EXPLANATORY MEMORANDUM TO

THE ELECTRICITY AND GAS (ENERGY COMPANY OBLIGATION) ORDER 2014

2014 No. 3219

1. This explanatory memorandum has been prepared by the Department of Energy and Climate Change and is laid before Parliament by Command of Her Majesty.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 The Electricity and Gas (Energy Company Obligation) Order 2014 ("the Order"), implements the Energy Company Obligation ("ECO") policy which places three distinct obligations on energy suppliers who have more than 250,000 domestic electricity and/or gas customers: a carbon emissions reduction obligation ("CERO"), a carbon saving community obligation ("CSCO") and a home heating cost reduction obligation ("HHCRO"). Each type of obligation requires a "supplier" as defined in the Order to promote the installation of qualifying measures in domestic premises in Great Britain. A supplier must achieve each of its obligations by 31 March 2017; these obligations must be met by installing qualifying measures which reduce carbon emissions or the cost of heating a home.

2.2 Suppliers are already subject to an ECO for the period 1 January 2013 to 31 March 2015, which is established by the Electricity and Gas (Energy Companies Obligation) Order 2012 ("the 2012 Order"). The 2012 Order has been amended by the Electricity and Gas (Energy Companies Obligation) (Amendment) Order 2014. In addition, on 22nd July, the Government laid in draft the Gas and Electricity (Energy Companies Obligation) (Amendment) (No. 2) Order 2014 (the "draft ECO1 Amendment Order"), which will make further amendments to the 2012 Order. The Order which is the subject of this Explanatory Memorandum provides for a new ECO obligation period from April 2015 to March 2017, with new targets for that period.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Legislative Context

4.1 This Order is to be made primarily in exercise of the powers conferred by sections 33BC and section 33BD of the Gas Act 1986, sections 41A and 41B of the Electricity Act 1989 and sections 103 and 103A of the Utilities Act 2000.

4.2 Article 33 of this Order will be made under section 2(2) of the European Communities Act 1972, and implements article 7(8) of Directive 2012/27/EU of the

European Parliament and of the Council on energy efficiency in respect of this supplier obligation scheme.

5. Territorial Extent and Application

5.1 This instrument applies to Great Britain.

6. European Convention on Human Rights

6.1 The Parliamentary Under Secretary of State for Energy and Climate Change has made the following statement regarding Human Rights:

In my view the provisions of the Electricity and Gas (Energy Company Obligation) Order 2014 are compatible with the Convention rights.

7. Policy background

7.1 Reducing carbon emissions from the residential sector in Great Britain will help the Government achieve the following objectives: (i) contribute towards reducing the UK's harmful greenhouse gas emissions; (ii) help improve energy security by reducing energy demand and therefore reducing the need to import energy; (iii) help tackle fuel poverty by reducing the cost of heating a home to a reasonable level; (iv) increase productivity (with the potential to boost growth and business competitiveness); (v) help the UK meet its carbon reduction and energy efficiency targets; and (vi) reduce the costs of meeting the UK's renewable energy target through promoting more efficient energy use.

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 carbon emissions 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. The extension of the scheme to 2017 provides continuity to a market which has had to adapt to significant change following the introduction of the 2012 Order.

7.3 The obligation is expressed in terms of energy efficiency outcomes (carbon tonnes saved, notional reductions on home heating costs), not expenditure. It is recognised that achieving these targets imposes costs on the obligated companies, who can be expected to pass those costs through to domestic consumers. The costs of the ECO policy will therefore be borne by households, though the energy bills of households which receive ECO measures will be reduced, from what they would otherwise be, on a sustainable basis. DECC in its Impact Assessment has estimated the costs as being around £800m per year on average during the period covered by this Order.

7.4 A set of proposals was announced in December 2013 with the overall intention of reducing the costs of the scheme, but without compromising on the level of ambition of those elements directed at the alleviation of fuel poverty; and of providing

longer-term certainty to the market by extending the scheme, with new targets, for a period of two years from the expiry of the current scheme. These proposals (along with a number of other suggestions designed generally to improve or simplify the operation of the scheme) were then set out in more detail in a public consultation document published on 5 March 2014.

7.5 As noted below, the Government's conclusions have now been set out in the consultation response published on 22 July 2014. A number of the changes adopted as a result of this consultation will be applied in respect of the first period of ECO (ending on 31 March 2015), and are provided for in the draft ECO1 Amendment Order. The Order that is the subject of this Explanatory Memorandum gives effect to those elements of the consultation outcome which are relevant to the second period of ECO (from 1 April 2015 to 31 March 2017).

7.6 In the light of the Government's initial proposals in December 2013, obligated energy companies made announcements to the effect that they would (if these proposals were implemented) expect their energy bills to consumers to be £30-35 lower than would have otherwise been the case. The Government believes that the final decisions now taken in the outcome of consultation should allow for energy bill reductions in line with, if not greater than, the levels anticipated in December 2013.

7.7 The principal effect of the Order is to introduce new ECO targets for the period 2015 -2017. In addition, the scheme introduces a number of other policy changes compared with the existing (2013-15) scheme, which are described in paragraphs 7.8 to 7.11.

7.8 This Order introduces an obligation on suppliers to deliver a minimum level of savings through the installation of solid wall insulation, in order to provide certainty to industry.

7.9 This Order provides that overachievement against the 2012 Order ("surplus actions") can be carried across into the 2015-17 ECO period. The rules governing carry forward are set out at article 27 of the draft Order. This encourages suppliers to continue delivering during the current phase of ECO if and when they meet their obligations. The Order also provides at article 11 that, if a supplier fails to meet its 2015 CERO target, the shortfall is multiplied by 1.1 and added to its CERO target for 2017. This provision has been included in light of Government's decision that the 2015 CERO target should not be enforceable – a change provided for in the draft ECO1 Amendment Order – to ensure that any under-delivery against that 2015 CERO target is more than compensated for in the future scheme.

7.10 Low income and vulnerable households will also directly benefit from the ECO as the policy requires energy companies to deliver energy efficiency and heating measures to these households, helping to tackle fuel poverty. The Home Heating Cost Reduction Obligation (HHCRO) requires energy suppliers to deliver measures to low income and vulnerable households in private tenure.

7.11 The Order simplifies the rules which obligated energy suppliers must apply to ensure that properties within HHCRO are private tenure. The Order includes scoring provisions at articles 19 to 23 which are designed to incentivise delivery of HHCRO

measures to non-gas households (which are more likely to be at risk of being in fuel poverty) and encourage a more balanced delivery mix (for example, more insulation measures alongside heating measures). The Order provides at article 29 that the score for HHCRO surplus actions is worked out by applying a "conversion factor" to the score the measure would have been given under the 2012 Order. This conversion factor is designed to ensure that scores for surplus actions are consistent with scores for measures installed under HHCRO in the 2015-17 obligation period. This approach will ensure that obligated suppliers can count measures delivered to date towards one of their ECO targets while providing certainty and continuity for the supply chain and, by extension, for recipient households. Finally, the Order requires installation warranties for all replacement boilers, to ensure adequate quality of installation of these measures.

- *Consolidation*

7.12 None.

8. Consultation outcome

8.1 On 5 March 2014 the Department of Energy and Climate Change launched a consultation on, amongst other things, proposals for the second phase of the ECO (1 April 2015 to 31 March 2017). The consultation sought views from across England, Scotland and Wales on a range of proposed changes to the ECO. The consultation proposals were published on the DECC website.

8.2 During the six week consultation period, DECC conducted seven stakeholder events around the country to present the consultation proposals and gather initial feedback from attendees. The consultation closed on 16 April 2014 and the Department received 266 responses from key stakeholders, including obligated energy suppliers.

8.3 The great majority of consultees firmly supported the proposal that there should be extension in the period of ECO, with new targets set, through to 2017, though those who opposed the lowering in ambition of some elements of ECO in the period up to 2015 tended to argue that the new targets for 2017 should be set at a higher level than the Government had proposed. The views of consultees are summarised in the Government's consultation response noted above.

8.4 In keeping with the intention of providing long term certainty to the market, Government largely concluded that the detailed rules relating to ECO in the period 2015-2017 should be in line with those now proposed for the period up to 2015, to ensure continuity. However, feedback from consultation was also used to inform a limited number of changes to ensure a better fit with the intended policy outcomes, in particular relating to the Home Heating Cost Reduction Obligation (HHCRO) element of ECO. These policy changes are noted in section 7 of this Explanatory Memorandum above.

9. Guidance

9.1 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 Administrator, Ofgem.

9.2 Copies of the published guidance will be circulated to all energy suppliers and other key stakeholders. The guidance will be available free of charge from the website of the Administrator.

10. Impact

10.1 The Impact Assessment covers all changes to the ECO set out in the Government Response published on 22nd July, both those which will be implemented by the draft ECO1 Amendment Order which was laid in Parliament on that date, and those which will be implemented by this Order, since the changes form a package and were consulted on together.

10.2 The Impact Assessment relating to this Order was initially published by the Department of Energy and Climate Change on 22 July. A revised version is published alongside this Order, following comments from the Regulatory Policy Committee (RPC). The changes made are presentational only and do not affect the appraisal of the policy. Specifically, the RPC agreed with DECC's assessment of the estimated costs to business under the revised ECO Regulations and that these were lower than would have been the case had the Regulations not been changed. However, the RPC wanted the Department to present the total estimated cost to business from the ECO Regulations, rather than the difference between the total estimated cost and the cost of the Regulations had they not been amended.

10.3 The Impact Assessment estimates the overall package of changes to ECO as having an overall positive impact on society of around £1bn (NPV), with around 1.9 million households likely to be supported with measures by the end of the scheme in 2017. It estimates the costs to the obligated suppliers of delivering their ECO targets to be around £800m per year on average over the remaining years of the scheme to 2017 (the period covered by the current Order), but notes that there remain uncertainties over cost estimates, cost profiles, and actual pass through to consumers.

10.4 There is no significant impact on the public sector, except that the Administrator, Ofgem (a public body), will continue to be responsible for administration of ECO over the new extended period from 2015 – 2017, as it is now, and will be required to produce new guidance as noted above in the preceding section.

11. Regulating small business

11.1 Energy suppliers with fewer than 250,000 customers will not be required to participate in the ECO. To minimise the impact on smaller suppliers who pass through the 250,000 customer account threshold, the size of an ECO will be tapered such that the size of the obligation on smaller companies increases gradually.

12. Monitoring and review

12.1 Monitoring of the ECO is being undertaken throughout the duration of the scheme. The Administrator submits monthly reports to the Secretary of State setting out the progress obligated energy suppliers are making towards meeting their obligations.

13. Contact

Tash Shotton and Catherine Birkbeck at the Department of Energy and Climate Change can answer any queries regarding the instrument.

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