As with CERT, energy companies can contract out their obligations or transfer or trade them to other obligated parties.

Suppliers with more than 50,000 domestic customers must pay **Feed in Tariffs (FITs)** to generators and other suppliers can opt-in on a yearly basis. Participating suppliers must verify the eligibility of generators, the accuracy of the information they provide and submit details to Ofgem for entry on the central FIT register. They must also manage the relationship with generators, calculate and make the payments due to them, and help to prevent and mitigate abuse of the scheme. All licensed suppliers, not just those who are mandatory or voluntary participants are required to make payments to support the costs of the scheme and a levelisation process distributes this burden between them according to market share. Suppliers paying FITs may claim administration costs from the levelisation process. This takes account of the likely difference in costs for mandatory and voluntary participants' administration costs (voluntary participants are able to claim an additional £35 per customer to reflect their higher per customer administration costs).

The Government is currently consulting on proposals to introduce the **Warm Home Discount (WHD)** scheme, which would require suppliers above the DECC-wide threshold, currently 50,000 domestic accounts, to provide support to vulnerable customers through their energy bills. Running from 2011/12 to 2014/15, the scheme would obligate suppliers to contribute to the policy on the basis of their share of total domestic energy accounts. The total obligation would rise from £250 million in 2011/12 to £310 million in 2014/15. A proportion of this expenditure would be targeted at households that are identified by Government, while suppliers would have discretion to set the household eligibility criteria for the remaining expenditure - subject to approval from Ofgem. To prevent an unfair allocation of the obligation falling on suppliers with a disproportionately high number of customers eligible for support, the obligation would be allocated to suppliers based on the share of total customer accounts. For spend on households identified by Government, a reconciliation process would re-distribute funds on the basis of the share of total customer accounts after payments had been paid to households. For spend on households identified by suppliers, minimum expenditure levels would be allocated to each supplier before payments are made, again based on share of total customer accounts.

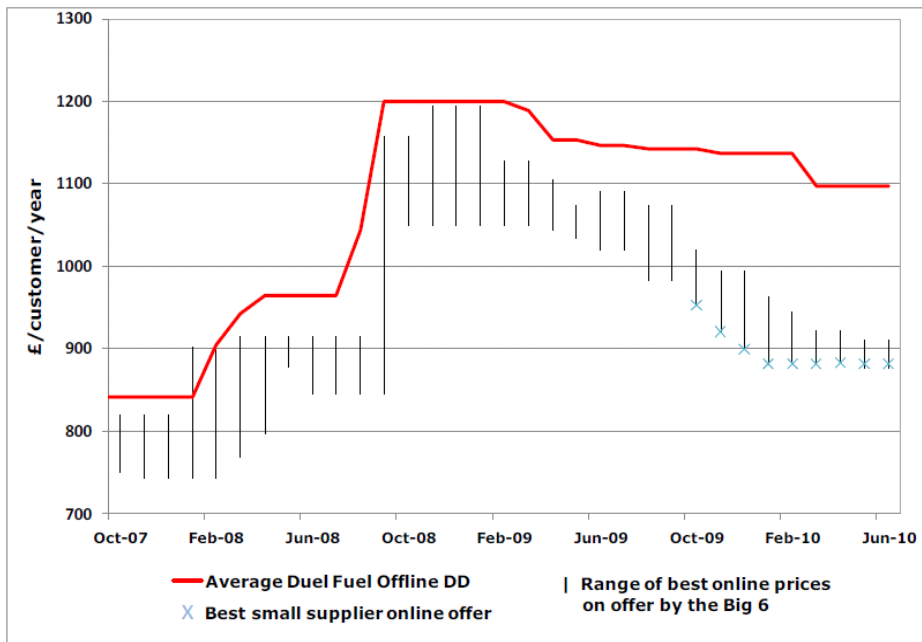
Problem under consideration

The government is concerned about barriers to competition in energy markets. There are many potential barriers to competition in retail energy markets. These include:

- **Pricing policies of the large Big 6 suppliers** – new entrants and small suppliers seeking to grow do not possess the historic endowment of a large base of stable, inactive customers. Small suppliers therefore have to compete for the part of the market who are more sensitive to price and more likely to switch away again. The incumbents are able to use their historic customer base to achieve greater aggregate profitability than new entrants.
- **Lack of liquidity in the wholesale markets** – Small suppliers' wholesale market requirements differ markedly from those of larger suppliers. They need to purchase smaller volumes and shapes of power which are not easily available in the wholesale market creating additional risk of not matching their demand profile exactly. This is a significant competitive disadvantage compared to large vertically integrated firms.
- **Cash-out regime** – supplier firms in the market who are out of balance i.e. the demand from their customers is larger or smaller than their contracted positions, have to buy or sell their imbalance at the system sell or system buy prices. These reflect the cost of the actions taken by National Grid as system operator to balance the system. Small suppliers find it harder to forecast the demand of their customer base, and the lack of liquidity makes it harder for them to fine tune their position as 'gate closure' approaches.
- **Regulatory requirements** – Government programmes can place significant fixed costs (e.g. administration and the costs of new systems) on suppliers. These costs weigh more heavily on small suppliers because they are unable to spread the fixed costs of compliance over a large customer base, and as such they cannot exploit economies of scale. The threshold at which many of these programmes apply is currently set at 50,000 accounts so growth beyond this point is harder.

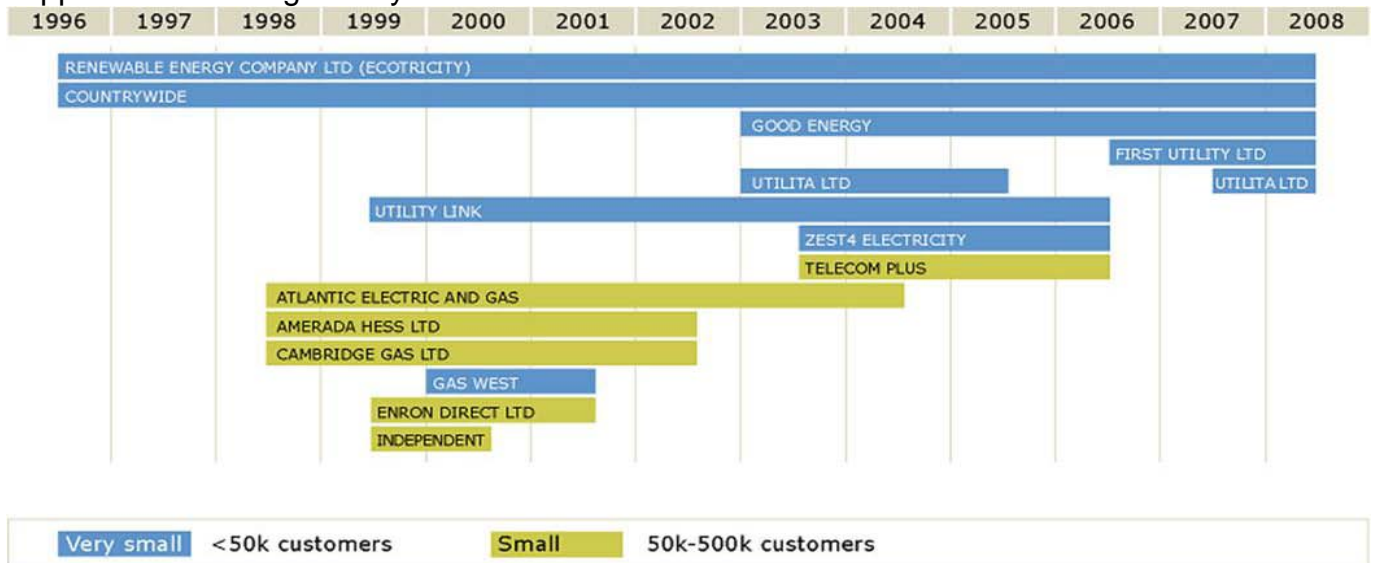
Removing barriers to entry and growth is important for fostering greater competition in the retail energy market through placing a competitive constraint on the pricing and behaviour of the incumbents in the market. There is evidence that the current set of small suppliers are influencing the pricing strategies of the Big 6 firms. The chart below shows that in 2009 and 2010 prices fell from the highs of 2008 in the online market for all suppliers due to the aggressive pricing of small suppliers. Offline deals (e.g. standard credit) in which small suppliers do not compete as vigorously remained high, highlighting the advantage the larger incumbent suppliers have in terms of maintaining their profitability.

Figure 2.5 National average dual fuel offline bills vs. best offer online bills



Source: Ofgem analysis

There has been a high level of entry and exit of small suppliers since 1996, with exit being driven by bankruptcy or acquisition by larger companies. There have in the past been suppliers with customer numbers greater than the current threshold for government programmes of 50,000² accounts but still significantly smaller than the big six are today. There are currently no suppliers in this range today so our information on the costs of firms this size is limited.



In this context the Government is keen to minimise the effects of Government programmes that could be detrimental to the state of competition in the retail energy supply market.

Rationale for intervention

There are a number of suppliers that are approaching the threshold level of accounts for Government programmes and could potentially breach the threshold in the coming years. Some Government programme may place a disproportionate cost on smaller suppliers to the detriment of competition in the market.

² A dual fuel customer is for calculation purposes 2 accounts as they take gas and electricity. This means a business with as little as 25,000 customers could breach the threshold.

Policy objective

The objectives are:

To improve the level of competition in the retail energy supply market by removing disproportionate compliance costs associated with some government programmes. The intended effects are to increase the competitive pressures in the retail energy market to achieve the associated benefits of more robust competition. Overall, increased competition should drive reductions in retail energy prices, efficiencies in suppliers' business activities and increase incentives for innovation.

Description of options considered

Two options have been considered against a counterfactual of no action. Option 1 is to raise the threshold for the programmes to 100,000 accounts whilst option 2 is to raise the thresholds to a higher level, which for the purposes of this impact assessment is assumed to be 250,000 accounts.

The preferred option is to raise the thresholds for compulsory participation in the FITs, CERT CESP and WHB to 100,000 accounts. Option 1 is preferred as we do not expect any supply companies to breach this level before this policy is reviewed and there are no additional benefits to option 2.

Assessing the costs and benefits

In order to identify the impact of raising the threshold for the government policies in scope of this IA we need to consider the questions:

- What assumptions need to be made about the policy landscape in scope for the appraisal period?
- How will the growth rates of small firms be affected by raising the threshold?
- If firms grow differently as a result of the change what will be the impact on the overall delivery level of the DECC policies and the cost of delivering them.

Policy landscape:

CERT and CESP both expire at the end of 2012. The government has announced its intention to implement an Energy Company Obligation (ECO) alongside the Green Deal from late 2012 onwards. The exact design of this policy has not yet been finalised. Given the lack of information this impact assessment will make the working assumption that ECO is an extension of CERT that would have the same basic policy design and would have the same costs for the duration of our appraisal period. It is important to note that this is a working assumption for the purposes of evaluation under uncertainty over future policy. These working assumptions do not represent a government view on the design of the announced ECO. FITs will remain in its current form. The government is currently consulting on WHB and it is expected to last until 2014/15 as detailed in the WHB consultation document. The only change assessed in this impact assessment is raising the threshold.

Growth of firms in the counterfactual:

There is significant uncertainty regarding the growth of firms in the absence of any intervention by government however we believe that passing through the threshold will impair their ability to grow and reduce the sustainability of their business model.

The cost of complying with these programmes is estimated to currently be around 3% of a customer bill and this is dominated by the cost of CERT. DECC estimates show that an average domestic electricity price including the cost of environmental obligations is £122/MWh

and £118/MWh excluding CERT, CESP and FITs costs. For gas the corresponding numbers are £36/MWh including environmental obligations and £35/MWh excluding CERT and CESP costs.

This means small suppliers passing through the 50,000 threshold will have to put their prices up by at least 3% in order to maintain the same margins.

Retail electricity price breakdown

£/MWh (real 2009 prices)	2010
Estimated average price without policies	107
Price impact of CERT	4
Price impact of CESP	0
Price impact of Future Supplier Obligation	0
Price impact of Better Billing	0
Price impact of Smart Metering	0
Price impact of the Existing RO	4
Price impact of the Extended RO	1
Price impact of EU ETS impact on wholesale price	6
Price impact of CCS	0
Price impact of FITs	0
Price impact of Security Measures	0
Estimated average price with policies	122
Estimated impact of policies	15
% impact (on baseline)	14%

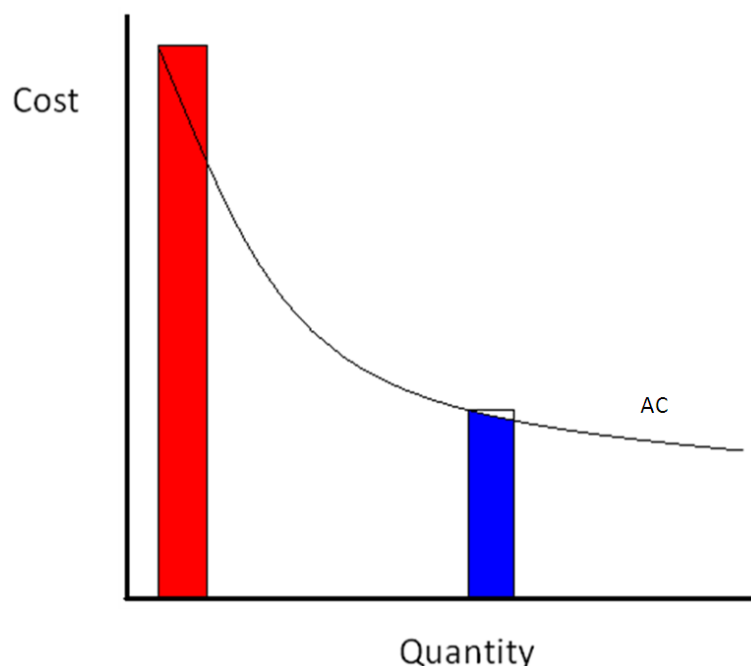
Source: DECC 2010

Retail gas price breakdown

£/MWh (real 2009 prices)	2010
Estimated average price without policies	35
Price impact of CERT	1
Price impact of CESP	0
Price impact of Future Supplier Obligation	0
Price impact of Better Billing	0
Price impact of Smart Metering	0
Price impact of RHI	0
Price impact of Security Measures	0
Estimated average price with policies	36
Estimated impact of policies	1
% impact (on baseline)	4%

Source: DECC 2010

Further to this, small suppliers cannot exploit the economies of scale in administering the programmes that larger suppliers can as they are still relatively small. It is likely that their costs of delivering these programmes will be higher, putting these suppliers at a competitive disadvantage. If a number of small suppliers each have to deliver a small amount of an obligation they will each have to set up the institutions to provide the required services. Each will incur fixed costs and will have to operate at the top of the average costs curve.



Given that there are currently no firms operating just over the 50,000 threshold it is not possible to estimate the average cost, and hence the bill impact of complying with the obligations for a small firm. It is possible that small firms could contract out the meeting of the obligations to an organisation that could exploit the economies of scale, however evidence from one small supplier suggested that even contracting out the delivery of CERT they could face a 50% cost premium compared to larger suppliers.

The cost disadvantage this gives smaller suppliers means that these firms will be less able to expand and exert competitive pressure on incumbents in the market. They will also find it harder to survive as they will have moved from having a regulatory cost advantage to having a regulatory cost disadvantage. This step change in costs increases risks to the sustainability of these businesses. Therefore we believe this could result in a retail market with fewer and smaller independent suppliers.

Although the cost disadvantage applies to the administration of CERT, CESP and FITs, we believe it is less likely to create a barrier to growth in the case of FITs. This is because payments are made to suppliers to administer FITs which are deemed to be cost reflective and reviewed annually. Currently the FITs programme currently pays out £65 per FITs generator to large suppliers and £100 per FITs generator to Suppliers with fewer than 50,000 accounts.

For the purposes of this IA we assess the following cases:

- **No growth beyond current threshold:** the current set of small suppliers grow up to the threshold but not pass through.
- **Slow growth above the threshold:** An alternative counterfactual scenario is that firms will approach the threshold at their current growth rates and pass through it. Once through the threshold these suppliers will lose the regulatory advantage and grow slowly, or possibly stagnate.

On balance we feel that it is not a viable business model to permanently remain below 50,000, and in fact it would be difficult to achieve in any case. In consultation with a number of small suppliers they supported this view. Therefore we feel that our second counterfactual is more likely, although we assess both to present a range of possible outcomes.

In the face of these new costs we would expect small suppliers to be less able to compete on price and that their growth rates will slow right down and might potentially stop. As an illustration our baseline counterfactual has four small suppliers growing at current rates such that they reach 50,000 accounts by the end of 2011. Once through the threshold we assume growth rates slow significantly such that four small suppliers reach 60,000 accounts each by 2016.

Costs and benefits of each option

Option 1, to raise the threshold to 100,000 should allow smaller suppliers to continue to grow uninhibited by government programmes. It should be noted that changing the CERT threshold will have by far the largest impact on the ability of small suppliers to expand compared changing the threshold on CESP or FITs. We would expect firms to continue to grow at their current rates³ until they reach the new threshold level. We would not expect small suppliers to reach a threshold level of 100,000 within the five year appraisal period. In order to present an illustration of the impact on costs we assume four firms reach 95,000 by 2015.

In relation to **CERT and CESP** this will create no additional costs relative to the baseline counterfactual. No carbon savings are expected to be lost as a result of the change as the total target for CERT, CESP and ECO would not change. The only difference would be how the obligation is split between different energy supply companies. There would be no additional costs related to larger energy companies carrying out proportionately more CERT installations than in the counterfactual. There may be some resource cost savings. Making some assumptions we can quantify this benefit.

³ Estimates of the growth rates are based on confidential information provided by small suppliers and then an extrapolation over the appraisal period.

The cost of providing CERT and CESP is currently estimated at 3% of a bill. Some evidence suggests that small suppliers may face a 50% premium on the cost of carrying out CERT. This cost estimate is based on a cost of outsourcing the obligations. In the absence of more information on small firms' costs we will assume it to be representative of additional resource costs of small businesses. We assume that the costs of complying with CERT and its successor are the same as detailed in the counterfactual section at £4 per MWh for electricity and £1 per MWh for gas. We assume that average consumption figures for domestic gas and electricity remain constant at the average of 2006 to 2008; this is 4.48MWh of electricity and 16.62 MWh for gas. We also assume that the small supplier's accounts are split evenly between electricity and gas accounts.

Taking these together with the assumed counterfactual growth rates where four small suppliers grow to 60,000 accounts in 2015 we estimate the resource savings to be £6.7m (NPV) over the next five years relative to the baseline. This calculation is made by taking the qualifying customer account numbers in each year and converting these in consumption figures for gas and electricity. This assumes a 50/50 split of accounts between gas and electricity. This is then multiplied by the £/MWh costs of providing CERT to generate the cost for a large supplier to carry out this amount of obligation. The resource cost saving is then calculated by taking the 50% premium of this and discounting to give an NPV for the benefits.

Year	2011	2012	2013	2014	2015
Accounts per small supplier	40,000	50,000	53,000	56,000	60,000
Qualifying account numbers	0	200,000	212,000	224,000	240,000
Cost of Large Supplier Carrying out CERT	0	£3.45m	£3.66m	£3.87m	£4.14m
Additional cost of small Supplier carrying out obligation	£0m	£1.73m	£1.83m	£1.93m	£2.07
Discount Factor	1.035	1.071	1.109	1.148	1.188
NPV	0	£1.61m	£1.65	£1.69	£1.74m

This saving arises as in the counterfactual more of the CERT and CESP obligation is paid for by smaller suppliers who are assumed to face a higher average cost.

There would also be a transfer from larger suppliers to smaller equal to £13.4m (NPV) over the next five years. This transfer is because relative to the counterfactual more of the obligation is met by larger suppliers. This transfer relative to our baseline counterfactual may have some distributional impacts. There will be extra costs that will be passed onto the customers of the big six and not to consumers of smaller suppliers. To give an idea of the scale the scenario above would represent adding approximately 13-14p on an average annual dual fuel bill of a big six customer. However in the context of distributional impacts this is so small it is not considered to be relevant.

These values are our best estimates of the costs and benefits of this option in relation to CERT and CESP. To provide a range we adjust our assumption about the size of the costs disadvantage faced by small suppliers from a lower bound of zero to an upper bound of a 100% premium they would have to pay. This gives a range of £0 to £13.4m for the resource saving. Whilst this range come from adjusting the cost disadvantage assumption the range is considered to be large enough to account for other variables that could affect the benefits as well such as company growth rates. For example the resource cost saving would be zero if small supplier do not breach the threshold in the counterfactual.

In relation to **FITs** we do not believe that FITs acts as a constraint on the growth of small firms, however we expect there to be very small implications for the resource costs associated with increasing the threshold for CERT if firms grow faster than would have otherwise been the case. In order to assess the impact on the administration costs associated with FITs we make the following assumptions:

- **The number of FITs installations is unaffected by this policy** - If a customer wanted to receive FITs and they were with a supplier that didn't offer FITs we would expect them to switch to one that did.
- **The administration costs associated with FITs are £65 for a large supplier and £100 for a small supplier** – these are the current level of 'cost reflective' payments paid to firms from a 'levelisation' fund in order to cover the administration costs for FITs. The levelisation fund is paid into by all licensed suppliers in proportion to their market share.
- **Three firms volunteer to supply FITs despite being below the threshold** - If a firm voluntarily chooses to supply FITs payment in the counterfactual they will continue to do so if the threshold is raised. There are currently three firms who are approaching the threshold that already voluntarily offer FITs

As a result of the difference in costs of administering FITs if there are more small suppliers administering FITs than under the counterfactual there will be a resource cost associated with this. Depending on the growth rates assumed in the counterfactual and the higher threshold case there could be an increase or decrease in costs. For example, with the illustrative numbers set out above there would be more accounts administered by smaller suppliers than in the counterfactual leading to an increase in costs:

- In our baseline by 2015 there are 240,000 accounts (4 firms times 60,000 accounts) covered by small suppliers offering FITs on a mandatory basis.
- With a higher threshold the volunteering firms would amount to 285,000 accounts (3 firms times 95,000)

The increase in costs has an NPV of £9,000 under a different scenario these numbers could equally be positive. If for example the small firms only grow to 75,000 by 2015 this would provide a benefit with an NPV of £12,000

Given their size relative to potential savings associated with CERT we do not consider it material to the decision of whether to pursue the option.

For the **Warm Home Discount** the total programme spend will be unchanged. Unlike FITs WHD does not have a process for redistributing administrative costs associated with complying with the obligation. This means that raising the threshold to 100,000 results in a transfer of benefits from larger suppliers to smaller suppliers relative to a threshold of 50,000. There will also be a resource cost saving associated with this if small suppliers would have faced higher administrative costs than large suppliers.

It is anticipated that some of the administrative costs of participating in the WHD scheme will not fully scale with the size of the obligation. However relative to CERT these benefits are likely to be small and we do not have strong evidence on the potential cost premium. Therefore we have not attempted to quantify them here as they are not considered to be material to the decision of whether to pursue the option.

Overarching competition effects

In addition to these monetised costs and benefits in relation to each programme of changing the threshold we would expect there to be competition benefits associated with the retail energy supply market. Given that CERT represents the largest cost barrier of those covered by this impact assessment we would expect the competition benefits to mainly accrue from changing the CERT threshold. With small suppliers able to compete more on price they should be able to provide a stronger level of competition to incumbents in the market place. Improved competition should drive reductions in retail energy supply prices, efficiencies in suppliers' business activities and increase incentives for innovation. Given the high level of uncertainties surrounding these benefits we have not attempted to monetise these benefits.

Title: Consultation on raising the threshold at which energy suppliers are required to participate in social and environmental programmes URN 10D/1023 Lead department or agency: DECC Other departments or agencies:	Impact Assessment (IA)
	IA No: DECC0048
	Date: 01/12/2010
	Stage: Consultation
	Source of intervention: Domestic
	Type of measure:
	Contact for enquiries: Keith.Evans@decc.gsi.gov.uk Luke.Davison@decc.gsi.gov.uk

Summary: Intervention and Options

What is the problem under consideration? Why is government intervention necessary?

Ofgem and Government are concerned about barriers to entry in retail energy markets. Ofgem is addressing many of these, but we have identified one potential barrier that is for Government to address, which is the impact of certain environmental and social programmes on smaller suppliers. The programmes of CERT, CESP and FITs place disproportionately greater burdens on smaller suppliers than large ones because they impose significant fixed costs such as setting up new systems. Currently small suppliers with fewer than 50,000 domestic customer accounts are not required to participate. However, Government is concerned that this threshold is too low and proposes to increase it to 100,000 for these programmes plus the new Warm Homes Bonus, to reduce potential burdens on smaller suppliers and promote competition.

What are the policy objectives and the intended effects?

The objective is to improve the level of competition in the retail energy supply market and minimise burdens on small energy suppliers by addressing compliance costs associated with CERT, CESP and FITs that have a disproportionate impact on small suppliers compared to large suppliers. The intended effects are to increase the competitive pressures in the retail energy market to achieve the consumer benefits associated with more robust competition. Overall, increased competition should drive reductions in retail energy prices, efficiencies in suppliers' business activities and increase incentives for innovation.

What policy options have been considered? Please justify preferred option (further details in Evidence Base)

Option 1 is to raise the threshold for FITs, CERT and CESP from 50 000 to 100 000 customer accounts and to set a 100 000 customer account threshold for the Warm Homes Bonus scheme

Option 2 is to raise the thresholds for all these programmes to 250 000 customer accounts.

Option 2 is not considered to generate any additional monetised or non-monetised costs or benefits over the appraisal period. Given the threshold level is due to be reviewed within two to three years, when other measures to promote competition are expected to have taken effect, Option 1 is preferred at this stage.

When will the policy be reviewed to establish its impact and the extent to which the policy objectives have been achieved?	It will be reviewed 2013-14
Are there arrangements in place that will allow a systematic collection of monitoring information for future policy review?	No

Ministerial Sign-off For consultation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister: Date:

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Description:

Price Base Year 2010	PV Base Year 2010	Time Period Years 5	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	High: Optional	Best Estimate: 6.7

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	Optional	Optional	Optional
High	Optional	Optional	Optional
Best Estimate	0	0	0.009

Description and scale of key monetised costs by ‘main affected groups’

Costs related to FITs may increase. More customers are likely to be captured under the voluntary supply of FITs. Suppliers who provide FITs voluntarily currently receive an extra £35 per FIT instalation per year compared to a compulsory supplier. These payments are reflective of the relative costs of larger and smaller suppliers. In our central scenario the growth profile of firms means that there are more small firms offering FITs over the appraisal period so there is a small increase in costs.

Other key non-monetised costs by ‘main affected groups’

No carbon or other benefits will be lost from CERT or CESP as relative to the counterfactual the obligation will merely be transferred to larger suppliers. This is a transfer between scenarios and not over time as large suppliers currently face all of the obligation. FITs is not anticipated to lose any of its impacts either. Whilst fewer suppliers may be obliged to participate in FITs it is assumed that consumers who wish to receive FITs would select an energy supplier that was offering FITs.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	Optional	Optional	0
High	Optional	Optional	13.4
Best Estimate	0		6.7

Description and scale of key monetised benefits by ‘main affected groups’

There are resource costs savings with a reduction to zero in the amount of CERT obligations carried out by small suppliers. In the baseline some CERT obligations are fulfilled by small suppliers. There is some evidence that small companies may face a 50% premium in the cost complying with CERT. As relative to the counterfactual the obligations are transferred to larger suppliers this premium is avoided. There may also be a small resource cost saving from fewer FITs installations being administered by smaller suppliers who have higher administrative costs.

Other key non-monetised benefits by ‘main affected groups’

It is not possible to quantify the benefit arising due to more robust competition. However, we can expect this to contribute towards downward pressure on retail energy prices producing the welfare benefits associated with more competitive markets.

Key assumptions/sensitivities/risks	Discount rate (%)	3.5
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Key sensitivities are the growth rates of small suppliers. The faster small companies grow towards the new threshold the more impact this will have on competitive pressure in the market. The longer that they remain between the previous and new thresholds the more of an impact this policy change will have in reduced administrative burdens for those companies. The levels of administrative payments for FITs are reviewed annually. However, given the lack of estimates of future administration payments it has been assumed that the differential is constant. A further key risk in relation to FITs is how many small suppliers choose to offer FITs voluntarily. If more small suppliers offer FITs voluntarily then there could be a resource cost associated with changing the thresholds in relation to FITs.

Impact on admin burden (AB) (£m):		Impact on policy cost savings (£m):		In scope
New AB: 0	AB savings:	Net:	Policy cost savings:	Yes/No

Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?	Great Britain				
From what date will the policy be implemented?	April 2011				
Which organisation(s) will enforce the policy?	Ofgem				
What is the annual change in enforcement cost (£m)?	0				
Does enforcement comply with Hampton principles?	Yes				
Does implementation go beyond minimum EU requirements?	N/A				
What is the CO ₂ equivalent change in greenhouse gas emissions? (Million tonnes CO ₂ equivalent)	Traded: 0		Non-traded: 0		
Does the proposal have an impact on competition?	Yes				
What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?	Costs: N/A		Benefits: N/A		
Annual cost (£m) per organisation (excl. Transition) (Constant Price)	Micro	< 20	Small	Medium	Large
Are any of these organisations exempt?	No	No	No	No	No

Specific Impact Tests: Checklist

Set out in the table below where information on any SITs undertaken as part of the analysis of the policy options can be found in the evidence base. For guidance on how to complete each test, double-click on the link for the guidance provided by the relevant department.

Please note this checklist is not intended to list each and every statutory consideration that departments should take into account when deciding which policy option to follow. It is the responsibility of departments to make sure that their duties are complied with.

Does your policy option/proposal have an impact on...?	Impact	Page ref within IA
Statutory equality duties ¹ Statutory Equality Duties Impact Test guidance	No	
Economic impacts		
Competition Competition Assessment Impact Test guidance	Yes	12
Small firms Small Firms Impact Test guidance	No	
Environmental impacts		
Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance	No	
Wider environmental issues Wider Environmental Issues Impact Test guidance	No	
Social impacts		
Health and well-being Health and Well-being Impact Test guidance	No	
Human rights Human Rights Impact Test guidance	No	
Justice system Justice Impact Test guidance	No	
Rural proofing Rural Proofing Impact Test guidance	Yes	13
Sustainable development Sustainable Development Impact Test guidance	No	

¹ Race, disability and gender Impact assessments are statutory requirements for relevant policies. Equality statutory requirements will be expanded 2011, once the Equality Bill comes into force. Statutory equality duties part of the Equality Bill apply to GB only. The Toolkit provides advice on statutory equality duties for public authorities with a remit in Northern Ireland.

Evidence Base (for summary sheets) – Notes

Use this space to set out the relevant references, evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Please fill in **References** section.

References

Include the links to relevant legislation and publications, such as public impact assessment of earlier stages (e.g. Consultation, Final, Enactment).

No.	Legislation or publication
1	
2	
3	
4	

+ Add another row

Evidence Base

Ensure that the information in this section provides clear evidence of the information provided in the summary pages of this form (recommended maximum of 30 pages). Complete the **Annual profile of monetised costs and benefits** (transition and recurring) below over the life of the preferred policy (use the spreadsheet attached if the period is longer than 10 years).

The spreadsheet also contains an emission changes table that you will need to fill in if your measure has an impact on greenhouse gas emissions.

Annual profile of monetised costs and benefits* - (£m) constant prices

	Y ₀	Y ₁	Y ₂	Y ₃	Y ₄
Transition costs					
Annual recurring cost					
Total annual costs	0	0	0	0.002	0.011
Transition benefits					
Annual recurring benefits					
Total annual benefits	0	1.7	1.8	1.9	2.1

* For non-monetised benefits please see summary pages and main evidence base section

Evidence Base (for summary sheets)

Policy background

The **Carbon Emissions Reduction Target (CERT)** is an obligation placed on suppliers with more than 50,000 domestic customer accounts. Participating suppliers are allocated a proportion of the total target based on their market share of the domestic energy market. They are required to meet these targets through the promotion of energy efficiency measures to households, for example by establishing schemes to encourage (usually with subsidy) the installation of loft or cavity wall insulation. These schemes can be delivered through third parties but suppliers must monitor the schemes and report to Ofgem. Ofgem both approves the schemes and also monitors compliance. Ofgem has the power to impose a financial penalty of up to 10% of company turnover if a supplier fails to achieve its target. CERT has recently been extended through to the end of 2012

The **Community Energy Savings Programme (CESP)** applies to suppliers with more than 50,000 domestic customer accounts and also to generators producing over 10 TWh/year on average. These businesses are required to deliver energy savings measures to domestic consumers in specified low income areas. Ofgem sets them targets based on their market share, approves proposals, monitors compliance and enforces CESP. As with CERT, energy companies can contract out their obligations or transfer or trade them to other obligated parties.

Suppliers with more than 50,000 domestic customers must pay **Feed in Tariffs (FITs)** to generators and other suppliers can opt-in on a yearly basis. Participating suppliers must verify the eligibility of generators, the accuracy of the information they provide and submit details to Ofgem for entry on the central FIT register. They must also manage the relationship with generators, calculate and make the payments due to them, and help to prevent and mitigate abuse of the scheme. All licensed suppliers, not just those who are mandatory or voluntary participants are required to make payments to support the costs of the scheme and a levelisation process distributes this burden between them according to market share. Suppliers paying FITs may claim administration costs from the levelisation process. This takes account of the likely difference in costs for mandatory and voluntary participants' administration costs (voluntary participants are able to claim an additional £35 per customer to reflect their higher per customer administration costs).

The Government is currently consulting on proposals to introduce the **Warm Home Discount (WHD)** scheme, which would require suppliers above the DECC-wide threshold, currently 50,000 domestic accounts, to provide support to vulnerable customers through their energy bills. Running from 2011/12 to 2014/15, the scheme would obligate suppliers to contribute to the policy on the basis of their share of total domestic energy accounts. The total obligation would rise from £250 million in 2011/12 to £310 million in 2014/15. A proportion of this expenditure would be targeted at households that are identified by Government, while suppliers would have discretion to set the household eligibility criteria for the remaining expenditure - subject to approval from Ofgem. To prevent an unfair allocation of the obligation falling on suppliers with a disproportionately high number of customers eligible for support, the obligation would be allocated to suppliers based on the share of total customer accounts. For spend on households identified by Government, a reconciliation process would re-distribute funds on the basis of the share of total customer accounts after payments had been paid to households. For spend on households identified by suppliers, minimum expenditure levels would be allocated to each supplier before payments are made, again based on share of total customer accounts.

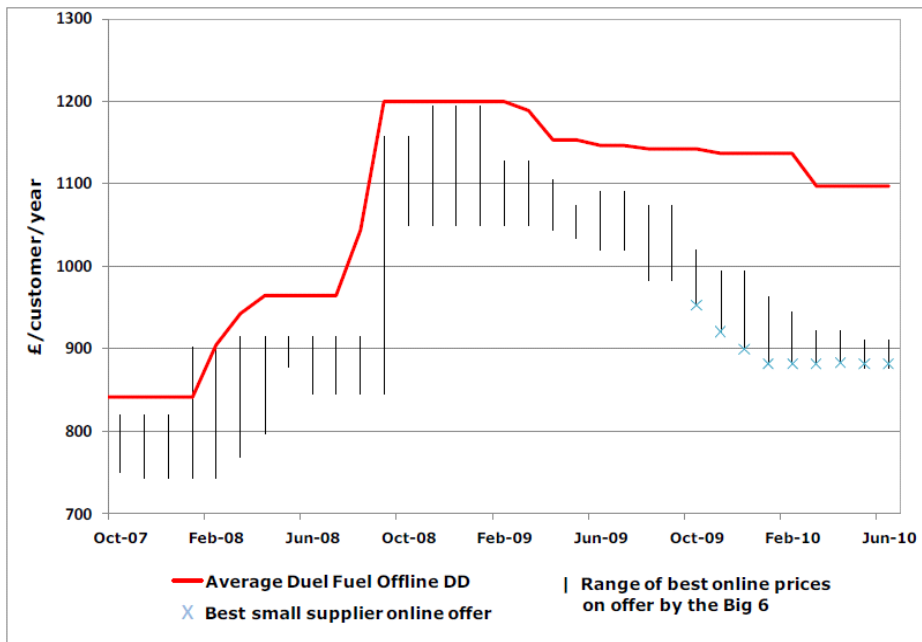
Problem under consideration

The government is concerned about barriers to competition in energy markets. There are many potential barriers to competition in retail energy markets. These include:

- **Pricing policies of the large Big 6 suppliers** – new entrants and small suppliers seeking to grow do not possess the historic endowment of a large base of stable, inactive customers. Small suppliers therefore have to compete for the part of the market who are more sensitive to price and more likely to switch away again. The incumbents are able to use their historic customer base to achieve greater aggregate profitability than new entrants.
- **Lack of liquidity in the wholesale markets** – Small suppliers' wholesale market requirements differ markedly from those of larger suppliers. They need to purchase smaller volumes and shapes of power which are not easily available in the wholesale market creating additional risk of not matching their demand profile exactly. This is a significant competitive disadvantage compared to large vertically integrated firms.
- **Cash-out regime** – supplier firms in the market who are out of balance i.e. the demand from their customers is larger or smaller than their contracted positions, have to buy or sell their imbalance at the system sell or system buy prices. These reflect the cost of the actions taken by National Grid as system operator to balance the system. Small suppliers find it harder to forecast the demand of their customer base, and the lack of liquidity makes it harder for them to fine tune their position as 'gate closure' approaches.
- **Regulatory requirements** – Government programmes can place significant fixed costs (e.g. administration and the costs of new systems) on suppliers. These costs weigh more heavily on small suppliers because they are unable to spread the fixed costs of compliance over a large customer base, and as such they cannot exploit economies of scale. The threshold at which many of these programmes apply is currently set at 50,000 accounts so growth beyond this point is harder.

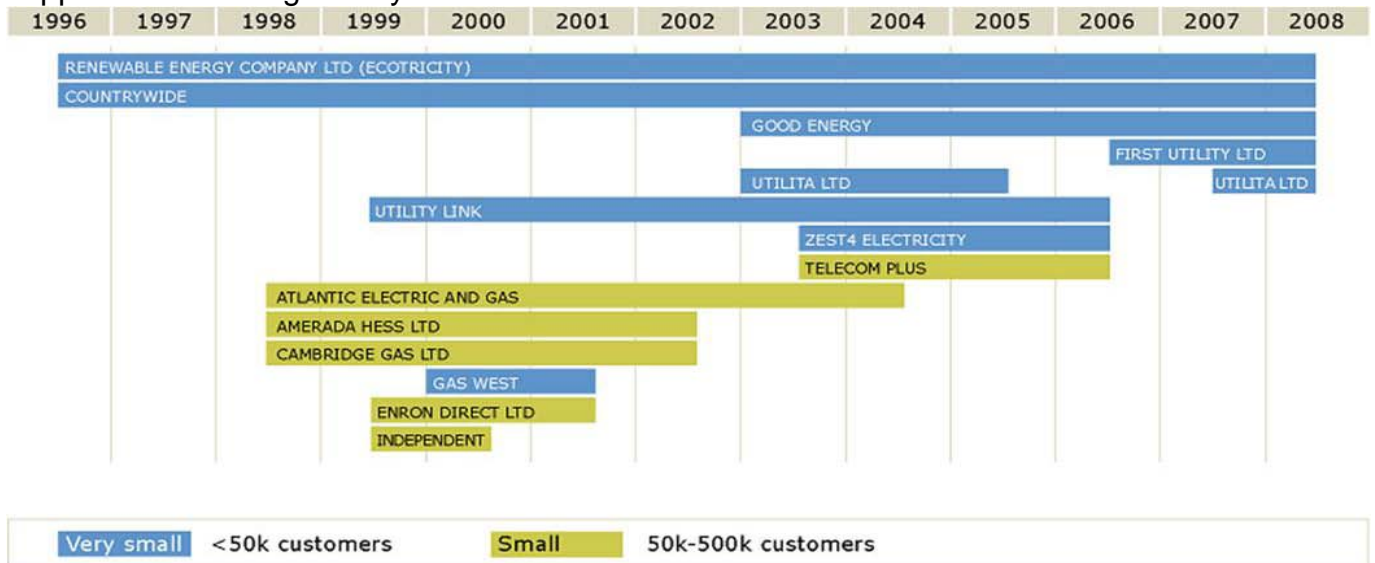
Removing barriers to entry and growth is important for fostering greater competition in the retail energy market through placing a competitive constraint on the pricing and behaviour of the incumbents in the market. There is evidence that the current set of small suppliers are influencing the pricing strategies of the Big 6 firms. The chart below shows that in 2009 and 2010 prices fell from the highs of 2008 in the online market for all suppliers due to the aggressive pricing of small suppliers. Offline deals (e.g. standard credit) in which small suppliers do not compete as vigorously remained high, highlighting the advantage the larger incumbent suppliers have in terms of maintaining their profitability.

Figure 2.5 National average dual fuel offline bills vs. best offer online bills



Source: Ofgem analysis

There has been a high level of entry and exit of small suppliers since 1996, with exit being driven by bankruptcy or acquisition by larger companies. There have in the past been suppliers with customer numbers greater than the current threshold for government programmes of 50,000² accounts but still significantly smaller than the big six are today. There are currently no suppliers in this range today so our information on the costs of firms this size is limited.



In this context the Government is keen to minimise the effects of Government programmes that could be detrimental to the state of competition in the retail energy supply market.

Rationale for intervention

There are a number of suppliers that are approaching the threshold level of accounts for Government programmes and could potentially breach the threshold in the coming years. Some Government programme may place a disproportionate cost on smaller suppliers to the detriment of competition in the market.

² A dual fuel customer is for calculation purposes 2 accounts as they take gas and electricity. This means a business with as little as 25,000 customers could breach the threshold.

Policy objective

The objectives are:

To improve the level of competition in the retail energy supply market by removing disproportionate compliance costs associated with some government programmes. The intended effects are to increase the competitive pressures in the retail energy market to achieve the associated benefits of more robust competition. Overall, increased competition should drive reductions in retail energy prices, efficiencies in suppliers' business activities and increase incentives for innovation.

Description of options considered

Two options have been considered against a counterfactual of no action. Option 1 is to raise the threshold for the programmes to 100,000 accounts whilst option 2 is to raise the thresholds to a higher level, which for the purposes of this impact assessment is assumed to be 250,000 accounts.

The preferred option is to raise the thresholds for compulsory participation in the FITs, CERT CESP and WHB to 100,000 accounts. Option 1 is preferred as we do not expect any supply companies to breach this level before this policy is reviewed and there are no additional benefits to option 2.

Assessing the costs and benefits

In order to identify the impact of raising the threshold for the government policies in scope of this IA we need to consider the questions:

- What assumptions need to be made about the policy landscape in scope for the appraisal period?
- How will the growth rates of small firms be affected by raising the threshold?
- If firms grow differently as a result of the change what will be the impact on the overall delivery level of the DECC policies and the cost of delivering them.

Policy landscape:

CERT and CESP both expire at the end of 2012. The government has announced its intention to implement an Energy Company Obligation (ECO) alongside the Green Deal from late 2012 onwards. The exact design of this policy has not yet been finalised. Given the lack of information this impact assessment will make the working assumption that ECO is an extension of CERT that would have the same basic policy design and would have the same costs for the duration of our appraisal period. It is important to note that this is a working assumption for the purposes of evaluation under uncertainty over future policy. These working assumptions do not represent a government view on the design of the announced ECO. FITs will remain in its current form. The government is currently consulting on WHB and it is expected to last until 2014/15 as detailed in the WHB consultation document. The only change assessed in this impact assessment is raising the threshold.

Growth of firms in the counterfactual:

There is significant uncertainty regarding the growth of firms in the absence of any intervention by government however we believe that passing through the threshold will impair their ability to grow and reduce the sustainability of their business model.

The cost of complying with these programmes is estimated to currently be around 3% of a customer bill and this is dominated by the cost of CERT. DECC estimates show that an average domestic electricity price including the cost of environmental obligations is £122/MWh

and £118/MWh excluding CERT, CESP and FITs costs. For gas the corresponding numbers are £36/MWh including environmental obligations and £35/MWh excluding CERT and CESP costs.

This means small suppliers passing through the 50,000 threshold will have to put their prices up by at least 3% in order to maintain the same margins.

Retail electricity price breakdown

£/MWh (real 2009 prices)	2010
Estimated average price without policies	107
Price impact of CERT	4
Price impact of CESP	0
Price impact of Future Supplier Obligation	0
Price impact of Better Billing	0
Price impact of Smart Metering	0
Price impact of the Existing RO	4
Price impact of the Extended RO	1
Price impact of EU ETS impact on wholesale price	6
Price impact of CCS	0
Price impact of FITs	0
Price impact of Security Measures	0
Estimated average price with policies	122
Estimated impact of policies	15
% impact (on baseline)	14%

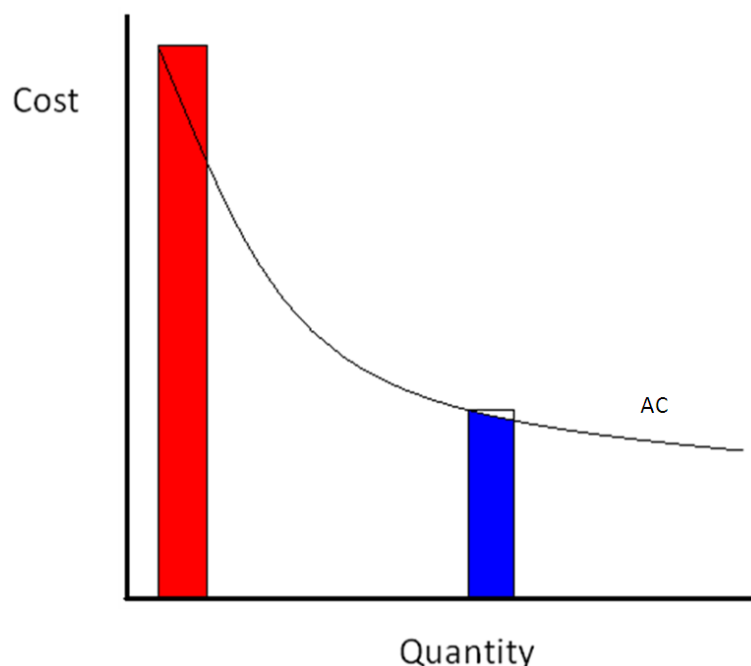
Source: DECC 2010

Retail gas price breakdown

£/MWh (real 2009 prices)	2010
Estimated average price without policies	35
Price impact of CERT	1
Price impact of CESP	0
Price impact of Future Supplier Obligation	0
Price impact of Better Billing	0
Price impact of Smart Metering	0
Price impact of RHI	0
Price impact of Security Measures	0
Estimated average price with policies	36
Estimated impact of policies	1
% impact (on baseline)	4%

Source: DECC 2010

Further to this, small suppliers cannot exploit the economies of scale in administering the programmes that larger suppliers can as they are still relatively small. It is likely that their costs of delivering these programmes will be higher, putting these suppliers at a competitive disadvantage. If a number of small suppliers each have to deliver a small amount of an obligation they will each have to set up the institutions to provide the required services. Each will incur fixed costs and will have to operate at the top of the average costs curve.



Given that there are currently no firms operating just over the 50,000 threshold it is not possible to estimate the average cost, and hence the bill impact of complying with the obligations for a small firm. It is possible that small firms could contract out the meeting of the obligations to an organisation that could exploit the economies of scale, however evidence from one small supplier suggested that even contracting out the delivery of CERT they could face a 50% cost premium compared to larger suppliers.

The cost disadvantage this gives smaller suppliers means that these firms will be less able to expand and exert competitive pressure on incumbents in the market. They will also find it harder to survive as they will have moved from having a regulatory cost advantage to having a regulatory cost disadvantage. This step change in costs increases risks to the sustainability of these businesses. Therefore we believe this could result in a retail market with fewer and smaller independent suppliers.

Although the cost disadvantage applies to the administration of CERT, CESP and FITs, we believe it is less likely to create a barrier to growth in the case of FITs. This is because payments are made to suppliers to administer FITs which are deemed to be cost reflective and reviewed annually. Currently the FITs programme currently pays out £65 per FITs generator to large suppliers and £100 per FITs generator to Suppliers with fewer than 50,000 accounts.

For the purposes of this IA we assess the following cases:

- **No growth beyond current threshold:** the current set of small suppliers grow up to the threshold but not pass through.
- **Slow growth above the threshold:** An alternative counterfactual scenario is that firms will approach the threshold at their current growth rates and pass through it. Once through the threshold these suppliers will lose the regulatory advantage and grow slowly, or possibly stagnate.

On balance we feel that it is not a viable business model to permanently remain below 50,000, and in fact it would be difficult to achieve in any case. In consultation with a number of small suppliers they supported this view. Therefore we feel that our second counterfactual is more likely, although we assess both to present a range of possible outcomes.

In the face of these new costs we would expect small suppliers to be less able to compete on price and that their growth rates will slow right down and might potentially stop. As an illustration our baseline counterfactual has four small suppliers growing at current rates such that they reach 50,000 accounts by the end of 2011. Once through the threshold we assume growth rates slow significantly such that four small suppliers reach 60,000 accounts each by 2016.

Costs and benefits of each option

Option 1, to raise the threshold to 100,000 should allow smaller suppliers to continue to grow uninhibited by government programmes. It should be noted that changing the CERT threshold will have by far the largest impact on the ability of small suppliers to expand compared changing the threshold on CESP or FITs. We would expect firms to continue to grow at their current rates³ until they reach the new threshold level. We would not expect small suppliers to reach a threshold level of 100,000 within the five year appraisal period. In order to present an illustration of the impact on costs we assume four firms reach 95,000 by 2015.

In relation to **CERT and CESP** this will create no additional costs relative to the baseline counterfactual. No carbon savings are expected to be lost as a result of the change as the total target for CERT, CESP and ECO would not change. The only difference would be how the obligation is split between different energy supply companies. There would be no additional costs related to larger energy companies carrying out proportionately more CERT installations than in the counterfactual. There may be some resource cost savings. Making some assumptions we can quantify this benefit.

³ Estimates of the growth rates are based on confidential information provided by small suppliers and then an extrapolation over the appraisal period.

The cost of providing CERT and CESP is currently estimated at 3% of a bill. Some evidence suggests that small suppliers may face a 50% premium on the cost of carrying out CERT. This cost estimate is based on a cost of outsourcing the obligations. In the absence of more information on small firms' costs we will assume it to be representative of additional resource costs of small businesses. We assume that the costs of complying with CERT and its successor are the same as detailed in the counterfactual section at £4 per MWh for electricity and £1 per MWh for gas. We assume that average consumption figures for domestic gas and electricity remain constant at the average of 2006 to 2008; this is 4.48MWh of electricity and 16.62 MWh for gas. We also assume that the small supplier's accounts are split evenly between electricity and gas accounts.

Taking these together with the assumed counterfactual growth rates where four small suppliers grow to 60,000 accounts in 2015 we estimate the resource savings to be £6.7m (NPV) over the next five years relative to the baseline. This calculation is made by taking the qualifying customer account numbers in each year and converting these in consumption figures for gas and electricity. This assumes a 50/50 split of accounts between gas and electricity. This is then multiplied by the £/MWh costs of providing CERT to generate the cost for a large supplier to carry out this amount of obligation. The resource cost saving is then calculated by taking the 50% premium of this and discounting to give an NPV for the benefits.

Year	2011	2012	2013	2014	2015
Accounts per small supplier	40,000	50,000	53,000	56,000	60,000
Qualifying account numbers	0	200,000	212,000	224,000	240,000
Cost of Large Supplier Carrying out CERT	0	£3.45m	£3.66m	£3.87m	£4.14m
Additional cost of small Supplier carrying out obligation	£0m	£1.73m	£1.83m	£1.93m	£2.07
Discount Factor	1.035	1.071	1.109	1.148	1.188
NPV	0	£1.61m	£1.65	£1.69	£1.74m

This saving arises as in the counterfactual more of the CERT and CESP obligation is paid for by smaller suppliers who are assumed to face a higher average cost.

There would also be a transfer from larger suppliers to smaller equal to £13.4m (NPV) over the next five years. This transfer is because relative to the counterfactual more of the obligation is met by larger suppliers. This transfer relative to our baseline counterfactual may have some distributional impacts. There will be extra costs that will be passed onto the customers of the big six and not to consumers of smaller suppliers. To give an idea of the scale the scenario above would represent adding approximately 13-14p on an average annual dual fuel bill of a big six customer. However in the context of distributional impacts this is so small it is not considered to be relevant.

These values are our best estimates of the costs and benefits of this option in relation to CERT and CESP. To provide a range we adjust our assumption about the size of the costs disadvantage faced by small suppliers from a lower bound of zero to an upper bound of a 100% premium they would have to pay. This gives a range of £0 to £13.4m for the resource saving. Whilst this range come from adjusting the cost disadvantage assumption the range is considered to be large enough to account for other variables that could affect the benefits as well such as company growth rates. For example the resource cost saving would be zero if small supplier do not breach the threshold in the counterfactual.

In relation to **FITs** we do not believe that FITs acts as a constraint on the growth of small firms, however we expect there to be very small implications for the resource costs associated with increasing the threshold for CERT if firms grow faster than would have otherwise been the case. In order to assess the impact on the administration costs associated with FITs we make the following assumptions:

- **The number of FITs installations is unaffected by this policy** - If a customer wanted to receive FITs and they were with a supplier that didn't offer FITs we would expect them to switch to one that did.
- **The administration costs associated with FITs are £65 for a large supplier and £100 for a small supplier** – these are the current level of 'cost reflective' payments paid to firms from a 'levelisation' fund in order to cover the administration costs for FITs. The levelisation fund is paid into by all licensed suppliers in proportion to their market share.
- **Three firms volunteer to supply FITs despite being below the threshold** - If a firm voluntarily chooses to supply FITs payment in the counterfactual they will continue to do so if the threshold is raised. There are currently three firms who are approaching the threshold that already voluntarily offer FITs

As a result of the difference in costs of administering FITs if there are more small suppliers administering FITs than under the counterfactual there will be a resource cost associated with this. Depending on the growth rates assumed in the counterfactual and the higher threshold case there could be an increase or decrease in costs. For example, with the illustrative numbers set out above there would be more accounts administered by smaller suppliers than in the counterfactual leading to an increase in costs:

- In our baseline by 2015 there are 240,000 accounts (4 firms times 60,000 accounts) covered by small suppliers offering FITs on a mandatory basis.
- With a higher threshold the volunteering firms would amount to 285,000 accounts (3 firms times 95,000)

The increase in costs has an NPV of £9,000 under a different scenario these numbers could equally be positive. If for example the small firms only grow to 75,000 by 2015 this would provide a benefit with an NPV of £12,000

Given their size relative to potential savings associated with CERT we do not consider it material to the decision of whether to pursue the option.

For the **Warm Home Discount** the total programme spend will be unchanged. Unlike FITs WHD does not have a process for redistributing administrative costs associated with complying with the obligation. This means that raising the threshold to 100,000 results in a transfer of benefits from larger suppliers to smaller suppliers relative to a threshold of 50,000. There will also be a resource cost saving associated with this if small suppliers would have faced higher administrative costs than large suppliers.

It is anticipated that some of the administrative costs of participating in the WHD scheme will not fully scale with the size of the obligation. However relative to CERT these benefits are likely to be small and we do not have strong evidence on the potential cost premium. Therefore we have not attempted to quantify them here as they are not considered to be material to the decision of whether to pursue the option.

Overarching competition effects

In addition to these monetised costs and benefits in relation to each programme of changing the threshold we would expect there to be competition benefits associated with the retail energy supply market. Given that CERT represents the largest cost barrier of those covered by this impact assessment we would expect the competition benefits to mainly accrue from changing the CERT threshold. With small suppliers able to compete more on price they should be able to provide a stronger level of competition to incumbents in the market place. Improved competition should drive reductions in retail energy supply prices, efficiencies in suppliers' business activities and increase incentives for innovation. Given the high level of uncertainties surrounding these benefits we have not attempted to monetise these benefits.

As a result of these changes to policy we would expect that small energy suppliers increase in size. In the longer term if the energy market has more medium sized firms there is the potential for resource cost implications. These will depend heavily on the pace at which the average costs of growing firms decline towards the costs of the big six. We would also expect that small firms growing will mean that they are exerting more competitive pressures in the market place. In line with this we would expect competition benefits to outweigh obligation resource costs once smaller suppliers grow significantly.

Option 2, to raise the threshold to 250,000 accounts should have a similar costs and benefits to option 1. We would propose to review the threshold level in two to three years once other actions Ofgem are taking in the market have had time to have effect. Given this proposed review period, coupled with the expectation that small suppliers would not breach the option 1 threshold in this period and the lack of additional benefits option 2 is not preferred at this stage.

Risks and assumptions

Key sensitivities are the growth rates of small suppliers. The faster small companies grow towards the new threshold and the longer that they remain between the previous and new thresholds as a result of this policy change the more of an impact this policy change will have. There is also considerable uncertainty about the baseline and what will happen to small supplier facing the costs of these programmes.

It is possible that small firms may cease to be able to compete once they have passed through the threshold and could stop trading. Using this scenario as a baseline would strengthen the competition arguments for raising the threshold but would reduce the monetised benefits.

The levels of administrative payments for FITs are due to be reviewed shortly and annually thereafter. However, given the lack of estimates of future administration payments it has been assumed that the differential is constant. If the differential changes then the value of the transfer will adjust accordingly. Another key sensitivity regarding FITs is whether small suppliers opt to provide FITs voluntarily. If more suppliers opt to provide FITs voluntarily then the more likely this policy change will have higher resource costs relating to FITs.

Summary and preferred option with description of implementation plan

The preferred option is to amend the CERT, CESP and FITs programmes, raising the threshold for compulsory participation for all of them to 100,000 accounts. This will be implemented by secondary legislation so that the new threshold is in place for 2012. It will also be used for Social Price Support, the detailed rules for which will be made in early 2011 and will come into force in April 2011.

Net Costs to Business

This policy is a reduction in regulatory burden on businesses. All of the direct costs discussed in this impact assessment are costs to business. Therefore our estimate net cost to business has a central estimate of -£6.7m. This represents a reduction in net costs to business with an equivalent annual benefit of £1.48m

Rural Consumers

The proposal will not preclude rural customers benefiting from the help provided by the various schemes to which the new threshold will apply.

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Annexes

Annex 1 should be used to set out the Post Implementation Review Plan as detailed below. Further annexes may be added where the Specific Impact Tests yield information relevant to an overall understanding of policy options.

Annex 1: Post Implementation Review (PIR) Plan

A PIR should be undertaken, usually three to five years after implementation of the policy, but exceptionally a longer period may be more appropriate. A PIR should examine the extent to which the implemented regulations have achieved their objectives, assess their costs and benefits and identify whether they are having any unintended consequences. Please set out the PIR Plan as detailed below. If there is no plan to do a PIR please provide reasons below.

<p>Basis of the review: [The basis of the review could be statutory (forming part of the legislation), it could be to review existing policy or there could be a political commitment to review];</p> <p>The threshold level will be reviewed to establish the impact of a change in the exemption threshold. .</p>
<p>Review objective: [Is it intended as a proportionate check that regulation is operating as expected to tackle the problem of concern?; or as a wider exploration of the policy approach taken?; or as a link from policy objective to outcome?]</p> <p>The review is intended to ascertain the impact of the increased threshold and whether any further change is needed.</p>
<p>Review approach and rationale: [e.g. describe here the review approach (in-depth evaluation, scope review of monitoring data, scan of stakeholder views, etc.) and the rationale that made choosing such an approach]</p> <p>The review will be conducted by a scan of stakeholder views and evidence.</p>
<p>Baseline: [The current (baseline) position against which the change introduced by the legislation can be measured]</p> <p>The baseline used will be determined following consultation responses.</p>
<p>Success criteria: [Criteria showing achievement of the policy objectives as set out in the final impact assessment; criteria for modifying or replacing the policy if it does not achieve its objectives]</p> <p>To be determined through consultation evidence.</p>
<p>Monitoring information arrangements: [Provide further details of the planned/existing arrangements in place that will allow a systematic collection of monitoring information for future policy review]</p> <p>This policy of reducing regulatory coverage does not provide suitable arrangements for monitoring information because it is deregulatory. Information will be monitored through continued discussions with suppliers regarding their costs.</p>
<p>Reasons for not planning a PIR: [If there is no plan to do a PIR please provide reasons here]</p>