

The Electricity and Gas (Energy Company Obligation) Order 2018

Department for Business, Energy and Industrial Strategy

RPC rating: fit for purpose

Description of the proposal

The Energy Company Obligation (ECO) places an obligation on larger energy suppliers to achieve both carbon and bill savings by promoting and installing energy efficiency measures into homes. The current phase of ECO (known as ECO2 transition or ECO2t) began in April 2017 and is due to end in September 2018. ECO2t comprises two obligations: the Carbon Emissions Reduction Obligation (CERO), which seeks to reduce lifetime carbon emissions through the deployment of (primarily) insulation measures, where they can be delivered most cost-effectively; and the Affordable Warmth (AW) Obligation, which looks to reduce lifetime notional heating costs in low-income and vulnerable households in, or at risk of, fuel poverty, through a mixture of insulation and efficient heating systems. Households in receipt of certain benefits can receive measures under AW. The eligible pool of households under ECO2t is currently around 4.7 million. Using the current scheme eligibility criteria, this is expected to decline by around 25 per cent, to 3.5m households by 2022, due to forecasted changes in eligible benefit caseloads.

ECO2t was designed to act as a transition between ECO2 (which ran between April 2015 and March 2017) and ECO3 (the subject of the present impact assessment), which is due to run between October 2018 and March 2022. Under the Department's proposal, CERO would end and supplier spending would be focussed on the AW obligation. It should be noted that ECO3 involves other changes, notably extending eligibility to households on disability benefits, and households in receipt of Child Benefit below an equalised income threshold of £25,500. This, along with removing the equalised income thresholds for Working and Child Tax Credits, and Universal Credit, is estimated to increase the size of the eligible pool of households to around 6.6 million.

Impacts of the proposal

Business

The ECO imposes obligations on energy suppliers over a certain size. This has meant from the start of the ECO, in January 2013, only the 'Big Six' energy suppliers were obligated. However, the number of energy suppliers has since grown to around 70 energy suppliers, of which around 16 (including the Big Six) are obligated under ECO. Following consultation, the Government is proposing a reduction in the threshold at which suppliers become obligated under ECO from 250,000 customer accounts to 200,000 from April 2019 and 150,000 from April 2020. This is expected to increase the number of obligated suppliers to around 27 and market coverage from around 94 per cent to around 99 per cent, i.e. back to about the same level as in 2013.

As announced in the 2015 spending review, ECO has a supplier spend envelope of £640 million per year, rising with inflation until March 2022. Under ECO2t, this was broken down into £165 million delivering CERO, £390 million delivering AW, and £85 million on administration. For ECO3, the breakdown is expected to be £585 million delivering AW and £55 million on administration. The lower administration costs assumption reflects the downward trend in reported supplier administration costs in delivering ECO (figure 3, page 26).

The Department estimates a business net present value (NPV) of -£2,072 million and a (rounded) equivalent annual net direct cost to business of £554 million (2014 price base year; 2015 present value base year). These figures are based on a four-year appraisal period, reflecting the 3.5-year duration of ECO3 and the fact that the costs are incurred by business during this period.

Wider impacts

The Department estimates an overall NPV of £718 million. This is calculated over a 46-year appraisal period, reflecting the lifetime of the energy efficiency measures expected to be installed (the IA refers to cavity wall and loft insulation) and their associated benefits to households. The figure reflects the benefits of the measures to households and reduced detriment to the environment. The main elements are energy savings from installed measures and non-traded carbon savings at £1,272 million and £622 million, respectively.

To reflect the positive distributional impacts of ECO on low income households, the Department has undertaken a further analysis by applying weights from the Treasury

Green Book to arrive at an equity-weighted NPV of £4,334 million. This is much higher than the figure in the consultation stage IA (around £2.8 billion), reflecting the new Green Book's greater weighting on low income households. The difference to the unadjusted NPV is mainly accounted for by £2,999 million additional utility to low income households from lower energy bills.

Quality of assessment

The Department has provided a detailed, clearly written and well-structured IA on a highly technical subject. The IA provides a clear explanation of the different cost and benefit elements, policy objectives and market failures. The consultation stage IA provided detailed monetised costs and benefits and set out the assumptions behind them. The Department has taken account of consultation feedback to update and improve their analysis. The Department sets out where consultees have provided new information and where this has led to assumptions being revised (table 1 on pages 16-17 and annex B). It has also provided a separate note on how it has engaged with stakeholders over and above the formal consultation. The main changes are:

- *Search costs.* A doubling of overall search (of households eligible for the scheme) costs assumptions, drawing on evidence from a supply chain survey.
- *Gas boiler and first-time central heating installation costs.* A sharp downward revision to cost assumptions, reflecting feedback from installers and obligated suppliers.
- *Contribution rates to solid wall insulation and gas boilers.* Lower market prices for solid wall insulation reflecting consultee feedback and the supply chain survey, resulting in higher contribution rates by households and public bodies.
- *Findability rates.* The assumed number of eligible properties that can be found has been increased for loft and cavity wall insulation, reflecting calibration to current market prices.

The increase in search costs is more than offset by the other changes, resulting in reduced overall costs to suppliers and an increase in the measures installed under ECO3 compared to that estimated in the consultation stage IA, from 1.0 million to 1.2 million.

Overall, the evidence base for the IA appears to have been strengthened significantly by the consultation.

The Department has responded positively to the comments made by the RPC at consultation. For example, it has: monetised costs to the administrator (Ofgem) and quantified the impact of local authority flexible eligibility (a voluntary element of ECO

that enables suppliers to work alongside participating local authorities); provided additional information on the AW modelling approach and the application of equity weights (reducing the need for the reader to cross-refer to the 2016 IA); and provided greater explanation and clarity, especially around how the EANDCB has been calculated and the treatment of economic rents. The Department also provides a useful detailed sensitivity analysis (pages 30-32).

Business impact target (BIT) score

In accordance with the framework treatment of measures in force for fewer than five years, the BIT score is the EANDCB multiplied by the lifetime of the measure, in this case 3.5 years.

Small and micro-business assessment (SaMBA)

The Department's SaMBA is sufficient. In particular, the Department provides a justification for the reduction in the customer account threshold noted above, describes the impacts of this change and sets out how these impacts will be mitigated. The Department's analysis suggests that no small or micro businesses are expected to be drawn into the scope of ECO. The IA also describes a proposed new tapering mechanism, which reduces the size of the obligation for suppliers when they first enter the scope of ECO. Using the latest available Ofgem data, BEIS estimates that under this proposal the 12 newly-obligated suppliers' combined share of the ECO3 obligation would be significantly lower than their market share (1 per cent compared to 5 per cent). The Department also notes that some small and micro businesses in the supply chain may indirectly benefit from supplier demand for their services.

The IA could be improved further by addressing the points below.

Comparison against other options considered in the consultation stage IA

Although not required by the better regulation framework at the final stage, the IA would be improved by providing at least a brief update of the comparison against the alternative options considered in the consultation stage IA. In particular, the application of the new Green Book weights would seem to make options 2 and 3 in the consultation stage IA (which have a tighter focus on low income households) more attractive on an equity-weighted NPV basis and the present IA would, therefore, benefit from further justification of the preference for option 1.

Monitoring and evaluation

Although it is clear from the IA that the Department is monitoring and evaluating each tranche of ECO and using this to inform the next scheme, the IA would benefit from including a section setting out explicitly how this will be undertaken for ECO3.

Pass-through of suppliers' costs to energy customers

The Department helpfully explains that the assumption that suppliers will recoup the costs they incur in meeting their obligation from their gas and electricity customers has been corroborated through discussions with obligated suppliers (footnote 133, page 38). The IA would benefit further from explaining how this is permitted within the broader regulatory regime operated by Ofgem. More generally, the IA would benefit from consideration of the impact of existing or forthcoming economic regulation of energy prices, in particular whether price caps, such as that relating to standard variable and default tariffs due to be introduced at the end of 2018, might prevent energy companies passing on some or all of the costs of the scheme (depending on whether they are allowed as part of the periodic review).

Clarity of explanation and presentation

The IA is generally clear, for what is a complex policy area, and contains detailed analysis supported by evidence. The IA would benefit, however, from providing an overall picture of the analytical framework and how all the different elements come together to deliver the final IA numbers. The IA would also benefit from some additional or clearer explanation in places, such as the rationale for revising the findability assumptions (e.g. pages 52-53).

The IA provides good explanatory information in footnotes (e.g. footnote 67 on the appraisal period; footnotes 82 and 83 on economic rents). The Department may wish to consider moving some of this explanation into the main text.

Where the Department refers to 'BEIS estimates or 'BEIS analysis' (e.g. paragraphs 7 and 27), the IA would benefit from discussing further the availability of any external information, such as from suppliers or independent experts.

The discussion and quantification of environmental impacts of the proposal within the IA is welcome. The IA could, however, benefit from a clear summary of impacts, which would make them more accessible for the reader.

Other issues

Competition impacts. The IA provides a brief assessment of the impacts of the proposal on competition (paragraphs 157-158). This includes that increased costs to newly-obligated suppliers could provide their customers with an incentive to switch to smaller suppliers. The IA would benefit from further discussion of potential impacts on competition, including whether low-income households expecting to benefit from ECO3 measures might be deterred from switching to smaller, non-obligated suppliers.

Possible role of landlord/tenancy inefficiency. Although low income households in rented accommodation may not have access to capital to improve energy efficiency, it will normally be the landlord's responsibility to repair/replace boilers etc. Landlords are more likely to have access to capital but there might be an agency problem in that landlords pay capital costs but not energy costs (unless reflected in rent payments). The IA would benefit from discussing this issue.

Disruption cost to householders. The IA would benefit from considering possible disruption costs to householder while ECO work is being undertaken.

Departmental assessment

Classification	Qualifying provision
Equivalent annual net direct cost to business (EANDCB)	£554.3 million (unrounded; 2014 price base year; 2015 present value base year).
Business net present value	£-2,072 million
Societal net present value	£718 million

RPC assessment

Classification	Qualifying provision
EANDCB – RPC validated	£554.3 million (unrounded; 2014 price base year; 2015 present value base year)
Business impact target score	£1,940 million (2014 price base year; 2015 present value base year)

	(Time-limited measure: EANDCB x 3.5 years)
Small and micro business assessment	Sufficient

Regulatory Policy Committee