Regulatory Policy Committee	**Opinion**	
Impact Assessment (IA)	Future of the Energy Obligation	
Lead Department/Agency	Department for Energy and Climate Change	
Stage	Final	
IA number	Not provided	
Origin	Domestic	
Expected date of implementation	April 2014 (SNR 7)	
Date submitted to RPC	15 May 2014	
RPC Opinion date and reference	31 July 2014	RPC14-DECC-2105
Departmental Assessment		
One-in, Two-out status	**IN**	
Estimate of the Equivalent Annual Net Cost to Business (EANCB)	**£661 million** (potential net impact of -£604 million on OITO account – explained below)	
RPC Overall Assessment	**GREEN**	

RPC comments

The IA is fit for purpose. The RPC is now in a position to validate the Department's estimated Equivalent Annual Net Cost to Business (EANCB). The Department has provided separately a spreadsheet containing the profile of costs and benefits over time, for both the policy proposal and the counterfactual.

However, the Department will need to amend its impact assessment to show the correct EANCB of £661 million, and not the potential net result on the OITO account. The introduction of the new ECO should be scored as an IN as it represents new regulation imposed on business.

The RPC is clear that the Department should not score this proposal on the Government's 'One-in, Two-out' account until it has satisfactorily resolved with the RPC the position of the original ECO in the account.

Background (extracts from IA)

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

"The rationale for intervention to amend the Energy Company Obligation (ECO) targets currently in legislation is to realise the government's commitment to reduce the pressure on domestic consumers' energy bills in the near term and to improve the operation of ECO in light of evidence on the operation of the scheme over its first year. Intervention to introduce targets for the period to 2017 is justified on the basis that ECO will continue to address market barriers associated with the uptake of energy efficiency measure and therefore continue to reduce Greenhouse Gas (GHG) emissions and help meet future Carbon Budgets. The targets will also contribute to distributional objectives."

What are the policy objectives and the intended effects?

"The overarching objective of the changes to the existing policy framework is to reduce the cost of ECO policies on domestic energy bills in the near term. The government will also provide longer term certainty to the energy efficiency market by introducing ECO targets in legislation for the two year period to the end of March 2017."

Comments on the robustness of the OITO assessment

The Government introduced the ECO on 1 January 2013. It was initially due to run until 31 March 2015. ECO requires energy companies to deliver carbon savings by achieving targets for specific measures that support three government objectives:

- reduce UK greenhouse gas emissions and contribute to carbon targets;
- maintain the security of UK energy supply; and
- tackle fuel poverty by addressing the key underlying drivers of low energy efficiency.

The measures include delivering 20.9 million tonnes of carbon dioxide ($MtCO_2$) lifetime savings by installing insulation measures in hard to treat households, i.e. housing where it is challenging to install insulation (the Carbon Emission Reduction Obligation); 6.8 $MtCO_2$ lifetime savings by installing a fuller range of insulation measures to households in low-income areas (the Carbon Saving Community Obligation); and £4.2 billion lifetime space and heating cost savings (i.e. savings over the lifetime of the installation) to low-income households (the Affordable Warmth obligation (AW)).

The Department's present impact assessment covers:

i. a number of changes to the ECO targets currently in legislation to 31 March 2015. The Department explains that the main change to the ECO is the reduction of the existing Carbon Emission Reduction Obligation (CERO) target by 33 per cent from April 2014; and

ii. new ECO targets at a reduced level for a further two-year period to 31 March 2017 (and includes a number of other changes commencing on 1 April 2015).

The revised carbon targets are presented in the table below:

	1 Jan 13 – 31 Mar 15	1 Apr 15 – 31 Mar 17
Carbon Emission Reduction Obligation (CERO)	20.9 $MtCO_2$ lifetime (14.0 $MtCO_2$ from 1 April 2014 under the new ECO)	12.4 $MtCO_2$ lifetime
Carbon Saving Community Obligation (CSCO)	6.8 $MtCO_2$ lifetime	6.0 $MtCO_2$ lifetime
Affordable Warmth (AW)	£4.2 billion lifetime savings	£3.7 billion lifetime savings

<u>Costs and Benefits of the Proposal</u>

- 1 April 2014 to 31 March 2015 – Relative to the counterfactual (which includes the original ECO), the new ECO involves a decrease in costs to energy suppliers during the period 1 April 2014 to 31 March 2015. This reflects reductions to the carbon targets and other changes that make it easier for suppliers to meet their targets. Costs to suppliers of the new ECO are estimated at £735 million.
- 1 April 2015 to 31 March 2017 –The estimated cost of ECO2 to suppliers is £1,697 million. All of this is additional to the counterfactual, where there is no ECO target in legislation after 31 March 2015.

Overall Impact – the gross cost to business over the full period 1 April 2014 to 31 March 2017 is therefore £2,432 million (£735 million plus £1,697 million).

The Better Regulation Framework Manual (BRFM) states that the expiry of a time limited measure that has been costly to business is treated as an OUT (paragraph 1.9.24, page 44 of the Better Regulation Framework Manual). Therefore, the expiry of the original ECO on 31 March 2015 would result in an OUT of value equivalent to the original cost of the measure. The RPC validated the original ECO with an estimated Equivalent Annual Net Cost to Business (EANCB) of £1,265 million (RPC10-DECC-0618(4) of 29 May 2012.

To calculate the impact of the new ECO on the 'One-in, Two-out' account, it is therefore necessary to use the gross cost to business (£2,432 million) rather than the net cost of the amended ECO as is used elsewhere in the IA. The £2,432 million gross cost to business of the new ECO, which is over the three financial years 2014-15 to 2016-17, translates into an estimated EANCB of £661 million (2009 prices and 2010 base year). This is the 'IN' calculated by the Department for the new ECO (paragraph 164 and Table 17, page 41). The Department's estimate appears to be a reasonable assessment of the direct impact on business, and the RPC can therefore validate this figure.

Impact on the OITO account

The introduction of the new ECO should therefore be scored as an IN as it represents new regulation imposed on business. However, the impact on the OITO account of the new ECO is the difference between the OUT for the original ECO and the IN for the new ECO. The Department calculates the resulting change in the burden on business as a reduction of £604 million each year (£1,265 million minus £661 million). This appears to be a correct assessment of the net impact of this proposal on the OITO account and the RPC is therefore content with the figure.

Following a request from the Committee, the Department has provided further information that explains that there is no legal requirement for energy companies to pass on these (net) cost savings to consumers. The Department has, however, made it clear to the RPC that it expects energy suppliers to pass on the savings, and that all suppliers have committed to do so. The RPC's validation reflects the Better Regulation Framework Manual (BRFM), July 2013 (paragraph 1.9.44, page 46), which states that pass-through of business costs to consumers should be treated as indirect, and, therefore, excluded from the Department's assessment of the estimated EANCB of the BRFM).

The RPC is clear that the Department should not score this proposal on the Government's 'One-in, Two-out' account until it has satisfactorily resolved with the RPC the position of the original ECO in the account.

The RPC is aware, however, that the treatment of ECO in the Government's 'One-in, One-out' account still depends on the outcome of the Office of National Statistic's (ONS) consideration of whether ECO should be classified as a tax. If the ONS was to decide that ECO (and, by implication, the new ECO) is a tax, these policies would then, therefore, be out of scope of OITO and would not score in the Government's account.

Comments on the robustness of the Small & Micro Business Assessment (SaMBA)

Through extending the ECO policy for two years, the proposal increases the scope of regulation on business. Therefore, a SaMBA is required.

Overall, the SaMBA is sufficient. The IA explains that small energy suppliers are excluded from the obligation.

The IA states that ECO installers, many of which are smaller firms, are likely to be affected indirectly in a positive way. This assessment appears to be reasonable for the whole of the new ECO period. However, the IA could provide further assessment of indirect negative impacts on ECO installers during the first year of the new ECO (when the carbon targets are lower than under the counterfactual) and impacts on small businesses as consumers of energy.

Quality of the analysis and evidence presented in the IA

Presentation of additional information on costs and benefits. Upon request by the RPC, the Department provided separately a spreadsheet containing the profile of costs and benefits over time, for both the policy proposal and the counterfactual. The IA would benefit from the inclusion of a summary of this information before publication.

Additional explanation of Business NPV and EANCB. Pages 1 and 2 of the IA need to be corrected before publication to show the correct EANCB of £661 million and not the potential net result on the OITO account. Also, the business NPV figure (page 1 of the IA) of £460 million is the net cost of the new ECO. It should, therefore, be presented as a negative figure.

Consultation stage IA. The IA makes several references to a consultation stage IA (e.g. paragraph 9, page 6). The Department did not submit a consultation stage IA to the RPC for scrutiny. Rather, it submitted the proposal for fast track confirmation on the basis that it is deregulatory. The RPC was not able to confirm the proposal for the fast-track, because the new ECO represents an increase in regulatory activity for the period after 31 March 2015, compared with the correct counterfactual of no ECO after this time. This final stage IA does use the correct counterfactual.

Signed **Michael Gibbons,** Chairman