

Appendix 8.1: Social and environmental obligation thresholds

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Introduction

1. Some government policies to deliver social and environmental objectives are delivered through energy suppliers. These policies put certain obligations on suppliers, for instance, to require them to meet certain carbon reduction targets or deliver notional bill savings, with the assumption that they will recover the cost of doing so from customers through energy bills. The Six Large Energy Firms as well as six independent suppliers currently fully comply with these initiatives, with smaller suppliers below the participation threshold.
2. This appendix explores the effect of these participation thresholds on competition. We describe the design of the schemes and the participation thresholds available for smaller suppliers, the views that parties have expressed to us in the course of this investigation, and finally we set out a summary of our analysis.
3. This appendix focuses on the following three main participation thresholds:
 - (a) The Energy Company Obligation (ECO) scheme, a Department of Energy and Climate Change (DECC)-led initiative to improve Great Britain's (GB) energy efficiency, which forms part of the government's wider plan for reducing greenhouse gas emissions and tackling fuel poverty.¹

¹ [DECC final stage impact assessment](#).

- (b) The Feed-in Tariff (FIT) scheme, which is the government's main financial incentive to encourage the uptake of small-scale, low-carbon electricity generating technologies to support the transition to the low carbon economy.
 - (c) The Warm Home Discount (WHD) scheme, which requires participating domestic energy suppliers to provide support, primarily direct energy bill reductions, to those who are in or at risk of fuel poverty.
4. This appendix focuses mainly on ECO – as it is the single largest obligation cost, initially in excess of £1 billion per annum across the suppliers to which this obligation applies (although the estimated cost to suppliers fell to around £0.8bn per annum from 2014 – see the cost of ECO section below) – and to a lesser extent on the FIT and WHD schemes. The third phase of the ECO scheme (ECO3), announced in the 2015 Autumn Statement and due to start in 2017, is expected to lower the costs further.
 5. This appendix does not cover the impact of any other exemptions such as payment method exemptions for small suppliers or SMART metering exemptions.

Overview of the Energy Company Obligation and how it works

Scheme overview

6. ECO is a policy that sits alongside the Green Deal,² with the aim of providing eligible³ domestic customers with financial support to deliver energy efficiency measures, as part of a strategy for achieving the UK's carbon targets and reducing fuel poverty. The ECO scheme came into effect on 1 January 2013, replacing the Carbon Emissions Reduction Target (CERT) and Community Energy Savings Programme (CESP). It is delivered through certain energy suppliers, who are assumed to recover the costs across their entire domestic customer base.
7. One of the rationales for delivering ECO through the energy suppliers was that since suppliers bear the costs of complying with the ECO scheme and then pass them through to tariffs which face competitive constraints from other suppliers, they would have an incentive to minimise these costs and therefore to efficiently deliver the ECO scheme. This, in turn, should minimise the impact on price.⁴ This competition element is one of the reasons why

² Please see Appendix 2.1: Legal and regulatory framework for further information.

³ Eligible customers include home owners and tenants on a range of means-tested benefits.

⁴ [DECC final stage impact assessment](#).

delivery through energy suppliers was considered preferable to other methods.

8. The original ECO scheme placed three obligations on energy suppliers: a 20.9 MtCO₂ savings under carbon emissions reduction obligation (CERO), 6.8 MtCO₂ savings under the carbon saving community obligation⁵ (CSCO) and a £4.2 billion home heating cost reduction obligation⁶ (HHCRO). In July 2014 DECC published a consultation response titled *The Future of the Energy Company Obligation*⁷ that set out the future of the scheme to 2017, and included a number of changes to the original design, following the December 2013 Autumn Statement (See Annex B).
9. On the 25 November 2015 the Government announced a third phase of ECO in the Autumn Statement.⁸ The ECO briefing paper states that ‘the government is implementing a package of measures to reduce the projected cost of green policies on the average annual household energy bill by £30 from 2017. The bulk of these savings will come from reforms to the current Energy Company Obligation (ECO) scheme. This will be replaced from April 2017 with a new cheaper domestic energy efficiency supplier obligation which will run for 5 years’.⁹ The cost of ECO is therefore expected to fall further from 2017.
10. DECC introduced ECO to work alongside the Green Deal. The Green Deal was intended to provide a financing option for energy efficiency measures. ECO was intended to provide additional support for hard-to-treat homes, and vulnerable and fuel poor households, who were unlikely to be able to partly or fully fund measures using private finance (including Green Deal finance). In the 2012 final stage impact assessment report DECC stated ‘the combination of these policies enables a more market-focused approach to delivering these measures, where competition amongst Green Deal providers is likely to drive take-up beyond the levels expected under CERT or the option of no policies.’
11. The targets are divided between obligated suppliers according to how much gas and electricity they supply to their customers. The original targets were to be achieved by 31 March 2015 with the current scheme now extended to March 2017. DECC made changes to the scheme at the same time, for example reducing the size of one of the obligations and allowing the

⁵ At least 15%, or 1 MtCO₂, must be delivered to rural households – the Rural Safeguard.

⁶ HHCRO aims to provide insulation and heating measures in order to improve the ability of low-income and vulnerable households to heat their home at an affordable cost.

⁷ [The Future of the Energy Company Obligation, Government Response July 2014](#)

⁸ [BRIEFING PAPER, Number CBP 06814, 14 December 2015](#)

⁹ [BRIEFING PAPER, Number CBP 06814, 14 December 2015](#)

installation of lower cost measures, thereby reducing the annual cost on the largest energy suppliers.

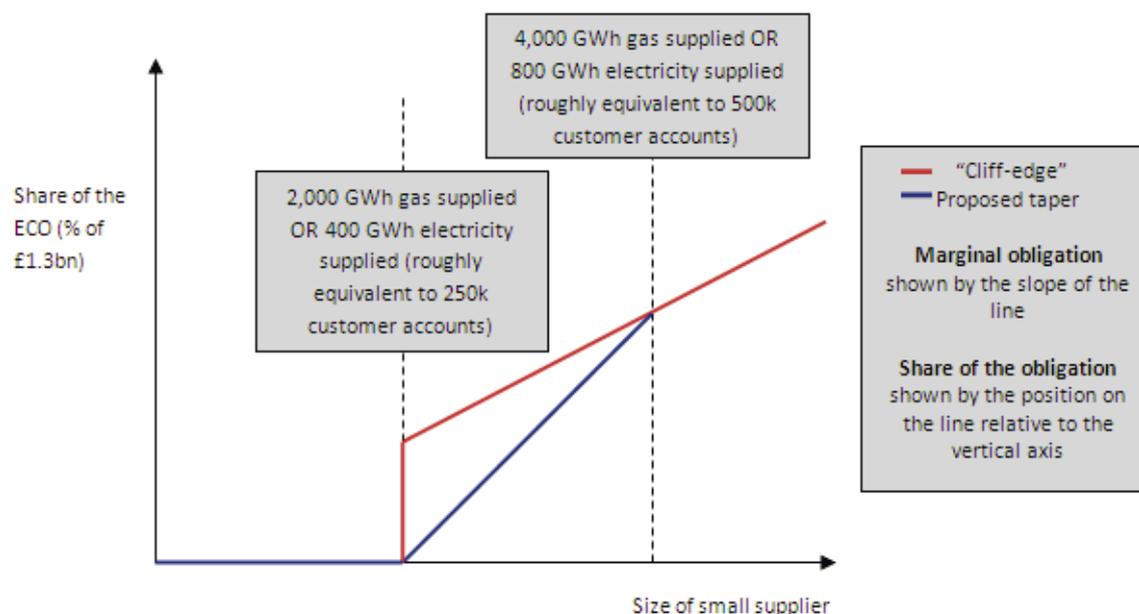
The obligation threshold

12. The obligation applies to all licensed gas and/or electricity suppliers that have 250,000 domestic customers or more, and supply more than 400 gigawatt hours of electricity or 2,000 gigawatt hours of gas to domestic customers, in any relevant year. Suppliers below this level of customer accounts are exempt from complying with the scheme. The rationale for a threshold was that both the Green Deal and the ECO scheme should facilitate entry of small firms as far as possible and not be a significant barrier to entry.
13. When a smaller supplier exceeds the threshold on 31 December of any given year, they are required to comply with the ECO scheme as of 1 April of the following year. To minimise the impact from entry into the scheme from disproportionate increased costs, a tapering effect is in place for suppliers passing through the threshold for the first time.
14. To reduce the impact on costs of a supplier reaching a 'cliff-edge' of 250,001 customer accounts, the tapering approach is as follows. DECC's impact assessment report explains that:

The tapering approach will involve a supplier receiving zero 'points' for their first 400 GWh of electricity supply or 2,000 GWh of gas supply, two 'points' for their second 400 GWh electricity or 2,000 GWh gas supply and one 'point' for all supply above 4,000 GWh of gas or 800 GWh electricity. The share of the obligation for each supplier will then be the proportion of 'points' they have.

Figure 45 in the DECC impact assessment illustrates the impact of this tapering approach against a simple proportional approach. This has been reproduced as Figure 1 below.

Figure 1: DECC 2012 impact assessment of the ECO scheme tapering approach



Source: [DECC final stage impact assessment](#).

The cost of the Energy Company Obligation

15. DECC's 2012 impact assessment¹⁰ estimated that the annual cost to suppliers of delivering ECO scheme would be about £1.3 billion per year. The first year of the scheme was 2013 and from the financial information provided to us, the out-turn cost was approximately £1.3 billion across all of the Six Large Energy Firms. In 2014 DECC published a revised impact assessment¹¹, estimating that that the cost to obligated suppliers would fall to around £0.8 billion per annum between 2014 and 2017, due to the changes to the scheme announced within the 2013 Autumn Statement.
16. In 2013 the total cost of the ECO scheme of around £1.3 billion spread amongst approximately 48 million domestic customer accounts, equated to a cost of around £27 per single fuel customer account.¹² These costs were fully avoided by suppliers with fewer than 250,000 customer accounts. First Utility and Ovo Energy have both passed the 500,000 threshold and as of April 2015:
 - (a) First Utility told us that it had no explicit plans to change its standard variable rate tariffs.

¹⁰ [DECC Final Stage Impact Assessment](#).

¹¹ DECC (October 2014), [The Future of the Energy Company Obligation: Final Impact Assessment](#).

¹² This cost is prior to the 2013 Autumn Statement changes to ECO, so the current cost being incurred by the suppliers will be lower.

(b) OVO Energy told us that it had no explicit plans to increase the prices of its variable tariffs,¹³ and that it had been pricing in the extra WHD and ECO costs ahead of crossing the threshold.

17. DECC monitors the cost of these schemes. For instance, it published in November 2014 the report *Estimated impacts of energy and climate change policies on energy prices and bills: 2014*. DECC's central scenario estimated that the gross average impact of the costs of the ECO scheme on average household energy bills in 2014 was £36 for a dual fuel customer (£15 on electricity and £21 on gas).¹⁴ (See Annex A for the 2014 DECC central scenario table.) This nets off to a smaller amount when efficiency savings on homes improved are taken into account.
18. DECC's estimated gross cost of £36 per household was based on an estimated bill, after the changes to the ECO announced in the December 2013 Autumn Statement. In explaining the difference between the £36 per household and the previous higher costs prior to the Autumn Statement, DECC stated:

The estimated annual average ECO cost before [the 2013 Autumn Statement] takes effect is around £1.4 billion for the original target period to 31 March 2015 (equivalent to around £59 per year on average on household bills). The relatively high estimated 2014 costs reflect the suppliers' trajectory towards compliance with the original targets where carbon target delivery run rates would need to ramp up from historic rates if the targets were to be met. Suppliers had delivered 39% and 28% of their CERO and CSCO obligations respectively (approved and notified measures) to the end of March 2014 which represents 56% of the original 2.25 year target obligation period. The costs reported between December 2013 and March 2014 will not be wholly indicative of the costs of complying with energy companies' original target, given that many of the companies will have additional 'free' compliance awarded towards their CERO target compliance, due to December 2013's pre-announced changes to the original ECO scheme. Therefore, their reported CERO costs in this period will relate to more carbon compliance than has been delivered.¹⁵

¹³ Both suppliers stated that they had no immediate plans based on the prevailing market conditions in April 2015.

¹⁴ DECC, *Estimated impacts of energy and climate change policies on energy prices and bills: 2014*.

¹⁵ Ibid, p26, footnote 31.

19. DECC estimated that the ECO scheme added an average of £36 on to dual fuel customers' bills in 2014. However, this figure did not reflect the energy efficiency savings delivered by the ECO scheme.¹⁶ DECC estimated that a household receiving a measure could save between £26 and £287 off its heating bill per year from installing insulation under the ECO scheme, depending on the measure installed. DECC also told us that the ECO scheme's costs were borne upfront whereas the benefits were realised over the longer term. For example, in 2030, the ECO scheme was estimated to lead to an average household bill saving of £34 (as measures installed under the ECO scheme in the past continued to save households money off their bills).
20. Data from 2015 suggests that the cost per customer per fuel has [redacted] for the Six Large Energy Firms. Centrica told us that this was due to a combination of improved efficiency in meeting the obligations, changes made to the obligation which came into effect in April 2014, and the timing of the delivery of the obligation. EDF Energy explained that the main reason for the year on year reduction was because delivery had been front loaded in the early years of the programme allowing it to reduce expenditure in 2015. In addition, 2015 was the first year following changes in the scheme rules that reduced the volume of the Carbon Emission Reduction Obligation as well as allowing cheaper measures. This reduced overall programme costs so again allowed for reduced spending in the final years of the programme. RWE told us that the decline was due to a combination of factors including, the changes to the scheme introduced in 2013, which were designed to reduce the cost of the programme, its [redacted], a significant decline in prices throughout the ECO programme (due in part to the change in rules and also [redacted]), as well as certain one-off factors.¹⁷

Overview of Feed-in tariffs and the Warm Home Discount

FITs and WHD overview

21. The FIT scheme, started in April 2010, encourages the uptake of small-scale, low carbon electricity generating technologies by households, communities and businesses through licensed electricity suppliers. It requires suppliers to make tariff payments on both generation and export of low carbon electricity.¹⁸

¹⁶ A positive NPV means that the cost of implementation is less than the savings achieved from the initiatives.

¹⁷ For example, towards the end of 2015, RWE had some large contracts that were delayed or failed to deliver, meaning that expected costs were not incurred during the year.

¹⁸ Ofgem, [Feed-in Tariff \(FIT\) scheme](#).

The tariff rates increase or decrease in line with inflation/deflation, but are also subject to degression, based on deployment levels over fixed periods.

22. This means that those households, communities and businesses that generate green electricity, for example from solar panels, are paid a fixed rate for every unit of electricity they produce. Any electricity generated but not used can be sold back to the grid, with the producer receiving an extra payment. The cost of this to the suppliers is recovered from their total customer base, in the same way as the ECO scheme. The FIT generator also benefits from the self-generated electricity consumed on site through savings on their electricity bill.
23. FIT licensees are required to take applicants through the registration process. They must be the main point of contact with accredited customers for the submission of meter readings and are responsible for making payments based on these readings. As part of issuing these payments, they are expected to check meter readings at least once every two years.
24. The WHD scheme was established in April 2011. The initiative requires domestic energy suppliers to provide direct and indirect support to fuel-poor customers.¹⁹ The scheme has recently been extended to March 2016.²⁰
25. Over the period of the scheme's operation, and for those suppliers that must comply with the WHD, the scheme has been divided into four different elements.²¹ These elements are a 'core group' comprising less well-off pensioners, identified with the help of the Department for Work and Pensions; a 'broader group' of customers identified as being at risk of fuel poverty, eligibility criteria set by the suppliers themselves; and 'industry initiatives' which enable suppliers to provide assistance beyond direct financial support. In addition, for the first two years of the scheme, a 'legacy spend element' was in place, which allowed participating suppliers to transition from previous arrangements linked to a voluntary agreement which existed prior to the introduction of WHD.

FITs and WHD thresholds

26. Licensed electricity suppliers with more than 250,000 domestic electricity customer accounts are required to become mandatory FIT licensees and to comply with the WHD (though for WHD, a dual fuel customer counts as two accounts). Unlike the ECO scheme, other licensed electricity suppliers may

¹⁹ Ofgem, [Warm Home Discount](#).

²⁰ Ofgem, [Response to Warm Home Discount: extension to 2015/16](#).

²¹ Ofgem, [Warm Home Discount](#).

elect to become voluntary FIT licensees (currently around 20) and suppliers can also voluntarily become WHD providers, as Co-operative Energy did.

27. Licensed Electricity Suppliers cannot offer FIT services unless they are confirmed to be a FIT licensee²². There is no tapering of FIT and WHD costs like the ECO obligations but FIT and WHD costs are significantly less than the cost of the ECO scheme.

The cost of FITs and WHD

28. The cost of FITs are increasing as more people install small-scale electricity generation in their homes. The cost of FITs to the Six Large Energy Firms was less than £100 million in 2011 which had increased to approximately £600 million by 2013²³. As a proportion of total social and environmental costs, this equated to around 6% in 2013.²⁴
29. The *WHD annual report: Scheme Year-3*,²⁵ published in March 2014, stated that suppliers more than exceeded their obligations, providing support totalling £291 million. First Utility and Utility Warehouse both joined the scheme for the first time in 2014 as they passed the customer account thresholds. The first iteration of the WHD scheme estimated that the total scheme costs over a four-year period would be over £1 billion.

Concerns raised in relation to policy and obligation costs

Concerns raised by the Six Large Energy Firms

30. The Six Large Energy Firms all expressed concerns around how the costs, associated with the ECO, FIT and WHD schemes affected their competitiveness against the smaller suppliers. There is a general consensus among the larger suppliers that these exemptions distort the markets. Some of the key messages provided by parties are set out below.

31. Centrica:

The structure of the GB regulatory regime imposes costs in an asymmetric way, such that larger (domestic) suppliers have obligations that smaller suppliers are spared and this affects costs. ECO, Feed-in Tariffs and the Warm Home Discount (WHD) all impose costs on our business that we are expected to pass on

²² However, they are obligated to participate in the 'levelisation' process.

²³ Per the financial accounts provided to us as part of our investigation

²⁴ Six Large Energy Firms combined 2013 average.

²⁵ Ofgem, [Warm Home Discount annual report: Scheme Year 3](#).

to our consumers. These costs are in the region of £70–80 on a dual fuel bill at standard consumption. Smaller suppliers are only required to comply with environmental and social regulations once they hold more than 250,000 accounts (and then on a tapered basis).

32. EDF Energy:

EDF Energy believed the total value of exemptions had reached up to around £60 per dual fuel account. This provided a significant cost advantage for smaller suppliers in the markets, but was also likely to provide a disincentive to grow beyond exemption thresholds, ie the marginal customer beyond 250,000 customer accounts represented a significant cost burden for suppliers who face meeting ECO obligation requirements for their whole customer base. While there has been strong growth in the retail supply markets, with some suppliers close to or exceeding the 500,000 account threshold it was likely the threshold would remain a disincentive for some. The four suppliers that have crossed the ECO and WHD thresholds would have incurred higher costs as a result of obligations, although they were also able to maintain or accelerate their growth. It was important that any regulatory intervention in the space of social and environmental obligations was cost reflective and did not afford any unintended competitive advantage.

33. RWE:

RWE estimated that the advantage from avoided costs for a small supplier was approximately £50–£60 per dual fuel account. The effect of this cost advantage could be clearly seen in the broker tables where the top (cheapest) positions were generally occupied by small suppliers. RWE's experience was that it simply could not compete at these price levels and this was impacting on RWE's ability to win back customers from small suppliers.

34. Scottish Power:

The main diseconomy of scale in the market at present results from the exemptions given to smaller suppliers in relation to government obligations such as ECO and the Warm Home Discount. We understand the original intention of these exemptions was to counter economies of scale issues for smaller suppliers in administering these programmes, but as

Scottish Power explained in a non-confidential letter to DECC, the level of exemption is far greater than that part of the administration costs that does not scale with the size of the obligation. The threshold of 250,000 customers for ECO and the Warm Home Discount is therefore a clear diseconomy of scale (in the sense that the incremental cost per customer increases significantly above the threshold) which is distorting the market.

35. SSE:

Given the scalability of costs, SSE considered that there are few diseconomies of scale just as there are relatively few economies of scale.

There would be a material increase in costs for suppliers once they exceed the 250,000 customer limit beyond which the small supplier exemptions from ECO and WHD are removed/tapered. SSE has estimated that these exemptions are worth in the region of £45 per customer for ECO and £12 per customer for WHD. A supply business operating below 250,000 customers would therefore benefit from costs per customer that are £57 (or c.5% of an average dual fuel bill) lower than would be the case absent the small supplier exemption. In the absence of material economies of scale, this provides a considerable cost advantage to smaller suppliers.

36. E.ON:

As the aggregate target carbon savings are fixed, and their incidence defined by the market share of obligated suppliers, the cost per customer (for obligated suppliers) would increase as more customers join smaller suppliers. [REDACTED].

The design of the ECO scheme was such that between 250,000 customers and roughly 500,000 customers (this upper boundary is actually defined by total power supplied, not customer numbers) a growing supplier incurs additional annualised costs of around [REDACTED]. This is based on E.ON's internal calculations that suggest that across all suppliers, annual ECO costs per customer are in the region [REDACTED] even after the recent revisions to the scheme.

37. In response to the provisional findings both E.ON and Centrica told us that, whilst they agreed that the cost for some smaller suppliers to fully comply with ECO would be high, they both believed that a full exemption over-compensated and was market distorting (See Annex C). They both argued that alternative solutions would be more appropriate than a full exemption.

E.ON told us that the scheme could be delivered through a 'secondary trading or a buy-out mechanism' and Centrica told us that 'delivery can be achieved through either brokerage or a white certification scheme'.

Concerns raised by smaller suppliers

38. We conducted interviews with a number of smaller independent suppliers to discuss their market entry and expansion experience. This can be found in the CMA's working paper on Retail barriers to entry and expansion.²⁶ Below we set out the key messages in relation to thresholds and policy costs from those interviews.
39. Some suppliers said that they slowed their rate of customer acquisitions to delay surpassing the obligation thresholds. This is because once a firm passes the threshold, it is obligated to comply with the obligations the following year.²⁷ Therefore some suppliers said that passing a threshold at the very end of a year was not desirable, so delayed customer acquisitions. Ovo Energy, Extraenergy and Ecotricity all mentioned having delayed their expansion plans because of the threshold. The length of time that suppliers suggested they might delay was not a significant length of time and therefore would only have a modest impact on the markets.
40. First Utility considered delaying by slowing down customer acquisitions but after due consideration decided that they should continue to acquire and pass the threshold without delay; similarly Co-operative Energy said that it had not delayed its expansion plans because of the threshold.
41. Co-operative Energy, prior to passing the 250,000 threshold, voluntarily set up a WHD scheme so that its customers did not miss out. It said that this indicated to it that the threshold was not a barrier to expansion.
42. Conversely to this, Utilita believed that the thresholds were a significant barrier to growth. The ECO counted towards a big proportion of its gross margin. In its view, applying the same ECO costs per customer to the small supplier as to the Six Large Energy Firms meant that it would account for a much bigger proportion of their costs. The non-domestic supplier, Haven, also thought that the thresholds presented a barrier to growth.
43. From a different perspective, Utility Warehouse, an independent supplier over the threshold, said that because the smaller suppliers avoided some of the

²⁶ See the CMA's working paper on [Retail barriers to entry and expansion](#).

²⁷ Compliance will commence in April of the following financial year of the firm.

obligations, they were able to offer a lower price compared with other suppliers. In its view this was unfair and inefficient.

Why was the threshold set at 250,000?

44. DECC conducted a consultation on the customer number thresholds for CERT, CESP, WHD and FIT. The responses to the consultation was published in June 2011.²⁸ The paper concluded that the threshold for the final year of CERT and CESP should be 250,000 customer accounts and that future programmes should include a tapering mechanism to reduce the 'cliff-edge' impact of reaching 250,001 customers. It concluded that the customer number threshold for the WHD scheme should also be set at 250,000 customers.
45. The rationale for the threshold was that the cost to the smaller suppliers associated with complying with the programmes represented a higher proportion of their overall costs than for larger suppliers, particularly as they were due to close the following year. The majority of respondents agreed with this, and that these disproportionately high costs would reduce competition as they could be a factor in deterring new businesses from entering the markets and that they reduced incentives on smaller market participants to grow.
46. DECC's original proposal was a threshold of 100,000 customers, 'founded on projections based on the growth rates that we had previously seen for new market entrants. These projections showed that it was unlikely that any small suppliers currently operating in the market would increase their customer numbers to 100,000 by 2013.'²⁹ Through the consultation, DECC received evidence that it would be necessary to raise the threshold to 250,000 customer accounts to exempt small suppliers from the final year of CERT and CESP and the new WHD obligation. The customer number threshold for becoming a mandatory FIT licensee was left at 50,000 customers, but was subsequently raised to 250,000 domestic electricity customers in August 2012 following a further review of FITs.
47. DECC believed that the threshold would bring significant benefits to smaller suppliers without imposing material costs on suppliers as a whole. Some respondents to the consultation suggested a one million threshold, which DECC dismissed as it believed it would have noticeably increased the costs

²⁸ DECC (June 2011), *Government response to the consultation on raising the threshold at which energy suppliers are required to participate in DECC environmental and social programmes.*

²⁹ *ibid*, p5.

for obligated incumbent suppliers. DECC decided on balance that a threshold of 250,000 customer accounts would be proportionate.

48. Some respondents to the consultation suggested that the threshold amounted to a subsidy from those customers with an incumbent supplier to those customers with a new supplier. DECC argued that from its analysis this was not economically significant. DECC also stated that it was not the government's intention to continue to increase the thresholds but to consider the ways in which future obligations, such as the ECO scheme, could be designed to minimise any disproportionate burden found by small suppliers.
49. In the final stage impact assessment DECC estimated the administration costs of ECO for the Six Large Energy Firms. The total cost across the Six Large Energy Firms was estimated to be £16.3 million, see Table 1 below. The estimate was split between the two carbon obligations and the affordable warmth obligation.

Table 1: DECC final stage impact assessment – ECO administrative costs to energy suppliers

<i>ECO administrative costs to energy suppliers</i>	<i>Cost (£)</i>
<i>Carbon obligations:</i>	
Monitoring/reporting set up costs	27,000
Familiarisation costs	16,000
Recurring administration costs	890,000
<i>Affordable warmth obligation:</i>	
Fixed costs	7.9m
Variable costs	7.4m
Total ECO administrative costs	16.3m

Source: [DECC final stage impact assessment](#), Table 17.

50. Taking the estimated fixed cost³⁰ of the warmth obligation of £7.9 million, across the Six Largest Energy Firms from the table above gives a cost of £1.3 million per supplier. Using the customer account numbers in Annex B, this would equate to approximately 9–26 pence per customer account for the Six Largest Energy Firms. For a smaller supplier with 250,000 customer accounts it would be £5.20 per account or £13.00 per account if the threshold were lowered to 100,000 customer accounts.
51. Looking at the carbon obligation costs, the DECC estimate of fixed costs – as seen in Table 1 above – is very low. The reason for this is that the Six Large Energy Firms delivered similar schemes prior to ECO so it was assumed that they would largely have the systems in place to deal with ECO without significant new investment in systems, infrastructure and people. This would not be the case for the smaller suppliers so it would not be unreasonable to

³⁰ Variable costs are incurred in relation to scale therefore are not considered to be an unfair burden on the smaller suppliers given DECC's low estimate

assume that the total fixed cost per account noted above would be higher still for the smaller suppliers.

52. The figures in Table 1 are from the original DECC impact assessment. Subsequently, DECC's 2014 ECO impact assessment reported that the administrative cost of ECO during its first year of operation (up to the end of December 2013) was around £80 million in total.³¹ The figure was based on quarterly returns from energy suppliers and the cost includes set up costs to administer the scheme, the cost of reporting and compliance, marketing costs, procurement costs, additional IT infrastructure, and all staff costs including specialist support, such as lawyers. The impact assessment also reported that there was no evidence that administrative costs were decreasing over time. Therefore, DECC told us that this suggested that it was difficult to make conclusions about the extent of one-off costs compared to ongoing administrative costs.

Our view

53. The government monitors progress on delivery and the cost of implementation of these schemes. Ofgem is responsible for enforcing compliance and publishes monthly ECO Compliance Reports and DECC monitors policy impacts on prices and bills. The latest DECC report entitled *Estimated Impacts of Energy and Climate Change Policies on Energy Prices and Bills*, was published in November 2014.
54. The government has already taken steps to reduce the burden on obligated suppliers. On 2 December 2013, the government announced plans to reduce the impact of complying with the ECO in its Autumn Statement. The ECO scheme was extended to 2017 to allow suppliers more time to meet their targets and changes made to the qualifying measures needed to meet primary targets. This decision should reduce the burden on obligated suppliers over the remaining life of the scheme.
55. The larger suppliers estimate the benefit of the ECO exemption as being around £45–£60 per dual fuel account. DECC estimated that this is lower, £36 for a dual fuel customer, taking into account the 2013 Autumn Statement changes. From a customer perspective the energy saving measures, DECC estimate the impact on prices to be even less. As set out in paragraph 20, the information we collected from the Six Large Energy Firms on the cost they had incurred in 2015 complying with their ECO obligations suggests that this has declined to around £20 to £25 per dual fuel customer, although the

³¹ [The Future of the Energy Company Obligation: Assessment of Impacts, March 2014.](#)

difference between these figures and the £36 DECC estimate may reflect the over-achievement of targets by the Six Large Energy Firms in earlier periods.

56. The WHD and FIT scheme costs are smaller than the cost of the ECO and some smaller suppliers have opted into delivering these schemes. We consider that these two schemes are not of significant concern in relation to cost exemptions.
57. We consider that the start-up costs and ongoing fixed costs associated with complying with the ECO, FITs, and WHD policy obligations would fall disproportionately on small and new market entrants if there were no thresholds. Therefore, it appears that some level of threshold is reasonable and unlikely to distort competition in the way that some firms argue. DECC introduced the threshold of 250,000 customer accounts, a threshold based on evidence it received in response to a public consultation. To minimise the impact of reaching the threshold, compliance is tapered up to 500,000 customers.
58. Without these exemptions, the cost of delivering any scheme would fall disproportionately on small suppliers and therefore make entry into the markets more difficult. Given the relative strength of firms above the exemptions thresholds compared with new entrants, due for instance to the existence of an established customer base and experience in dealing with regulatory requirements, the impact of the current exemptions are not likely to be significantly market distorting.
59. While we agree with the theoretical reasoning underlying the proposals set out by E.ON and Centrica, our analysis indicates that the current thresholds are not significantly market distorting in the present market conditions.
60. For example, we note that the Mid-tier Suppliers plus Utilita and ExtraEnergy are all now obligated and continue to grow rapidly. This indicates that the exemptions and tapering are not acting as a material barrier to expansion for these firms. Moreover, while there is a relatively large number of smaller suppliers which remain below the threshold, these firms account for a very small proportion of the market (less than 3% in Q1 2016)³². Therefore, we do not consider that the extent to which the exemptions push costs onto the customers of the Six Large Energy Firms to be material. Finally, we observe that to the extent that the exemptions for smaller suppliers confer a cost advantage, this is unlikely to outweigh the (broader) cost disadvantages faced by smaller suppliers due to their smaller scale. For example, the analysis that we carried out in Appendix 10.1 on the cost bases of First Utility and Ovo suggests that the impact of lower social and environmental costs is broadly

³² Cornwall Energy

matched by the impact of relatively high levels of customer acquisition and overhead costs. As a result, we consider that these exemptions do not create a net distortion of competition between energy suppliers.

61. As noted, going forward the Government has announced a third ECO phase due to start April 2017. It is planned that this will be a new cheaper domestic energy efficiency obligation and will be subject to consultation prior to implementation.³³ This should mitigate further the concerns raised by energy suppliers.

³³ [The Energy Company Obligation, House of Commons Briefing Paper, December 2015.](#)

Annex A: DECC estimated average impact of energy and climate change policies

Table 1: Estimated average impact of energy and climate change policies on household energy bills

Real 2014	£		
	2014		
	Gas	Electricity	Dual fuel
1. Bill before policies (inc VAT)	832	627	1,459
2. Bill impact of energy efficiency savings (ex VAT)*	-76	-100	-176
Of which:			
Green Deal and ECO†	2	-8	-6
Smart meters	-0.4	-0.5	-1
Historic energy efficiency policies	-31	-36	-67
Products policy	14	-56	-41
Building regulations	-61	-	-61
Private rental sector regulations	-	-	-
3. Bill impact of price effects and rebates (ex VAT)§	30	59	89
Of which:			
ECO	21	15	36
Smart meters	2	1	3
Small-scale FITs	-	9	9
RO	-	36	36
CfDs	-	-	-
Capacity Market gross auction cost	-	-	-
EU ETS carbon cost	-	7	7
Carbon Price Floor carbon cost	-	16	16
Other wholesale price effects of policies	-	-5	-5
WHD support	7	6	13
4. WHD rebate	-	-13	-13
5. Government electricity rebate	-	-12	-12
6. VAT impact of policies (2 + 3 - 4 - 5) x 5%¶	-2	-1	-3
7. Estimated impact of policies, £ (2 + 3 + 6)	-49	-41	-90
Estimated impact of policies (7/1)	-6%	-7%	-6%
Bill after policies (1 + 7)	783	586	1,369
Of which:			
Wholesale energy costs	402 (51%)	235 (40%)	637 (46%)
Network costs	147 (19%)	139 (24%)	286 (21%)
Supplier costs and margins	167 (21%)	124 (21%)	291 (21%)
Energy and climate change policies	30 (4%)	59 (10%)	89 (7%)
VAT @ 5%	37 (5%)	29 (5%)	66 (5%)

Source: DECC, [Estimated impacts of energy and climate change policies on energy prices and bills: 2014](#). Supplementary tables.

Table 2: Estimated average impact of energy and climate change policies on household consumption

	MWh	
	2014	
	Gas	Electricity
1. Consumption before policies	16.6	4.5
2. Impact of energy efficiency policies	-1.6	-0.7
Estimated impact of policies	-10%	-17%
Of which:		
Green Deal and ECO	0.03	-0.1
Smart meters	0.0	0.0
Historic energy efficiency policies	-0.7	-0.3
Products policy	0.3	-0.4
Building regulations	-1.3	-
Private rented sector regulations	-	-
3. Consumption after policies (1 + 2)	15.0	3.7

Source: DECC, [Estimated impacts of energy and climate change policies on energy prices and bills: 2014](#). Supplementary tables.

Table 3: Estimated average impact of energy and climate change policies on household energy prices

<i>Real 2014</i>	<i>£/MWh</i>	
	<i>2014</i>	
	<i>Gas</i>	<i>Electricity</i>
1. Price before policies	50	140
2. Price impact of policies	2	23
Of which:		
ECO	1	4
Smart meters	0.1	0.3
Small-scale FITs	-	2
RO	-	10
CfD	-	-
Capacity Market gross auction cost	-	-
EU ETS carbon cost	-	2
Carbon Price Floor carbon cost	-	4
Other wholesale price effects of policies	-	-1
WHD support cost	0.5	2
3. VAT impact of policies (2 x 5%)	0.1	1
4. Estimated impact of policies, £ (2 + 3)	2	24
Estimated impact of policies (4/1)	4%	17%
Price after policies (1 + 4)	52	164
Of which:		
Wholesale energy costs	27 (51%)	63 (38%)
Network costs	10 (19%)	37 (23%)
Supplier costs and margins	11 (21%)	33 (20%)
Energy and climate change policies	2 (4%)	23 (14%)
VAT @ 5%	2 (5%)	8 (5%)

Source: DECC, [Estimated impacts of energy and climate change policies on energy prices and bills: 2014](#). Supplementary tables.

Annex B: The Future of the Energy Company Obligation: Final Impact Assessment

1. In response to the performance and on-going review of ECO the Government launched ECO2 which came into effect in 2015. The final impact assessment for ECO2 sets out the rationale and full legislative changes to ECO1.³⁴
2. One of the key changes meant a significant reduction in the cost of ECO2 to obligated energy suppliers. ECO2 extended the majority of ECO1 targets to March 2017 allowing the cost of implementation to be spread over a longer period of time. A 33% reduction in CERO targets will also reduce the cost to the obligated energy suppliers.
3. Other scheme changes allowed suppliers to more fully realise the benefits of carry-forward over performance in cases where suppliers exceed their targets in any given year. There were also changes to qualifying measures so that more measures qualified under ECO2 rules such that now cavity wall and loft insulation count as qualifying measures.
4. For further detail please see the DECC Final Impact Assessment Report (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/373650/ECO_IA_with_SoS_e-sigf_v2.pdf).

³⁴ [The Future of the Energy Company Obligation, Final Impact Assessment, October 2014.](#)

Annex C: The number of GB domestic customer accounts by the UK's largest energy suppliers

Domestic customer accounts – numbers at 31 January 2015

<i>Supplier</i>	<i>Total domestic customer accounts ('000)</i>
British Gas	[X]
EDF Energy	[X]
E.ON	[X]
First Utility	[X]
Ovo Energy	[X]
RWE	[X]
Scottish Power	[X]
SSE	[X]
Utility Warehouse	[X]
Other suppliers	[X]
Total	[X]

Source: Cornwall Energy

Annex D: Responses to provisional findings

1. Below we set out the responses to Appendix 7.1 of the provisional findings that was published on the 10 July 2015. Only two of the main parties responded to the paper published in the provisional findings.
2. E.ON told us that:
 - (a) “E.ON does not agree with the CMA that the current exemptions that small suppliers receive on certain social and environmental obligations do not give rise to an AEC due to distortion of competition. As we made clear in our Updated Issues Response, E.ON believes that there is a distortion as the exemption creates a clear cost disparity between smaller and larger suppliers and allows smaller suppliers to offer some of the lowest fixed price contracts in the market. This distorts competition in this part of the market to the detriment of those customers choosing to be with a larger supplier, including those less active customers of the larger suppliers who end up picking up the Energy Company Obligation (“ECO”) and Warm Homes Discount (“WHD”) costs for their more active fellow energy customers.”
 - (b) “E.ON recognises the potential impact of obligation costs on small suppliers, but strongly believes that altering the rules in the context of ECO to more easily allow for secondary trading or a buy-out mechanism would help ensure obligated parties could meet their obligations in a cost effective way. This would encourage the most efficient delivery operators to install more measures, whilst providing a low cost way for smaller suppliers to expand. This would allow for the removal of the exemption and hence avoid distorting the retail energy market.”
3. Centrica told us that:
 - (a) “Whilst we acknowledge that the majority of smaller suppliers agree that the policy exemptions are not creating a barrier to growth we think that the CMA is wrong to conclude that they are not distorting competition.
 - (b) For example, the CMA’s own analysis of the DECC impact assessment show that the Energy Company Obligation (ECO) results in a £36 cost advantage per customer for exempt suppliers. Whilst we believe the DECC figures are too low, even if they were correct, the benefit conferred would far exceed the administration costs per account for ECO the CMA has estimated for small suppliers. The current exemption therefore over-compensates smaller suppliers and thus distorts competition between

large and small suppliers. We believe that the CMA should reconsider its provisional finding on this matter.

- (c) In particular, we note that the diseconomies of scale small suppliers would experience with the delivery and administration of energy policies could be managed in a more proportionate way. For example, the cost of delivery could be moved to general taxation, or failing that, the scheme could be amended such so that delivery can be achieved through either brokerage or a white certification scheme. This would remove both the cost distortions of the current model and economies of scale benefit larger suppliers would gain in the absence of an exemption.”