

Energy Company Obligation

This discussion paper sets out Consumer Focus's 'asks' for the new energy company obligation (ECO). It also provides background information on the current supplier obligation, Carbon Emissions Reduction Target (CERT), the relationship between the new obligation and the Green Deal finance mechanism and a range of issues relating to the suitability of the obligation for tackling fuel poverty.

The Government has announced that it will introduce a new ECO as part of the Green Deal. This will take over from the existing CERT obligation on companies which finishes in December 2012. The Government has stated that the ECO will focus on providing energy efficiency measures to low income and vulnerable consumers and those living in 'hard to treat' properties. Given that the Government will use primary legislation to introduce the new ECO, there is potential for substantial reform of the existing CERT obligation.

Consumer Focus wants the design of the ECO to incorporate the following 'asks' in order to tackle fuel poverty and meet the needs of low income and vulnerable consumers:

The ECO and fuel poverty: Consumer Focus 'asks'

Deliver UK Fuel Poverty Strategy targets

- The ECO should explicitly reduce fuel poverty and fuel poverty severity through energy efficiency measures, as well as reduce carbon. The Government should set out the contribution it expects from ECO towards reducing fuel poverty and meeting the UK Fuel Poverty Strategy targets
- The Government should also set out the contribution towards fuel poverty reduction it expects from publicly-funded grant programmes (possibly using an 'assisted Green Deal' finance mechanism), social housing programmes and schemes that use FIT and RHI revenue streams
- The ECO should focus on low income and fuel poor consumers in recognition of the wider social and economic benefits of warmer, healthier homes. This will require ring-fencing a substantial proportion of ECO resources towards tackling fuel poverty
- The ECO should be subject to the same public scrutiny, quality checks and monitoring as that currently applicable to Warm Front

Using an integrated approach...

- Given the limited value of the Green Deal finance mechanism to the fuel poor, the Government should make sure fuel poor consumers are able to access an integrated programme that brings together the ECO, grants (or 'assisted Green Deal finance'), FIT and RHI etc
- The integrated programme should aim to improve the homes of low income consumers to a minimum standard of EPC B, or EPC C in the case of hard to treat homes, where practical
- The ECO should be delivered through an area-based approach, complemented by non-area specific programmes for priority consumers

- The UK Government should agree with the devolved Governments how best to integrate their energy efficiency grant and area programmes with the ECO

...and competition to deliver efficiencies

- The ECO should be opened up to competition. This should encourage equal access to ECO programmes between suppliers and other energy efficiency providers, eg ESCOs, local authorities, RSLs, Warm Zones, co-operatives and other local organisations. The creation of a 'central pot' which different providers bid into is a possible route for achieving this
- All Green Deal providers must identify and offer the alternative of ECO support to vulnerable consumers to ensure energy efficiency improvements are accessible to all consumers. The ECO must be built into business processes so that provision of support is seamless to the consumer

The ECO must be financed fairly

- Fuel company contributions to the ECO should be set at no less than the current CERT level. Fuel generators should also contribute, as with CESP
- ECO resources should not subsidise 'able to pay' consumers taking advantage of the Green Deal finance mechanism, other than those in hard to treat housing, since this will reduce its ability to tackle fuel poverty. The proportion of resources going to able to pay consumers in hard to treat homes must not undermine the 'ring-fenced' element for low income consumers
- Economies of scale are a mid to long-term prospect – Government should make additional resources available for Green Deal (ie the combined package of the finance mechanism and ECO) to overcome short term cost barriers. Potential sources of funds include Green Investment Bank, ETS auction proceeds, carbon floor price proceeds and European Investment Bank loans
- Policy should aim to limit the contribution of low income consumers towards the ECO through their energy bills. For example, the Government should investigate basing the ECO levy on consumption, rather than a fixed level that is the same for all consumers. The former approach is likely to be more progressive and sustainable, given that energy consumption generally increases with income

And fund only measures that cut energy bills and carbon emissions

- While it is important fuel companies offer benefit entitlement checks, social tariffs and other 'social' programmes to low income consumers, ECO resources should not be used to fund these. Nevertheless, it is important ECO programmes are integrated with social programmes
- The ECO should fully fund solid wall insulation (SWI) for low income consumers. A combined package of the Green Deal finance package and ECO should fund SWI for 'able to pay' consumers. The Green Investment Bank could play a useful role in this respect
- A combined package of ECO, FIT and RHI should be developed to enable the installation of micro-gen in the homes of low income and fuel poor households, with priority given to those off the gas network

For those most in need

- Given the difficulty of identifying fuel poor consumers, the ECO should use a combined proxy of benefit or tax credit status and poor housing to define eligibility, similar to the Scottish Government's Energy Assistance Package (benefit status plus EPC E, F and G rated properties)

- Some flexibility should be incorporated within the eligibility criteria for ECO to make sure that consumers obviously in need but outside the formal criteria receive help

Background

The Government has stated that it will “include powers in the forthcoming Energy Security and Green Economy bill to introduce a new obligation on energy companies from 2012, to take over beyond CERT”. This reinforces the 2007 Energy White Paper statement that the Government will continue some form of energy efficiency supplier obligation until 2020.

DECC’s 2010 ‘Annual Energy Statement’ states that ‘the new obligation will underpin the Green Deal and focus particularly on those householders (eg the poorest and most vulnerable) and those types of property (eg the hardest to heat) which cannot achieve financial savings without a measure of support’.

In a speech to the Economist Energy Summit, 10 June, Chris Huhne, Energy and Climate Change Secretary, stated, ‘Some people – such as the fuel-poor, and those in hard-to-heat homes lacking cavity walls – will need extra help because energy savings alone will not be enough. We intend to provide that help by refocusing the obligations on energy companies. Local authorities could also join with energy companies to reach those who live in houses that need it most. Insulation measures are often cheaper if implemented a street at a time.’

The Government has also stated that the new obligation will include targets on thermal efficiency, as well as carbon, and will encourage greater competition than currently exists under CERT. The Comprehensive Spending Review announced that Warm Front will continue but at a much reduced level until 2013. After this, the Green Deal and energy company obligation will become the main funding mechanism for tackling fuel poverty. It appears that the Government intends to end the public funding of energy efficiency measures for low income households (in England at least).

The above suggests that the Government intends the new energy company obligation to:

- focus on vulnerable consumers and those living in hard to treat homes
- encourage delivery of the obligation through area-based approaches (building on CESP)
- introduce mechanisms that will allow more companies to enter the energy efficiency market on an equal footing with energy companies
- replace Warm Front as the main programme for delivering energy efficiency measures into low income consumers’ homes.

Consumer Focus perspective

Consumer Focus has previously called for the following improvements to CERT:

- a higher priority group proportion than the current 40 per cent
- improved effectiveness at tackling fuel poverty
- measuring the impact of CERT on improving energy efficiency standards
- reduced control by fuel companies and more local control of delivery
- increased use of area-based approaches
- better integration with Warm Front
- more resources to hard to treat homes (which have lost out under CERT, despite consumers in such properties paying towards CERT and its predecessors)

The Government's outline proposals for the new energy company obligation appear to move towards some of these calls. However, we are very concerned about the cut to Warm Front and the potential ending of public funding of energy efficiency measures for low income consumers.

This will considerably undermine the Government's ability to meet its statutory fuel poverty target, its responsibility for meeting that target and the public scrutiny of fuel poverty programmes.

Challenges for the ECO

Much of the detail of the new obligation is still not clear, particularly its relationship with other energy efficiency programmes. The following outlines some of the uncertainties:

Level of resources

Will the Government set the new ECO at the same level as CERT? The notional cost of 'CERT plus' (which starts in April 2011) is £51pa per dual fuel consumer (DECC, CERT plus IA). The cost is notional because the Government assumes this level of expenditure is required to meet suppliers' carbon reduction targets. DECC's recent analysis of energy and climate change policies on energy prices and bills assumes ECO expenditure will stay at roughly the same level as CERT. However, this is based on the assumption that the coalition Government will continue many of the previous Government's programmes.

Supplier spend on CERT plus is estimated at £1.3 billion a year (calculated from DECC's CERT plus IA). However, once (able-to-pay) householder and social landlord contributions are taken into account, costs rise to £2.2 billion a year, plus a further £0.9 billion 'hidden costs' (eg re-decorating, time spent clearing) or a total cost of **£3.1 billion a year**. If the ECO entails expenditure at a similar level, it could make a substantial contribution towards tackling fuel poverty. The CERT IA does not disaggregate the combined householder and social landlord contribution of £0.9 billion. While social landlords may be expected to continue to add further value to the ECO, as with CERT, it is not reasonable to expect low income consumers to contribute towards the cost of measures.

Will electricity generators contribute to the new ECO, as is the case with the current CESP pilot? Generators are expected to contribute a notional £175 million (half of the total cost) over the three year CESP period. CESP is estimated to add around £3.10 a year to the average consumer bill (CESP IA)

Carbon or fuel poverty?

The Government intends to retain the primary purpose of ECO as a carbon reduction programme but improve its value to low income consumers by adding a thermal efficiency target. However, this is still very different to setting explicit fuel poverty targets, as is the case with Warm Front. Programmes designed to tackle fuel poverty result in different packages of measures than programmes designed to reduce carbon.

If the new ECO is going to make an effective contribution towards tackling fuel poverty and improve the energy efficiency standards of hard to treat homes, complementary targets to carbon saving are required, eg number of households taken out of fuel poverty, SAP or EPC improvement targets.

Priority group mechanism

Will the Government continue to use the priority group (PG) mechanism to ensure the ECO is equitable? Suppliers currently have to meet 40 per cent of their CERT target from PG consumers. This must increase if the ECO is to focus on tackling fuel poverty and the PG mechanism is retained.

The current PG consists of consumers in receipt of certain income and disability benefits, plus all pensioners over 70. There are 11.2 million households in the PG (43 per cent of all households in Britain). This reduces to 8.8 million households (34 per cent of all households), if pensioners not on benefits are excluded (CERT plus IA).

'CERT plus' specifies a new Super Priority Group (SPG) which will account for at least 15 per cent of the suppliers' total target (this forms part of the 40 per cent target). The SPG consists of those eligible for Cold Weather Payments, plus families in receipt of Child Tax Credit below an income threshold (currently £16,190 a year). There are 5.6 million households in Britain in the SPG (21 per cent of all households) (CERT plus IA)

The Government may wish to introduce a new method of reaching consumers in need, particularly if the ECO is to play a key role in tackling fuel poverty. However, as there is no detailed information on the energy efficiency of homes, it is difficult to identify 'fuel poor' consumers since this requires information about both housing conditions and consumers' incomes. There are currently estimated to be around six million households in fuel poverty in Britain. This may increase with the impact of the recession, recent cuts to benefits and predicted increases in fuel prices. The last Government adopted a crude rule of thumb that fuel poverty programmes had to address twice as many households as the number in fuel poverty, if they were to reach all of the fuel poor (Government evidence to FOE/HtA judicial review). This would imply 12 million households.

The previous Government suggested that all social housing tenants should be defined as PG. CERT currently assumes 75 per cent of social housing tenants are PG, reflecting the high proportion of social housing tenants who claim benefits and are over 70 (CERT plus IA). The last Government also intended the ECO to help social housing providers achieve the proposed Warm Homes Standard (all social housing to be improved to at least SAP70 by 2020) (HEM).

4.5 million households live in social housing in Britain (17 per cent of all households) (analysis of England, Scotland and Wales house condition surveys). The last Government expected the social housing sector to play a key role in delivering measures suitable for hard to treat homes, particularly solid wall insulation (SWI) (HEM). This was expected to reduce costs of measures through economies of scale, so bringing benefits to all households. ECO funds were intended to help achieve this objective, although social housing providers were expected to also contribute a substantial element from their own funds.

Measures available under the new ECO and hard to treat homes

To what extent can the new ECO effectively help hard to treat homes? In England there are 6.6 million¹ homes built with solid walls (31 per cent of all homes), 2.8 million homes off the gas network (13 per cent), 1.5 million homes with no loft space (7 per cent) and 0.3 million high rise flats (2 per cent). In total, hard to treat homes represent 43 per cent of all homes in England (BRE, 2008).

¹ 7.6 million in Britain (29 per cent of all homes), of whom 3.1 million are currently in the CERT PG.

Because CERT is designed to deliver carbon savings cost effectively, CERT can only offer limited help to consumers living in hard to treat homes (although consumers still pay towards the costs of CERT). This is because measures suitable for such properties, eg solid wall insulation, oil boilers, heat pumps, are more expensive than measures suited to other property types, such as cavity wall insulation.

The Government currently estimates, for example, the average cost of external solid wall insulation at £13,000 and air source heat pumps at £6,000. This compares with £450 for cavity wall insulation and £2,700 for the replacement of G-rated gas CH boilers (CERT plus IA). Thus, for a given level of spend, a much smaller number of hard to treat homes can be improved than 'easy to treat' homes.

The current CERT extension programme is required to achieve at least 68 per cent of savings from insulation measures. Thus, insulation accounts for the bulk of CERT measures in the illustrative mix. However, the Government also assumes CERT will install significant levels of heating controls, boiler upgrades, heat pumps, fuel switching and solar thermal.

Even if the new ECO focuses on carbon rather than fuel poverty, it will still lead to a wider variety of installed measures than the Green Deal finance mechanism (which is currently expected to mainly focus on insulation). The inclusion of thermal efficiency targets within ECO will help increase the installation of heating systems, although there is considerable uncertainty about what effect this will have in practice.

Will the new ECO continue to fund microgen for SPG consumers, as is currently the case with CERT? (CERT will not fund microgen for non SPG consumers because the Government considers these consumers can take advantage of FIT and the forthcoming RHI). Could a Government-assured free solar PV service bring the benefits of free on-site electricity to these consumers, while covering the costs and risks of installation, maintenance and removal? (Note: the National Housing Federation hopes to secure a European Investment Bank loan which, in conjunction with FIT, will allow large scale installation of PV in housing association properties).

Interaction with other programmes

How will the ECO element of Green Deal interact with the Green Deal finance mechanism? If the finance mechanism requires extensive subsidy from the ECO to fund more expensive measures, this would mean less resources for tackling fuel poverty. Many commentators have highlighted the importance of low interest rates for ensuring the viability of the finance mechanism. The Green Investment Bank could play an important role in this respect.

If consumers in hard to treat homes are expected to contribute towards costs through the Green Deal finance mechanism but receive a subsidy from the ECO, what level of subsidy is required to make the finance mechanism viable? Will the level of subsidy vary according to whether the consumer is 'able to pay' or 'priority'? Or will it use an 'energy bills as proportion of income' mechanism, ie consumers do not pay more than 10 per cent of their income on their energy bill (covering both supply and Green Deal service charge)?

To what extent does the Coalition Government intend the ECO to focus on social tenants? This is important for the potential interaction with social housing providers' expenditure on energy efficiency (part of which may come from the Green Deal finance mechanism, if social housing providers become 'Green Deal providers'). The last government expected the ECO to play a central role in social housing providers' improvement programmes. This was seen as key to transforming the market for hard to treat measures, particularly solid wall insulation.

What contribution is expected from social housing providers towards ECO measures? Under CERT plus, social housing providers are expected to contribute around 50 per cent of the costs of measures. Social housing is also expected to account for a certain proportion of PG measures, eg 20 per cent of CWI jobs, 50 per cent of replacement G rated boilers (CERT plus IA).

Does the Government intend the ECO to become the main vehicle for delivering the energy efficiency element of its Fuel Poverty Strategy (FPS) or will it continue to provide funding for a grant-aid programme with both contributing to FPS targets? The Comprehensive Spending Review suggests that all public funding for energy efficiency measures will finish in 2013. Thus, for the first time in over 30 years there will be no publicly-funded energy efficiency programme in England.

If the Government does continue to fund energy efficiency grant programmes what form will this take and how will it interact with the Green Deal finance mechanism and the ECO? ACE is proposing an 'assisted finance scheme' in which the Government funds the Green Deal charge for low income consumers. Thus, unlike Warm Front, the Green Deal finance mechanism would allow the Government to spread the costs of measures over a 25 year period, rather than pay the full costs up-front.

How will the ECO interact with FIT and RHI (if the latter goes ahead)? If consumers are to receive 'whole house improvements' (preferably to bring them up to the standards of homes built today), improvement packages will need to take advantage of all support mechanisms. Ideally, improvement packages should start with the most cost effective energy efficiency measures first before renewable technologies are considered. However, there is a risk that FIT and RHI will create perverse incentives to prioritise microgeneration, unless there is a pre-requirement that homes are fully insulated first.

Will the ECO fund microgeneration for SPG consumers, as is the case for CERT plus? There are already some companies offering free solar PV to consumers in return for keeping FIT proceeds. However, it is not clear whether these companies will target low income communities (although Eaga has set up a scheme for social housing providers). There may be a case for using ECO, in conjunction with the FIT and proposed RHI, to facilitate the installation of renewable measures in the homes of low income consumers. This should allow more advantageous terms than the current FIT market offers.

Interaction with devolved Government programmes

The Welsh Assembly Government and Scottish Government currently intend to continue their existing publicly-funded grant aid programmes, although they are roughly a year behind England with respect to public spending reviews. Both of the devolved Government programmes are (or about to be in the case of Wales) fully integrated with CERT, unlike Warm Front². In effect, CERT pays for insulation measures in Scotland and Wales and public funds pay for more expensive heating and micro-gen measures (plus an anticipated input from FIT and RHI in Welsh Assembly Government's case).

The devolved Governments will presumably expect the new ECO to play a similar role with respect to underpinning their grant-aid programmes.

² Eaga carries out a certain amount of trading of Warm Front insulation measures with suppliers to help 'stretch' the Warm Front budget.

Delivery of ECO

The CERT mechanism puts energy companies in a powerful position with respect to delivering energy efficiency programmes. Suppliers are able to offer measures at a very cheap rate due to the subsidy from consumers. Suppliers have undoubtedly brought down the costs of a range of energy efficiency measures through bulk delivery, driving down contractors' prices and market transformation.

However, the CERT system has caused distortions such as over-reliance on CFLs, lack of geographic equity, delivery of only one improvement at a time (despite the cost of consumer contact), little impact on fuel poverty (despite the PG mechanism) and minimal offers to consumers in hard to treat homes (despite their contribution towards its costs).

The CESP pilot was heralded as a 'bridge to the future' (ie the new ECO). It has created incentives that are designed to encourage suppliers to offer multiple measures, use area-based approaches, involve local authorities, install more expensive measures (particularly solid wall insulation) and focus on consumers living in deprived areas.

It is not yet known whether the incentives have had the desired effect. At the time of CESP design, DECC officials admitted they had to take a 'finger in the air' approach in deciding the appropriate size of the incentive mechanisms. DECC also conceded that they were constrained by having to use secondary legislation to make a carbon-based supplier obligation mechanism deliver other Government objectives.

CESP should provide some useful lessons for the new ECO. However, given that primary legislation will determine the shape of the new ECO, there is potential to develop a substantially different mechanism to CERT and CESP. This would allow a more direct approach than the current carbon-based mechanism to achieving such policy objectives as area-based delivery, tackling fuel poverty, involving local authorities, integration with other programmes, whole house improvements, tackling hard to treat homes and reducing fuel company control. A managed fund, possibly using the Green Investment Bank, would make it easier to achieve these multiple objectives.

Summary

The following conclusions can be drawn from the above analysis.

There are likely to be a number of competing demands on ECO resources. These include:

- the large numbers of consumers in need, whether defined by PG, SPG or fuel poverty status, particularly given that these consumers cannot be expected to contribute towards costs
- the extensive problem of hard to treat homes in Britain and the substantial costs involved in improving such homes to a reasonable standard
- the possible priority given to social housing, although this may reduce if social housing providers can make substantial use of the Green Deal finance mechanism

The subsidy required from the ECO to make the Green Deal finance mechanism more viable for certain measures is potentially considerable, unless a mechanism is introduced to reduce the interest rates charged by the finance mechanism.

The interaction between the ECO, Green Deal finance mechanism, social housing programmes, public grants, FIT and RHI will need addressing if consumers are to be offered 'whole house' packages as an integrated whole.

The interaction between the ECO and Devolved Government programmes will need addressing – discussions to date have mainly focussed on English programmes.

The intention to make ECO the primary mechanism for tackling fuel poverty, replacing Warm Front, reduces public scrutiny of fuel poverty policy and the targeting of fuel poverty programmes. It also represents a dramatic shift away from the current emphasis of the supplier obligation on 'low hanging fruit' energy efficiency measures and 'easy to reach' consumers.

The introduction of primary legislation offers the opportunity to carry out a substantial re-design of the ECO, including the setting of key social policy priorities, as well as carbon reduction.

Consumer Focus considers the ECO can play a useful role in tackling fuel poverty but only in conjunction with other programmes. We have set out our proposals for the new obligation at the beginning of this paper.