EXPLANATORY MEMORANDUM TO

THE ELECTRICITY AND GAS (ENERGY COMPANY OBLIGATION) ORDER 2018

2018 No. XXXX

1. Introduction

1.1 This explanatory memorandum has been prepared by the Department for Business, Energy and Industrial Strategy and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 The Order places a home-heating cost reduction obligation on licensed gas and electricity suppliers that exceed domestic customer and gas or electricity supply thresholds set out in the Order and requires them to promote the installation of measures in Great Britain for reducing the cost to individuals of heating their homes. A supplier must achieve its obligation by 31st March 2022.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

Matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business (English Votes for English Laws)

3.2 The territorial application of this instrument includes Scotland.

4. Extent and Territorial Application

4.1 The territorial extent of this instrument is England and Wales and Scotland.

4.2 The territorial application of this instrument is Great Britain.

5. European Convention on Human Rights

5.1 The Minister of State for Energy and Clean Growth has made the following statement regarding Human Rights:

"In my view the provisions of the Electricity and Gas (Energy Company Obligation) Order 2018 are compatible with the Convention rights."

6. Legislative Context

6.1 The Order is made primarily in exercise of the powers conferred by sections 33BD of the Gas Act 1986, section 41B of the Electricity Act 1989 and section 103A of the Utilities Act 2000. Article 38 is made under section 2(2) of the European Communities Act 1972 and implements article 7(8) of Directive 2012/27/EU on energy efficiency in respect of this obligation scheme.

6.2 The Electricity and Gas (Energy Company Obligation) Order 2014 ("the 2014 Order") placed a home-heating cost reduction obligation, and other obligations, on certain gas

and electricity suppliers for the period from 1st April 2015 to 30th September 2018 (the "ECO2" scheme).

6.3 Many of the powers to make the scheme in relation to Scotland have been transferred to the Scottish Ministers by sections 59 and 60 of the Scotland Act 2016. These powers are exercisable by the Secretary of State with the agreement of the Scottish Ministers for the purpose of making orders to come into force not earlier than 1st October 2018. The Order will not be brought into force before that date.

6.4 The Order includes a reference to the Warm Home Discount Regulations 2011, on the basis of the amendments to be made by the Warm Home Discount (Miscellaneous Amendments) Regulations 2018, which have been laid in draft in Parliament for approval. The Order will not be made before those Regulations are brought into force.

7. Policy background

What is being done and why?

7.1 The principle objectives of the scheme are to: (i) help alleviate fuel poverty and meet fuel poverty targets; (ii) contribute to carbon reduction targets in the domestic sector (iii) reduce the costs of meeting the UK's renewable energy target through promoting more efficient energy use, and; (iv) encourage innovation in the industry.

7.2 Market failures and barriers are known to reduce the take up of cost-effective energy efficiency measures. As a result, without Government intervention, residential fuel poverty will not fall to the extent that is possible, with a corresponding reduction of impact on the objectives described above. The Order continues a policy which has been in place since January 2013, and which is designed to address the market failures and barriers which are preventing a greater demand for and delivery of cost-effective energy efficiency measures.

7.3 Between January 2013, when the first ECO scheme began, and April 2018, the most recent date for which data is available, over 2.3 million energy efficiency measures have been installed in approximately 1.8 million homes through the scheme, helping to reduce people's energy bills, making homes more energy efficient, saving carbon and making our energy system more resilient.

7.4 The 2015 Spending Review announced plans for an ECO scheme to run to 31st March 2022 at an estimated level of £640m per year in 2017 prices. The ECO2 scheme comes to an end on 30th September 2018. The principal effect of the Order is to introduce a new home-heating cost reduction obligation for the period up to 31st March 2022 (the "ECO3" scheme). This obligation is expressed in terms of outcomes not expenditure. The obligation is a notional lifetime bill savings target of £8.253bn to be achieved by 31st March 2022. In addition, the Order introduces a number of other policy changes compared with the ECO2 scheme.

7.5 The focus of the scheme is changed so that the whole scheme will be a home-heating cost reduction obligation aimed at low income, vulnerable and fuel poor households. This is intended to improve the targeting of households in or at risk of fuel poverty and least able to afford energy efficiency measures without financial support. It is intended that greater progress will be made towards the objectives of reducing fuel poverty in the residential sector of Great Britain while taking into account the costs of finding suitable eligible households, through increasing the number of households who are eligible for support under the home-heating cost reduction obligation.

7.6 The suite of means-tested benefits for determining eligibility of private tenure households under the home-heating cost reduction obligation in the ECO2 scheme is retained. However, eligibility is also extended to recipients of Child Benefit (subject to a specified income threshold) and certain disability and related disability benefits administered by the Department for Work and Pensions or by Veterans UK on behalf of the Ministry of Defence. This will increase the number of low income, vulnerable and fuel poor households eligible for support and will help those with higher heating needs and vulnerable to the effects of cold homes.

7.7 Income thresholds will no longer be an additional criterion for eligibility by means of Universal Credit and Tax Credits. This will serve to simplify eligibility with respect to these benefits.

7.8 In keeping with the Fuel Poverty Strategy for England, eligibility for certain measures will extend only to those social housing properties with an Energy Performance Certificate ('EPC') band rating of E, F or G. However, any measures to be delivered under the new innovation provisions of ECO3 (demonstration actions or innovation measures) can be installed in social housing properties with an EPC band rating of D, E, F or G.

7.9 The Order allows up to 25% of a supplier's obligation to be met through measures delivered under Local Authority Flexible Eligibility. This utilises local authorities' knowledge of their area and ability to identify households most vulnerable to the cold. An uplift will be provided for measures delivered under Flexible Eligibility to the lowest income households in F and G rated properties to help reduce fuel poverty for those living in the least energy efficient homes.

7.10 The Energy Efficiency (Private Rented Property) (England and Wales) Regulations 2015 prescribe, subject to exceptions, a minimum level of energy efficiency for private rented properties. Therefore, the use of ECO in certain circumstances will be restricted so that ECO measures are not obtained by landlords to meet their statutory requirements. Similar restrictions will apply in Scotland.

7.11 In order to ensure the targeting of fuel poor households in rural areas, and particularly those off the gas grid, a 15% rural sub-obligation is included within the scheme. This replaces and extends the 15% rural sub-obligation that existed under part of the ECO2 scheme.

7.12 The supplier obligation threshold will change over the duration of the scheme. The obligation threshold will be lowered to take into account changes in the market since the first ECO scheme. The 250,000 customer account threshold will be retained for the first phase of the scheme (but the supply threshold will be altered to 1,400 GWh of gas or 500 GWh of electricity per year). The customer threshold will then be reduced to 200,000 customer accounts (and 1,100 GWh of gas and 400 GWh of electricity per year) for the second phase of the scheme in April 2019 and further reduced to 150,000 customer accounts (and 700GWh of gas or 300GWh of electricity) for the third and fourth phases of the scheme. The phased approach will allow newly obligated suppliers to prepare to deliver their obligation.

7.13 Limits will be placed on replacements for broken heating systems or other heating measures in these premises, with exceptions. The limit is expected to be the equivalent of 35,000 replacements per year. The replacement of broken oil boilers is included within this limit. This will help low income rural households to replace broken oil boilers rather than having to rely on higher cost alternatives. Other than for

the replacement of broken heating systems within this limit, the installation of completely new oil boilers will not be allowed under the scheme. The installation or replacement of coal boilers will not be allowed under the scheme.

7.14 To encourage greater delivery of insulation and the delivery of multiple measures to households, an inefficient heating system can be upgraded, in certain circumstances, such as where it is delivered alongside certain insulation measures. Encouraging the insulation of homes is consistent with the need to focus on measures that are more cost effective in tackling fuel poverty.

7.15 Measures which are accredited under the Renewable Heat Incentive (RHI) scheme will not be eligible under ECO3 unless they are a ground source heat pump. Where a ground source heat pump is accredited under the RHI, it will not be eligible under ECO3 if an obligated energy supplier has been assigned rights under the RHI scheme. This will prevent the double subsidy of most renewable heat measures with the exception made for ground source heat pumps due to their high up-front costs and very long-term benefits.

7.16 The Order allows the scheme to support innovative products. This has been introduced to encourage the industry to use new cost-effective technologies and more energy efficient fabrics to improve the energy efficiency of the GB housing stock. The innovation part of the scheme is capped at 10% of a supplier's obligation and is voluntary. The scheme has two innovation routes: Demonstration Actions and Innovation Measures. Demonstration Actions is designed to encourage suppliers to provide funding for field testing of a new product; the supplier will receive a score based upon their financial contribution (a score is the amount by which a measure contributes towards meeting a supplier's obligation and scores are attributed by Ofgem as the scheme administrator). Innovation Measures are designed to encourage new measures, that may have been delivered outside of ECO, to be introduced into the scheme by giving a 25% increase to the score. Both routes will be subject to an application process that will assess a range of matters.

7.17 The Order also introduces a Monitored Measure option. This allows suppliers to use, for example, monitoring technology to monitor precisely how measures already allowed under the scheme perform when installed into a property. If the measures installed are shown to perform better than the score normally attributed to them under ECO3, then the supplier will be able to count the additional demonstrated savings towards their obligation. This route is capped at 10% of a supplier's obligation.

7.18 The Order requires suppliers to deliver a minimum amount of savings to solid wall properties, such as through the installation of solid wall insulation. This is intended to provide certainty to that sector of industry. In addition, suppliers can use combinations of other measures to solid walled homes that deliver the same or higher savings as solid wall insulation to meet this requirement. This is designed to allow flexibility for alternative measures to be installed that could be more cost-effective or appropriate for the individual property and could support innovation. The minimum requirement for treating solid wall properties is reduced to approximately the equivalent of delivering solid wall insulation to 17,000 solid walled homes per year. This is intended to balance support for treating solid walled homes with ensuring the scheme delivers value for money.

7.19 The Order provides that over delivery against a supplier's obligation under the 2014 Order ("carry over") can be carried across into the new scheme, subject to certain

limits. This encourages suppliers to continue to deliver measures during ECO2 if and when they meet their obligations under ECO2. Delivery of coal-fuelled heating systems will not be permitted to be carried across. The Order also allows that measures completed on or after 1st October 2018 but before the Order is commenced, can count towards a supplier's obligation ("early delivery").

7.20 There is a high level of interest in the scheme from energy suppliers who deliver the scheme, fuel poverty groups and installers, and some interest in the scheme from the public.

8. European Union (Withdrawal) Act/Withdrawal of the United Kingdom from the European Union

8.1 This instrument does not relate to withdrawal from the European Union or trigger the statement requirements under the European Union (Withdrawal) Act.

9. Consolidation

9.1 None.

10. Consultation outcome

10.1 On 31st March 2018 the Department for Business, Energy and Industrial Strategy published a consultation on proposals for the ECO3 scheme. During the four-week public consultation period, the Department conducted three stakeholder events around the country to present the consultation proposals and gather initial feedback from attendees. A four week consultation period was considered appropriate as this will be the third ECO scheme, with changes but also with similarities to previous ECO schemes, and to enable publication of the Government Response before summer recess to provide clarity to obligated energy suppliers and the supply chain on the next ECO scheme. The consultation closed on 29th April 2018 and the department received 239 responses, including from energy suppliers, installers, manufacturers, managing agents and members of the public.

10.2 The majority of consultees broadly supported the proposals and the final policy decisions reflect this. A majority agreed that the scheme should be an entirely home-heating cost reduction scheme, and that innovation should be included. As such the outcome of the consultation is to implement the consultation proposals, but with some changes, in particular: a gradual reduction to the supplier threshold level, allowing oil boilers but only in limited circumstances, allowing ground source heat pumps to be eligible even if they receive the RHI, changes to eligibility and scoring rules for early delivery, extending innovation to social housing with EPC Band D and adjustments to the design of the solid wall minimum. A fuller description of the changes and a summary of the responses to these and other areas are included in the Government's consultation response which will be published on the gov.uk website.

10.3 As part of the consultation process the Department discussed its proposals with the devolved administrations in Scotland and Wales and subsequently received their formal responses.

11. Guidance

11.1 After this Order is laid, an updated version of the non-statutory guidance for obligated suppliers will be consulted on, and then published, by the Gas and Electricity Markets Authority ("the Administrator") in the autumn.

11.2 After this Order is laid, specific guidance for Local Authority Flexible Eligibility and the application process for Demonstration Actions, Innovation Measures and Monitored Measures will be published by BEIS and the Administrator in the autumn.

11.3 The guidance will be made available free of charge from the website of the Administrator.

12. Impact

12.1 The impact on business, charities or voluntary bodies is mainly that obligated energy suppliers will incur costs in meeting their obligations. They are expected to recoup their costs by passing them onto their domestic customers through their energy bills, although the energy bills of those households which receive measures will be reduced for the long-term from what they would be otherwise. The costs to obligated suppliers are estimated to be around £640m per year on average over the scheme to 2022 (the period covered by the Order), in 2017 prices, but the actual costs incurred by suppliers in meeting their obligations will depend on a range of factors, including: the cost of finding eligible households willing to install energy efficiency measures; the cost of installing energy efficiency measures into these homes; and, the level of co-funding suppliers can secure from local authorities, households and others.

12.2 There is no significant impact on the public sector. The Administrator will continue to be responsible for administration of ECO3, as it is for ECO2, and will produce updated guidance as noted in the preceding section.

12.3 The consultation stage impact assessment estimated that ECO3 would have a positive value to society of £722m (NPV, in 2017 prices), with nearly 1 million measures estimated to be installed into around 900,000 households (including around 240,000 fuel poor homes in England) between autumn 2018 and the end of the scheme in 2022. A Final Stage Impact Assessment will be published ahead of the Parliamentary debates on the Order, once assessed by the Regulatory Policy Committee.

13. Regulating small business

13.1 Analysis of currently available data suggests that the legislation will not apply to activities that are undertaken by small businesses. The supplier threshold means that small businesses (those with fewer than 50 full time employees) are likely to be exempt from obligations under this Order.

13.2 In order to minimise the impact of the requirements on suppliers just above the supplier threshold, the Order includes a taper mechanism for phase 1 of the scheme, which reduces the share of the obligation these suppliers receive. For later phases this is replaced by a supplier allowance which, for all suppliers, exempts electricity and gas supply up to the threshold amounts from the calculation of each supplier's share of the overall targets. This means that suppliers just above the supplier thresholds receive a proportionately smaller share of the overall targets.

14. Monitoring & review

14.1 The approach to monitoring of this legislation is through a requirement on the Administrator to submit monthly progress reports to the Secretary of State on suppliers' performance against the overall target. The Department also has regular engagement with the Administrator, obligated suppliers, supply chain, local authorities and others to understand progress on delivery and any delivery issues.

14.2 The regulation does not include a statutory review clause by virtue of section 28(3)(d) of the Small Business, Enterprise and Employment Act 2015, because the deadline for the Administrator to determine whether suppliers have met their obligation under the Order is 30th September 2022.

15. Contact

15.1 Stuart Chapman at the Department for Business, Energy and Industrial Strategy Telephone: 0300 068 5695 or email: stuart.chapman@beis.gov.uk can be contacted with any queries regarding the instrument.

15.2 Richard Mellish at the Department for Business, Energy and Industrial Strategy can confirm that this Explanatory Memorandum meets the required standard.

15.3 The Minister of State for Energy and Clean Growth at the Department for Business, Energy and Industrial Strategy can confirm that this Explanatory Memorandum meets the required standard.