Extra help where it is needed: a new Energy Company Obligation

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The content of this paper is subject to the consultation outcome

Contents

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1 Our objectives for the ECO

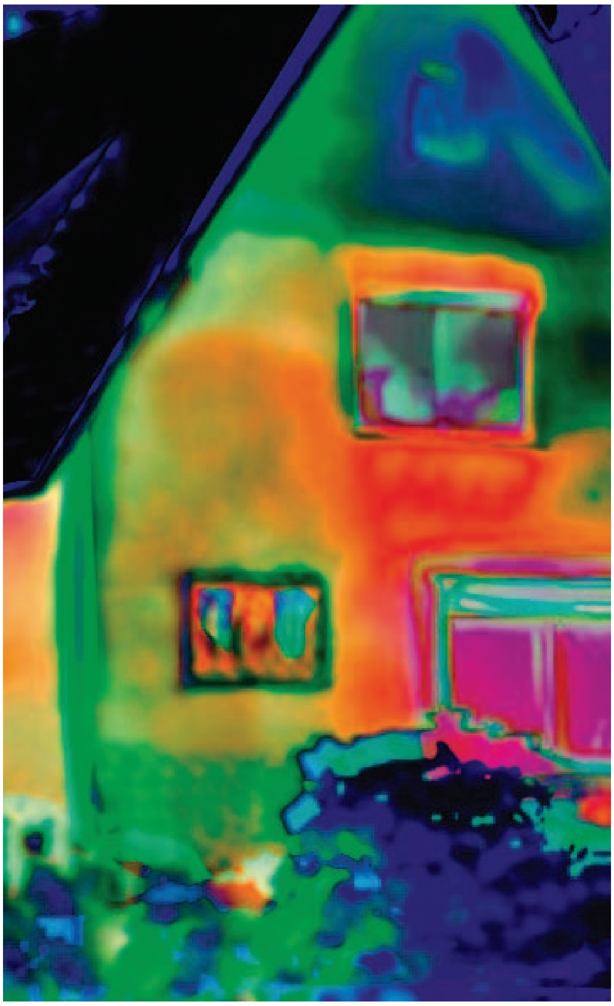
The Green Deal will establish a new market for energy efficiency measures from 2012, at the heart of which will be a new financing mechanism. Green Deal finance will promote a cost-effective response to our aims on energy efficiency and place the emphasis for paying for energy efficiency measures with the beneficiary.

The Golden Rule, whereby expected savings from measures repay the costs, is key to Green Deal. There are some cases where the Golden Rule will not work but where there are strong policy reasons still to promote energy efficiency measures. The key mechanism to support in these cases will be a new Energy Company Obligation (ECO).

ECO will be entirely focussed on:

- the needs of the lower income and most vulnerable; and
- those properties needing the next most cost-effective measures that do not meet the Golden Rule – for example, solid wall insulation (SWI).

ECO will not be like previous obligations with carbon goals able to be achieved across all households. From the outset, the targets will only be achieved within a certain householder group (lower income and vulnerable households where Green Deal is less likely to work) and/or with certain property types, such as those needing SWI.



1.1 Householder support: Lower income and vulnerable households

Households on very low incomes tend to under-heat their homes significantly which can pose health problems, particularly for the most vulnerable. ECO can be expected to play an important role in supporting the upfront costs of basic heating and insulation measures for those low income and vulnerable households who are likely to struggle to heat their homes to a suitable level. To this end, the Energy Bill enables us to set an ‘affordable warmth’ target to provide for the ECO to promote a wider range of measures to those lower income and vulnerable households who are identified as needing support/assistance. Efficient central heating systems, as well as insulation, are key to helping improve people’s ability to heat their homes, bringing potential health and social benefits.

Introducing a new ‘affordable warmth’ target will also help in situations where Green Deal finance, which relies on repayments made through savings on energy bills, will either not be appropriate or not be sufficient to make sure that households can benefit from the Green Deal. In such cases, helping the householders to heat their home to a more suitable level without increasing their bills, rather than fuel bill savings *per se*, is the principal objective.

1.2 Developing supply – the next most cost-effective measure

Green Deal finance supports measures that pay for themselves through savings. However, if we are to make significant in-roads in cutting overall household emissions we must look beyond these measures to the next most cost-effective measures. In many cases, SWI will be the next most cost-effective measure and, whilst it produces significant savings, these do not repay the relatively high installation costs within a reasonable timeframe.

There is currently only a small market for SWI, and it is significantly more costly to install than straightforward loft or cavity wall insulation. In most cases, SWI will not meet the Golden Rule. ECO will offer further support in addition to Green Deal finance for these harder to treat properties.

One of the reasons why SWI is currently expensive is that the supply chain is still relatively small in comparison to the scale of delivery we need. Support from the ECO will be a significant driving force, providing market certainty; promoting innovation and investment within the supply chains; and driving down costs and ensuring that all consumers really can improve their homes and benefit from the Green Deal. As the supply increases, costs should fall and the absolute amount of subsidy needed to help the measure meet the Golden Rule should fall.

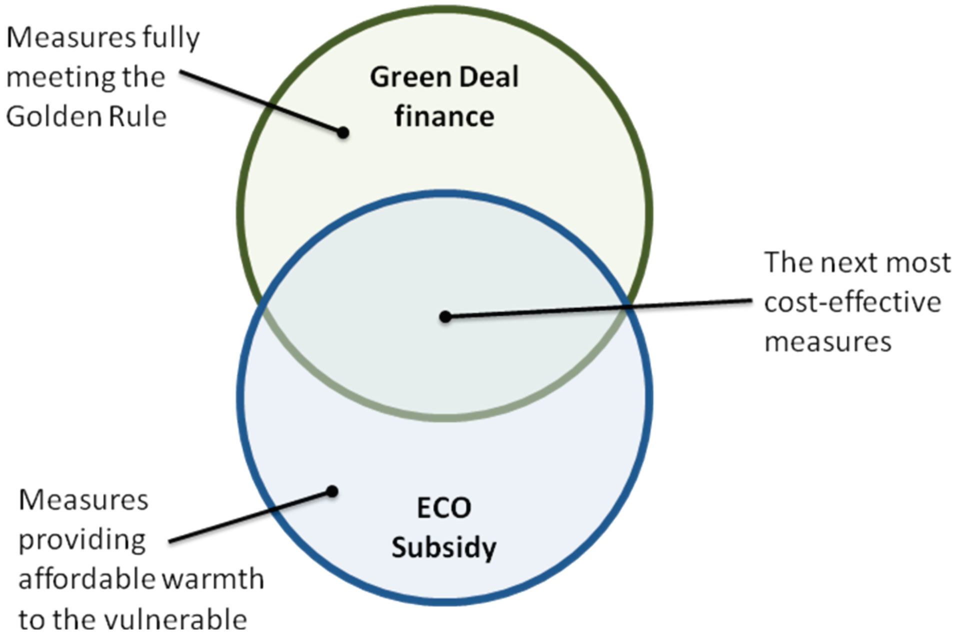
1.3 Bringing ECO and Green Deal together

ECO is intended to benefit lower income households and support the supply potential of the next most cost effective measures. It will not, however, fall to the consumer to bring Green Deal finance and ECO together. We would expect ECO support to be integrated into the Green Deal framework so that where ECO financial support and Green Deal finance combine to deliver improvements, the details are arranged behind the scenes. The consumer will see one seamless package and offer from a Green Deal provider. In addition we would generally expect that any measures provided with ECO support (whether through a Green Deal or not) will need to meet the same standards of quality and accreditation as those delivered through the wider Green Deal.

Over recent years there has been a series of obligations placed on energy companies requiring them to support the energy efficiency improvement of homes. Two of these schemes are currently in effect - the Carbon Emissions Reductions Target (CERT) and the Community Energy Saving Programme (CESP). Both CERT and CESP will expire in December 2012.
The new ECO will need to be more than just a new phase or extension of existing schemes. The opportunities for domestic energy efficiency and the market for delivering improvements after 2012 will be very different to the situation when CERT and CESP were originally designed. The ECO needs to be a wholly new obligation, built from the ground-up to integrate with the Green Deal framework and operate in the post-2012 world.

The Green Deal finance market in particular will provide new opportunities and challenges for the way ECO operates. Suppliers and Green Deal Providers will need to work together to provide an offer to the consumer that comprises the optimum mix of support between Green Deal finance and ECO subsidy. Figure 1 below illustrates the overall combination of support we might expect for UK households.

Fig 1. Illustrative overall interaction between Green Deal finance and ECO subsidy



Note: Diagram is not to scale

In many cases a package of measures appropriate for a house will generate savings large enough for the full up-front costs to be met through Green Deal finance. For more expensive measures, and where Green Deal finance is not a suitable option, ECO subsidy may need to cover the full cost of installation.

Green Deal may only part-repay the costs. For some measures, this implies the householder part-funds the measure upfront or leaves it out of their Green Deal package. For the next most cost-effective measure we are seeking to develop, ECO will meet this difference.

The powers for which we are seeking Parliamentary approval in the Energy Bill are necessary to enable us to build an ECO that fully achieves these outcomes, and is both transparent and cost-effective.

Proposals for the overall scale of ambition for the ECO will be set out as part of the consultation later this year.

2 Policy challenges

In view of the scheme’s twin objectives, the powers in the Bill allow us to establish two distinct obligations, one set in terms of carbon emissions reductions, and the other focussed on reducing the cost of heating – an “affordable warmth” target.

As illustrated in Fig.1, in many cases support for hard to treat properties will feature a mix of ECO subsidy and Green Deal finance. This is key to ensuring that those benefiting from the measures are contributing towards at least part of the costs, thus minimising the overall distributional impact of the ECO on energy bills. In time, many more people will benefit from the lower costs this approach will drive.

2.1 A target for emissions reductions

One of the major challenges for the ECO and Green Deal is the changing nature of the types of measures that need to be delivered. CERT, by focusing on delivering low-cost measures, has been very successful at installing simple loft and cavity wall insulation. From 2012 Green Deal finance will offer a route to deliver the remaining low cost loft and cavity wall opportunities at no upfront cost and without need for subsidy. However to meet our carbon budgets cost effectively, we will need to go far beyond just lofts and cavity walls, and move towards the next most cost effective measures.

However, some 7 million of the most difficult to treat homes require some form of solid wall insulation. The Committee on Climate Change recommended in their 2009 Report, '*Meeting Carbon Budgets – the need for a step change*'[1] that 2.3million solid wall homes will need to have taken up solid wall insulation by 2022 in order for the UK to be on track to achieve carbon budgets. ECO support for these properties will help drive this market, and the supply chain to fulfil it, enabling us to unlock the resulting carbon savings more cost effectively.

2.2 A target for supporting affordable warmth

Vulnerable and low-income households are one of the main groups for whom Green Deal finance will not generally be appropriate. Poorer households living in inefficient properties have a high propensity to under-heat their homes, which can be detrimental to their physical and mental health – particularly for the most vulnerable – as well as leading to social isolation. The financial constraints these households face means that they often lack the means to upgrade the energy performance of their homes even lacking basic measures such as boilers and heating systems, cavity and loft insulation, in some cases. This is particularly true in private housing tenures, where energy performance standards are generally lower.

In these cases, our objective is actively to enable such households to have warmer homes rather than necessarily to save money on their energy bills, promoting improved health and welfare as a result. As such, the affordable warmth part of ECO will focus on providing upfront support for thermal performance measures which will help households to heat their homes more affordably. This will contribute to the Government's drive to upgrade the energy performance of the housing stock, and in many cases will also contribute to carbon reduction goals.

[1] CCC Report, 'Meeting Carbon Budgets – the need for a step change': www.theccc.org.uk/reports

As well as working alongside Green Deal finance and the wider ECO to ensure a wider range of households stand to benefit from appropriate support through Green Deal, this is in line with the Government's statutory fuel poverty targets, which Professor John Hills is currently considering as part of an Independent Review on fuel poverty.

2.3 Ensuring an open market

We want to ensure the maximum possible scale and range of energy efficiency delivery overall. Because subsidy from the energy companies may ultimately translate into higher energy prices for all bill payers, we want to ensure that the costs of ECO are as low as possible to minimise these overall impacts, and/or to ensure that an even proportion can be targeted towards the lowest income and most vulnerable who might feel the bill impacts most keenly. Therefore it is clear that energy companies should be providing ECO subsidy through those delivery chains which can deliver energy efficiency improvements most cost effectively. As the energy companies are in competition they have natural business incentives to deliver their obligation as cost effectively as possible. However it may be difficult and expensive for smaller Green Deal providers to engage and negotiate with energy companies even when they can deliver energy efficiency improvements very cost effectively. Also, for equally natural business reasons, an energy company might also be a Green Deal provider and might have a preference for funding their own internal Green Deal activity. The company might prefer to provide ECO subsidy to its own Green Deal transactions, as this would allow it to grow the Green Deal side of its business and gain market share (at the expense of other Green Deal providers which had no such access to funding).

The emergence of a diverse and competitive Green Deal provider market is likely to lead to cost-efficiencies all round, including ultimately lower costs of delivery for ECO itself. The behaviours and outcomes outlined above might inhibit competition, making it more difficult for newer or smaller players to establish a foothold in the market, leading to less cost effective delivery and less choice for consumers.

Although our primary legislative powers might allow us to require or encourage ECO companies to deliver activity in particular ways, for example through partnerships with a diverse range of Green Deal providers, this would represent a substantial regulatory intervention in the functioning of the ECO market and we would want to be clear on the need and rationale for it. Another approach that has been suggested is the development of some form of brokerage arrangement linking ECO companies and potential delivery partners, putting them in touch with each other and matching offers of ECO subsidy with the various offers of cost-effective delivery within the Green Deal framework. This might introduce greater transparency and liquidity into the market overall. We will continue to seek views on these important issues from industry and other stakeholders.

2.4 Partnerships

Given the above Green Deal Providers and ECO suppliers will naturally wish to work together. There will also be scope for much broader delivery partnerships to develop. For example many local authorities and social landlords are already beginning to plan to how they might help deliver the Green Deal to householders on a street by street basis in their areas. Community and local groups also have both a stake in the outcome of local schemes and have valuable knowledge and/or resource of their own to contribute. There are clearly many lessons to be learnt from existing partnership arrangements under CERT and CESP, and the evaluations of these programmes are helping to inform options for the ECO. We are keen to build on the strengths of CERT and CESP to design a framework that is sufficiently flexible to enable partnerships to develop to deliver the most effective local solutions, which could bring economies of scale and the sort of local community buy-in that could be crucial to encouraging take-up by individual householders.

2.5 Transparency

A key criticism of CERT has been the relatively poor transparency over costs and delivery. We are keen to improve this under the ECO, but this will require better and more frequent provision of data on a wider set of issues. We have included powers in the Energy Bill that would allow more detailed data provision requirements to be placed on suppliers to this end. In the meantime, we are looking closely at precisely what sorts of information would be helpful and of interest in terms of allowing better scrutiny of the scheme, and to what extent it might be practical and sensible to collect it. For example, we are exploring the scope for collecting some form of data that would allow us to better understand the cost the scheme is incurring suppliers to deliver, and to who and where the benefits are being delivered.

In addition, we are looking into ways in which Government might be able to help energy companies find eligible households, particularly for the affordable warmth target. This could be important in helping energy companies identify and treat particularly disadvantaged households in the most cost effective ways. The Energy Bill also includes provision for referrals to be made, in certain very specific circumstances, which the energy companies would be required to follow up in some way (‘mandated’ referrals); but whether and if so how this power would be exercised will need to be consulted on and considered carefully .

2.6 Equity

As the delivery costs of ECO are assumed to be recovered by the energy companies through increases in consumer bills and therefore spread across all households, it is important for the credibility of the scheme to ensure that all households have fair access to the benefits, safeguarding distributional equity. In addition to providing for affordable warmth, this includes considering how the benefits of support for solid wall insulation can be delivered equitably. We are looking into learning the lessons from CERT, particularly the Super Priority Group, in designing the scheme to provide confidence that the poorest and most vulnerable, for whom there can be significant economic and social barriers to accessing support, stand to benefit equitably. This could be delivered by providing a ‘distributional safeguard’, essentially by setting a minimum proportion of the carbon target to be delivered in a defined group of households.

2.7 Next steps

More detailed issues around the scale of the ECO and its operation will be consulted on this autumn. At this stage, we would not want to preclude the possibility of the ECO delivering other energy saving measures. However, the focus set out in this document reflects our current view of the policy priorities.

Annex A

What is an energy company obligation?

Although the ECO will be a wholly new scheme, with a different scope and set of priorities to CERT and CESP, it does share the same basic underlying mechanic – that being to require energy companies to meet targets through actions to encourage energy efficiency. This Annex provides some context by setting out how the existing CERT scheme operates on the ground at present.

Using powers in existing and proposed new primary legislation[2], the Government can place a legal obligation on energy companies requiring them to promote measures which improve domestic energy efficiency, reduce emissions and reduce the cost to households of heating their homes. For example, CERT and CESP place a legal requirement on energy companies to reduce the overall amount of CO_2 emitted by householders. The Government sets an overall target, which is then apportioned to the main energy companies according to their market share. Companies meet their targets by promoting the uptake of energy saving solutions, such as insulation, to household consumers.
When these schemes are set up, the Government establishes a broad delivery framework that suppliers must adhere to when discharging their obligations, and may prescribe minimum levels of certain types of activity where a specific policy priority is identified – for example support targeted at the most vulnerable households for reasons of securing an equitable distribution of benefits across income groups. But beyond these rules, energy companies are free to decide how to achieve their targets. This flexibility affords suppliers the space needed to compete with each other in delivering targets at lowest cost, and so represents a key underlying principle of the obligation model.

Cost of delivery

The energy companies are responsible for meeting the full costs of delivering their obligations – no Government funding is involved. However, it is generally accepted that costs are passed on to consumer energy bills. As the costs of the scheme are assumed to be spread across all households it is important to minimise them as far as possible (weighed against the environmental and social ambitions and benefits).

Giving the energy companies freedom in how they deliver allows scope for competition between companies in discharging their obligations. Each company attempts to fulfil its obligation as cost-effectively as possible, thus harnessing the commercial pressures of competition to ensure the overall scheme and policy objectives are achieved with as few indirect costs to consumers as possible.

The main approach companies have followed tends to involve the use of subsidy to encourage up-take of the measures. The obligated companies often work with third parties – for example local installer companies or, in the case of loft insulation and appliances, the DIY retailers – to market and install measures.

[2] The three Acts underpinning CERT and CESP are:
Gas Act 1986: www.legislation.gov.uk/ukpga/1986/44
Electricity Act 1989: www.legislation.gov.uk/ukpga/1989/29/contents
Utilities Act 2000: www.legislation.gov.uk/ukpga/2000/27/contents

Delivery of the obligations is monitored and policed by the scheme administrator, a role currently undertaken by Ofgem (the Office of Gas and Electricity Markets). Ofgem is responsible for awarding companies with points towards their targets for each energy saving measure installed. Most measures receive a score based on the modelled real-world carbon savings they achieve. Under existing schemes there is a long list of allowable measures that suppliers can promote, but they will naturally gravitate towards the most cost-effective in terms of £ per tonne of carbon, which tends to be loft and cavity wall insulation and high-efficiency lights and appliances.

If, at the end of the obligation period, an energy company has failed to achieve its target, Ofgem has the power to fine the obligated energy company up to 10% of global turnover. To date companies have always met their obligations comfortably before the scheme closing date.

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