EXPLANATORY MEMORANDUM TO THE

THE DRAFT ELECTRICITY AND GAS (ENERGY EFFICIENCY OBLIGATIONS) ORDER 2004

1. This explanatory memorandum has been prepared by the Department for Environment, Food and Rural Affairs and is laid before Parliament for approval of each House by Command of Her Majesty.

2. Description

2.1 The Electricity and Gas (Energy Efficiency Obligations) Order 2004 (the draft Order), if in force, would place an overall obligation on electricity and gas suppliers to meet targets for the promotion of improvements in domestic energy efficiency. It requires the Gas and Electricity Markets Authority (known as Ofgem) to determine individual targets for each supplier. Ofgem must also determine which energy efficiency measures suppliers can use to meet their targets and what improvements in energy efficiency should be attributed to them, and is also responsible for enforcement.

3. Matters of interest to the JCSI

3.1 The draft Order establishes energy efficiency obligations for certain electricity or gas suppliers for the period 1 April 2005 to 31 March 2008. These are the successors to the energy efficiency obligations established under the Electricity and Gas (Energy Efficiency Obligations) Order 2001 (S.I 2001/4011, as amended by S.I. 2003/1180) for the period 1 April 2002 to 31 March 2005. Some provisions of the 2001 Order continue in force after 31 March 2005 (see, for example, the reporting requirement in article 13).

3.2 Although it is made under the same powers as the 2001 Order and is intended to achieve broadly similar effects, the draft Order does not follow the drafting of the 2001 Order. The new approach is intended to make the draft Order more transparent and accessible to users.

4. Legislative background

4.1 The Order is made under powers in the Gas Act 1986, the Electricity Act 1989 and the Utilities Act 2000. The powers enable the Secretary of State to set an overall target for the promotion of improvements in energy efficiency and to impose an energy efficiency obligation on certain electricity and gas suppliers.

4.2 The powers were used for the first time when an energy efficiency obligation was imposed on electricity and gas suppliers by the Electricity and Gas (Energy Efficiency Obligations) Order 2001). That energy efficiency obligation was for the period 1 April 2002 to 31 March 2005. The draft Order imposes a new obligation on suppliers for the period 1 April 2005 to 31 March 2008.

4.3 Under the 2001 Order, suppliers are required to direct at least 50% of energy savings to those in receipt of at least one of the benefits or tax credits listed in the Schedule to the Order. That Order was amended by the Electricity and Gas (Energy Efficiency Obligations) (Amendment) Order 2003 which updated that list to reflect the introduction of new tax credits and state pension credit.

5. Extent

5.1 This instrument applies to Great Britain.

6. European Convention on Human Rights

6.1 Lord Whitty, Parliamentary Under Secretary of State at the Department for Environment, Food and Rural Affairs, has made the following statement regarding Human Rights:

In my view the provisions of the Electricity and Gas (Energy Efficiency Obligations) Order 2004 are compatible with the Convention rights.

7. Policy Background

7.1 The purpose of the energy efficiency obligation in promoting energy efficiency is to help electricity and gas consumers in the household sector to use energy more efficiently and in turn reduce their fuel costs or enjoy greater comfort.

7.2 In doing so, the primary aim is to make a significant contribution to the UK's legally binding target under the Kyoto protocol (once in force) to cut greenhouse gas emissions by 12.5% below 1990 levels by 2008-2012 and its domestic goal to cut emissions of carbon dioxide by 20% below 1990 levels by 2010. Energy efficiency measures are one of the key components of the Government's UK Climate Change Programme.

7.3 'Energy Efficiency – the Government's Plan for Action', published in April 2004, set out the aim to secure carbon savings in the household sector in the UK of around 4.2 million tonnes of carbon (MtC). Of this, the energy efficiency obligations imposed by the draft Order are expected to contribute about 0.7MtC by 2010.

7.4 In providing particular help to low-income consumers who spend a larger proportion of their income on energy, it is expected that the energy efficiency obligations will also contribute to the alleviation of fuel poverty.

7.5 The draft order includes incentives for energy service actions, which the Government considers to be an effective way to improve energy efficiency, and for innovative actions, such as micro CHP, to encourage the development of new energy efficient technologies. These incentives are intended to promote market transformation and raise customer awareness and are expected to increase energy savings in the longer term.

7.6 There has been extensive consultation on the energy efficiency obligations, both informal and formal. A brief summary of the responses to the statutory consultation is contained in the Regulatory Impact Assessment.

8. Impact

8.1 A Regulatory Impact Assessment is attached to this Memorandum.

9. Contact

Janet Miller
Sustainable Energy Policy Division
Department for Environment, Food and Rural Affairs
Tel: 020-7082 8710
e-mail: janet.miller@defra.gsi.gov.uk

FINAL REGULATORY IMPACT ASSESSMENT

DRAFT ELECTRICITY AND GAS (ENERGY EFFICIENCY OBLIGATIONS ORDER) 2004

INTRODUCTION

1. The Electricity Act 1989 and the Gas Act 1986, as amended by the Utilities Act 2000, contain powers for the Secretary of State, by Order, to impose an obligation on electricity and gas suppliers to achieve energy efficiency targets.

2. This final Regulatory Impact Assessment (RIA) considers the impact of a draft Order setting out the details of an energy efficiency obligation to be imposed by the Secretary of State for the period 1 April 2005 to 31 March 2008. The draft Order would set a total obligation of 130 terawatt hours (TWh) of fuel-standardised lifetime-discounted energy benefits. The fuel-standardisation is devised to ensure that the target units are directly related to the carbon emissions saved, irrespective of the fuel(s) concerned. Projected energy savings will be discounted over the lifetime of the measure at the standard Treasury discount rate of 3.5% a year. Suppliers would meet their targets by encouraging and assisting domestic consumers to take up energy saving measures.

3. The obligation will be known as the Energy Efficiency Commitment 2005-2008 (EEC 2005-2008) and will apply in England, Scotland and Wales. The draft Order includes a requirement on suppliers to achieve at least 50% of their energy savings from a Priority Group of low-income consumers.

4. These proposals have been appraised for their potential environmental, societal, and economic impacts.

PURPOSE AND INTENDED EFFECT

5. The purpose of the energy efficiency obligations in promoting energy efficiency is to help electricity and gas consumers in the household sector to use less energy. In doing so, the primary aim is to make a significant contribution to the UK's legally binding target under the Kyoto protocol (once in force) to cut greenhouse gas emissions by 12.5% below 1990 levels by 2008–2012 and its domestic goal to cut emissions of carbon dioxide by 20% below 1990 levels by 2010. Energy efficiency measures are one of the key components of the Government's UK Climate Change Programme.

6. The Energy White Paper "Our energy future – creating a low carbon economy", published in February 2003, set energy efficiency at the heart of UK energy policy, identifying improved energy efficiency as the most cost-effective way to meet all of our energy policy goals. By using less energy we can reduce carbon emissions, enhance the security of our energy supplies, improve the competitiveness of UK businesses and reduce fuel poverty. In the Energy White Paper the Government made a commitment to

"consult on an expansion of the EEC to run from 2005 to at least 2008, at possibly twice its current level of activity".

7. Energy Efficiency The Government's Plan for Action, published by Defra in April 2004, sets out the aim to secure carbon savings in the household sector in the UK of around 4.2 million tonnes of carbon (MtC). Of this, the **the EEC 2005 - 2008 is expected to contribute about 0.7MtC by 2010.**

8. In providing particular help to low-income consumers, who spend a larger proportion of their income on energy, it is expected that EEC will also contribute to the alleviation of fuel poverty. The Fuel Poverty Implementation Plan, to be published later this year, will set out how the Government intends to tackle fuel poverty.

RISK ASSESSMENT

9. Man-made emissions of carbon dioxide and other greenhouse gases are accumulating in the atmosphere and starting to change our climate. There is now strong scientific evidence that climate change is happening and that it is being accelerated by human activity – notably carbon dioxide released by burning fossil fuels such as coal, oil and gas. This is now acknowledged to have a serious impact including severe flooding, droughts and storms with high economic, human and environmental cost both nationally and internationally, particularly in developing countries.

10. Energy efficiency has a key role in meeting the Government's climate change targets by reducing emissions of carbon dioxide. The Government's Energy White Paper states that using less energy is the cheapest, cleanest and safest way of addressing its energy policy objectives. In order to achieve the Government's aims, as set out in the Energy White Paper, a doubling of energy efficiency improvements in all sectors is required. Extending the EEC from 2005 will make a significant contribution to the UK's legally binding target under the Kyoto protocol to cut greenhouse gas emissions by 12.5% below 1990 levels by 2008–2012 and its domestic goal to cut emissions of carbon dioxide by 20% below 1990 levels by 2010.

11. It is also recognised that the EEC can contribute to the Government's targets to alleviate fuel poverty. The Government currently estimates the number of households in the UK in fuel poverty at 3 million in 2001. Householders living in fuel poverty may suffer from cold-related illnesses, stress and anxiety. There is also a risk of fuel debt or householders forsaking other essential items to pay fuel bills. The Fuel Poverty Action Plan, to be published later this year, will set out how the Government intends to meet the target of eradicating fuel poverty in vulnerable households by 2010.

THE OPTIONS

12. There are a number of ways in which household energy efficiency can be improved. In the past various programmes have offered grants and subsidies, yet have distorted the market or were not generally regarded as the most cost-effective approach. The

Government is considering the feasibility of fiscal incentives or disincentives to encourage householder demand for energy efficiency measures. However, voluntary action by households has historically been limited due to a number of well-established barriers to investment in energy efficiency measures, particularly customer apathy. The EEC 2002-05 has demonstrated that the EEC mechanism is an effective way to stimulate the provision of household energy efficiency in terms of cost-effectively delivering a range of energy efficiency measures.

13. The EEC 2005-2008 is intended as a continuation of the current EEC that runs from April 2002 to March 2005, for which a RIA was completed in November 2001. The Energy White Paper stated that the Government would consult on an expansion of the EEC to run from 2005 to at least 2008, at possibly twice its current level of activity.

14. The options identified for the EEC 2005 to 2008 were:

Option 1 Implement the EEC from 2005 - 2008, as proposed in the Energy White Paper, at around twice its current level of activity.

Option 2 Implement the EEC from 2005 – 2008 continuing at the same level of activity as the current EEC.

Option 3 Do not extend the current EEC programme beyond 2005.

15. In order to achieve the Government's aims, as set out in the Energy White Paper, a doubling of energy efficiency improvements in all sectors is required. If the EEC were continued at the same level (option 2), or discontinued (option 3) the Government's aims would not be met and the risks set out above would not be mitigated. In addition there would be no new benefits to consumers.

16. If the Government does not increase the scale of the EEC obligation, as in Option 2, the benefits and costs would be roughly half that of Option 1. If the Government does nothing, as in Option 3, then it is highly unlikely that households or energy suppliers will take any significant actions to improve energy efficiency.

17. As a result the Government would find it increasingly difficult to achieve its goals for reducing carbon dioxide emissions and contributing to the alleviation of fuel poverty. To the extent that household energy efficiency measures cost-effectively reduce carbon emissions it reduces the burdens placed on UK industry in achieving the Government's overall objectives.

18. Table 1 below summarises the expected carbon savings and cost to consumers for each of the three options. The table also shows the expected resource expenditure over the three years and the energy cost savings by 2010 and 2020.

Table 1 The expected carbon savings and costs of each option

	Expected carbon saving	Expected cost to consumers, per fuel and per annum	Resource expenditure* for 3 year programme	Energy cost savings*		
				By 2010	By 2020	Over lifetime
Option 1	0.7 MtC	£9.00	£1,400M	£ 1,100M	£ 3,400M	£5,400M
Option 2	0.4 MtC	£4.50	£700M	£600M	£1,700M	£2,700M
Option 3	0 MtC	£0	£0	£0	£0	£0

* Note: resource expenditure and energy benefits are both net of comfort taking and business as usual deadweight.

19. The detailed analysis has focused on option 1, as set out in the Energy White Paper. Option 1 would extend the EEC from 2005 – 2008 at around twice its current level. This would secure total consumer savings of 130 TWh (fuel-standardised lifetime-discounted), in reduced energy use or greater comfort. It is expected that this level of obligation will contribute annual carbon savings of around 0.7MtC in 2010.This would make an important contribution to the 4.2 MtC of carbon savings from household sector by 2010 set out under the Government's Energy Efficiency Action Plan, and provide ongoing benefits to consumers. The detailed analysis, which has been carried out in relation to Option 1, can be found in Annex 1 to the Energy Efficiency Commitment from April 2005 – Consultation Proposals, published by Defra in May 2004.

BENEFITS AND COSTS

20. The costs and benefits of EEC options (particularly the level of the target) are established using an illustrative mix of possible measures representing a balanced selection of measures generally regarded as cost-effective. The data and assumptions underlying the illustrative mix are informed by information provided by energy suppliers, by representatives of the industries concerned, and by experts, including the Energy Saving Trust (EST) and the Building Research Establishment (BRE).

21. The analysis behind the illustrative mix takes account of a number of issues including:

- The likely **number of each possible measure** installed over the period 2005–2008. This has been assessed to take account of the current state of the housing stock, of other physical and market constraints, and of typical replacement cycles for boilers and appliances;
- Estimates of the **unit cost of each measure** are based upon the set of EEC 2002-2005 illustrative mix figures, allowing for 4 years' inflation at 2.5% to convert to 2004 prices. While real costs per measure have declined significantly over the successive Energy Efficiency Standards of Performance (EESoP) and EEC 2002-2005 schemes, it is recognised that from 2005 the costs for some measures, such as insulation, are likely to increase;

- The **supplier contribution** is the share of the direct cost of the measures that the supplier is likely to have to meet, in order to induce the householder to take up the offered EEC measure. This is based on the cost to the supplier and the final price that the consumer is prepared to pay. The difference is the supplier contribution, or inducement cost. The level of the subsidy or inducement cost will depend on the householder's willingness and ability to pay. For this reason, households on income or disability benefits are expected to require higher inducement than other households. A Priority Group of consumers has been identified, as defined later;
- In estimating the EEC carbon savings, it has been assumed that when suppliers offer a measure under the EEC, they will unavoidably pick up and meet the cost of assisting consumers who would have taken the measure in any event (**deadweight**), as well as stimulating additional take-up. Thus the energy and cost savings and the lifetime-discounted energy savings attributed to the EEC, count the energy savings benefits from all installations, including the Business As Usual deadweight. This avoids the otherwise intractable problem of allocating deadweight to supplier's activity when determining the energy savings they have achieved;
- Indicative estimates of **suppliers' costs of developing and administering the EEC 2005-2008** programmes additional to the inducement cost, are generally similar to those assumed for EEC 2002-2005, but also take account of suppliers' views, particularly for measures where marketing intensity will need to increase significantly. They are assessed for each measure individually, and on average, such costs are expected to make up around 21% of the suppliers' direct costs;
- **Energy improvement** is defined as the benefit to the household from an energy efficiency measure, either from lower bills, or from increased comfort (eg in terms of increased warmth);
- The **annual carbon saving** resulting from each installation has been calculated using the annual energy saving, minus the comfort taken, and the carbon intensity of the fuel saved (e.g. for condensing boilers this would be the carbon intensity of gas). The carbon intensities for each fuel are consistent with Defra's Environmental Reporting – Guidelines for Company Reporting on Greenhouse Gas Emissions. Since the EEC carbon saving contribution to the Climate Change Programme has to be estimated for 2010, the energy savings for each measure are also calculated for this year.

22. The **assumed lifetimes** for the measures in the illustrative mix are generally the same as those used in setting the EEC 2002-2005 targets and were estimated following discussions with the BRE and EST. Projected energy savings will be discounted over the lifetime of the measure at the standard Treasury discount rate of 3.5% a year, in setting the EEC 2005-2008 energy savings for a measure. Note that this tends to increase the savings relative to those for the current EEC for which a discount rate of 6% a year applies.

23. The analysis has taken account of concerns that the energy efficiency industry may be unable to meet suppliers' demands for extra activity. Views from the energy suppliers, the insulation manufacturers, and the insulation installers were considered, in addition to

independent reports on the insulation industry. Overall this risk is considered to be relatively low.

24. The analysis has also considered the possibility that the energy efficiency measures included in the illustrative mix may not perform as expected and do not deliver the proposed carbon impact. There is a risk that some of the measures do not deliver the full energy saving potential as determined, because of different behaviour/usage than assumed or because of physical underperformance. Continuing monitoring studies are eliminating or reducing this risk. Furthermore, some allowance for potential underperformance of insulation measures is implicitly included in "comfort taking" of 30%, as studies suggest that real comfort taking in the long term is less than that. So therefore the risk on carbon savings due to underperformance is considered low, but there is some risk that the benefits may be slightly overstated.

25. The Government recognises the importance of promoting stronger consumer demand in order to achieve the improvement in energy efficiency in the household sector set out in the Energy White Paper and required by the EEC 2005-08. It has, for example, recently given additional funding to the Energy Saving Trust to promote the EEC and will continue to look for ways to promote stronger consumer demand.

26. The carbon savings of 0.7MtC/yr in 2010 are estimated net of comfort taking (which is approximately a 25% reduction), and of business as usual activity (leading to a further 17% reduction). The carbon savings correspond to net annual delivered energy savings of around 10TWh/yr. Before corrections are taken for comfort and business as usual deadweight, the gross energy savings are around 17TWh/yr. The annual energy savings are the basis on which the energy cost benefits are calculated, using projected prices for 2010 for each fuel. On the other hand, the obligation target score is set in terms of gross lifetime-discounted energy savings, with relative carbon weightings for each of the different fuels. The lifetime of the energy efficiency measures must be taken into account when determining the lifetime energy savings, and are typically in the range of 10-40 years. When determining the energy savings to be attributed to the measures delivered under the EEC it is impractical to make corrections for comfort and deadweight. It is therefore important to realise that the "TWh" used for the EEC are not simply related to the annual energy savings or to the carbon savings but also depend on the mix of measures as well as the scaling factor used in the carbon weighting. For the illustrative mix as a whole, comfort and deadweight corrections would reduce the gross 130TWh obligation score to 80TWh net. Therefore, in the simplest of terms, the carbon saving of 0.7MtC corresponds to 80/130TWh, i.e. about 60% of the total energy savings.

<u>Environmental</u>

27. EEC 2005-2008 as proposed would benefit the **environment** by reducing carbon dioxide emissions by about 0.7MtC per year in 2010, helping to tackle climate change and improve local air quality. In addition reduced energy demand will reduce wider environmental impacts of energy extraction, production and supply. In contributing to the Government's climate change abatement programme, all consumers will share the

benefits such as cleaner air and the mitigation of carbon emissions from reduced energy production.
Considering the social cost of a tonne of carbon is possibly £35-£140, the carbon savings equate to additional benefits of about £24M-£95M per annum.

Social

28. EEC 2005-2008 as proposed would provide **social benefits** through reducing fuel bills and improving comfort, thus also contributing to the alleviation of fuel poverty and the risk of ill health caused by cold homes, particularly for children and the elderly. EEC activity raises the overall energy efficiency standards of the housing stock. EEC 2005-08 would also provide particular help to those on low-incomes by requiring 50% of energy savings to be focussed on a priority group of those in receipt of benefits and tax credits or pension credit.

29. If the costs of the EEC 2002-05 were passed on in full by suppliers, it is expected that the average energy bill would increase by no more than about £4 per customer per fuel each year of the programme (or about £7.2 p.a. per household, since not all households are gas customers) (in 2004 prices). Extending the EEC from 2005 – 2008 is likely to result in a potential additional cost of £5 per customer per fuel (or about £9 p.a. per household). The overall increase would therefore be an increase on average of not more than about £9 (in 2004 prices) per customer per fuel per annum (or about £16 p.a. per household) over the three years, compared to prices before the start of the EEC in 2002. In practice, the energy suppliers may absorb a part of the costs.

30. There is an offsetting benefit, in terms of lower energy consumption or improved comfort for consumers. The Government estimates that the average annual ongoing financial benefit under the 2005-2008 period, in lower energy bills or increased comfort, would be around £15 a year for the lifetime of the measures, which can be much longer than the three year period of the EEC.

31. The EEC does not dictate what measures suppliers must take in order to meet their obligations. The suppliers are operating in a competitive market and so will want to retain customers by keeping prices down.

Economic

32. EEC 2005-2008 as proposed would provide **economic benefits** in promoting innovation by creating market opportunities for new or more efficient technologies and improving security of energy supply by reducing demand in the domestic sector.

33. Costs for the current EEC were based on discussions with energy suppliers, the energy efficiency industry and the Energy Saving Trust taking into account evidence from the energy suppliers about the costs of past programmes and the costs of the Government's Warm Front programme. The costs for EEC 2005-08 have been similarly

estimated on the basis of discussions with suppliers of energy efficiency products and services, plus information about the costs of the EEC 2002 - 2005.

34. The costs given in this RIA are the total net resource costs, not just the subsidies expected to be given by suppliers through the EEC. In other words, some beneficiaries of the EEC programme are given a 100 per cent subsidy, whilst others part fund the product or service provided. All the monies spent by the suppliers, homeowners and landlords are counted, and then debited by the estimated business as usual investment in these energy savings measures during the EEC period. The corresponding savings are discounted at the 3.5 per cent Treasury rate.

35. The estimated ongoing annual energy savings to consumers, including comfort taking, would reach a total of around £390M in gross terms by the end of the EEC 2005 - 2008 period. This represents approximately £310M net of business as usual activity. It is estimated that the measures installed under the EEC 2005-2008 would provide an average annual ongoing gross financial benefit for consumers, in lower energy bills or increased comfort, of about £15 per household. These benefits will continue beyond the EEC period, for the lifetime of the measures. Under option 1, the gross benefit per household to priority group consumers would be higher than the average, at around £20 a year. Overall lifetime-discounted savings (net of business as usual improvements) are estimated to amount to a net present value of around £1,100M by 2010, £3,400M by 2020, and £5,400M over the lifetime of the measures. Comfort taking is estimated to account for around 25%.

36 The cost to the suppliers for the three years of the obligation under the EEC is estimated to be no more than about £9 per gas or electricity consumer bill per year, averaged over the three years. Energy suppliers may pass some or all of this cost through to their domestic customers. Passed on in full, it corresponds to an average energy price rise of around 3%, or just under 20p per week. The net resource cost over the EEC period (i.e. total cost of measures net of business as usual deadweight, plus implementation costs) is approximately £1,400M, of which implementation costs are estimated to make up around £200M, i.e. 15% of the total. Comparing this total with the savings benefits above, one finds that for 2020 the net present value of savings exceeds the resource cost by a factor of around 2 ½.

37. The above analysis of costs and benefits relates to the Government's illustrative mix of measures. Under the current EEC, the measures adopted by suppliers have been broadly in line with the illustrative mix for that programme. However, if suppliers were to adopt a different mix of measures, the outcomes in terms of costs and benefits could be slightly different, because of the differing cost/savings ratios of measures, and disparate prices of electricity and fossil fuels.

38. The proposed target is based on comprehensive analysis. If, in the event of unforeseen circumstances that significantly affected the Government's assumptions, it were necessary to reconsider the level of energy efficiency obligation, any amendment would be effected by a further statutory instrument, following consultation.

EQUITY AND FAIRNESS

39. The Government believes that all sectors must play their part in contributing to improving energy efficiency and reducing emissions of greenhouse gases to contribute to meeting our climate change target. Accordingly the UK Climate Change Programme sets out a package of policies and measures for all sectors of the economy. The EEC makes an important contribution to energy efficiency savings in the household sector.

40. Consideration has been given to how the Government can best achieve its climate change abatement objectives through the EEC whilst ensuring equity and fairness for consumers. Under the EEC the onus is upon the obligated suppliers to ensure that their targets are met as cost effectively as possible. It is likely that these costs will be passed on to consumers of electricity and gas through their bills. For those consumers receiving energy efficiency measures under the EEC, the savings may outweigh such an increase in bills. Some consumers may receive measures for free whereas others may receive subsidised measures.

41. Those on low incomes are most likely to be affected by any increase in energy bills since they spend a higher proportion of their income on electricity and gas. In recognition of this the draft Order would require suppliers to direct at least 50% of their energy-savings to a Priority Group of low-income consumers in receipt of certain income related benefits or tax credits. This will ensure that low income consumers receive a fair share of the benefits of the EEC.

42. The EEC Priority Group is defined as householders in receipt the following benefits or tax credits.

income support
housing benefit
council tax benefit
income based jobseekers allowance
attendance allowance
disability living allowance
disablement pension benefit (which must include constant attendance allowance)
war disablement pension (which must include the mobility supplement or constant attendance allowance)
child tax credit (where the consumer's relevant income is £14,600 or less)
working tax credit (where the consumer's relevant income is £14,600 or less)
state pension credit

43. There are a proportion of consumers who will have higher energy bills, but may not receive any corresponding energy efficiency improvements under the scheme. These are most likely to be owner occupiers in older houses, which do not have the potential for cavity wall insulation, or who may have already carried out all cost effective energy efficiency measures in their home. However, households only need to install two 20-

Watt Compact Fluorescent Lights (CFLs) in high usage fittings for the extra cost of the new EEC to be easily covered by the financial savings.

44. Manufacturers and suppliers of energy efficient products and services such as cavity wall insulation, efficient boilers, loft insulation, heating controls and draft proofing will obviously benefit from a growth in the size of these markets. It is not possible to know what changes in the pattern of production and consumption will result in other areas of the economy and hence who loses as a result of these gains.

Competition issues

45. Competition issues arise in two different markets – the market for energy supply and the market for energy efficiency services. EEC does not create any barriers to entry into the market for the supply of electricity or gas. However, it does raise the entry costs, as it is an obligation on suppliers, although these costs may be passed through to consumers.

46. Suppliers' individual energy efficiency targets are based on their customer numbers. So as not to deter new entry by small firms and to reflect the relatively higher costs incurred by smaller companies, the obligations are not imposed on firms supplying less than 50,000 customers.

47. Suppliers are allowed to pass on the costs of their obligations under the EEC. A supplier that is inefficient and pursues high-cost energy efficiency measures or that increases their prices simply in order to increase economic rent is likely to lose customers as they have the freedom to switch to another supplier.

48. Suppliers have an incentive to keep the costs of their obligations under the EEC as low as possible in order to minimise the amount of any pass through. This reflects the competitive supplier market and the will to retain customers. Suppliers therefore have an incentive to be competitive in the supply of energy efficiency products and services. Barriers to entry into the market for most energy efficient products and services are relatively low.

49. Whilst some suppliers may choose to undertake a large proportion of their obligations through in-house contractors, there is no reason to suppose this will reduce competition in the rest of the energy supply market.

50. It is possible that short run bottlenecks could develop in the supply of certain energy efficient products such as loft insulation or cavity wall insulation, given a rapid expansion in the market for these products. Any resulting price increases are likely to be short lived, given that new market entry is possible. The indication given in the EEC 2005-2008 consultation document and in Energy Efficiency The Government's Plan for Action (April 2004) that there will be an EEC from 2008 to 2011 could help induce new market entry.

Small Firms' Impact test

51. The proposals will not impose costs on small businesses. The draft Order does not apply to new and small energy suppliers with fewer than 50,000 customers. This means that new entrants would not have to set up EEC programmes while at an early stage. The draft Order contains other provisions that avoid the risk of creating barriers to new entrant companies: where a supplier prefers not to set up its own EEC programmes, then it may transfer all or part of its target to another supplier, purchase accredited performance from another supplier or contract out the operation of its programme.

52. When suppliers are setting up retail schemes, for example for energy efficient appliances or CFLs, small independent retailers may be disadvantaged, as it is easier for suppliers to set up schemes with large retailers or retail chains. To mitigate this effect, the Energy Saving Trust and Retailer Associations, e.g. through the Energy Efficiency Partnership for Homes, are promoting and working on setting up schemes specifically for small independent retailers.

Consultation

53. There has been extensive informal consultation since 2002 with the energy suppliers, energy efficiency industry, consumer groups and other interested parties on the EEC post 2005.

54. The consultation document that was published in May 2004 with a partial RIA, was the statutory consultation required by the Utilities Act. It sought comments on the proposed level of the overall obligation for EEC 2005 - 2008 and the format of the scheme. These detailed proposals, setting out the costs and benefits, had been discussed, inter alia, with a High Level Advisory Committee including Government Departments, Devolved Administrations, Ofgem, the Energy Saving Trust, representatives of the energy efficiency industry and the suppliers. The consultation document was sent to all those with an interest in the further development of the EEC.

55. There were 126 responses to the consultation. The majority of respondents were supportive of EEC and its proposed expansion. Following consultation, changes are recommended in two main areas covered by the order, as set out below. A brief summary of the key points raised in consultation responses in areas is at Annex A.

Determination of suppliers' targets

56. The consultation proposal was that the overall EEC obligation should be apportioned between suppliers in relation to the number of their domestic customers. In order to reflect the higher costs potentially incurred by smaller companies, it was proposed that the targets should be progressive, so that a smaller company would have a lower target in relation to its customer numbers than a larger company. This would be achieved by means of an adjustment factor applied to suppliers' targets to take account of such economies of scale. This proposal was strongly opposed by some energy suppliers,

largely on the grounds that the economies of scale did not exist, or that they did not apply to any but the smallest companies.

57. In view of the importance of this issue to suppliers, and the potential impact on their targets, the Government offered a further opportunity to comment to suppliers and to Ofgem, which is responsible for setting suppliers' individual targets. The Government sought views on the original proposal and on two alternative approaches. Firstly, an adjustment factor that was constant above a threshold of 500,000 customers per supplier per fuel, which means that above that level a supplier's target would be directly proportional to its customer numbers, but below that level would be progressive, as originally proposed. Secondly, to have no adjustment factor, so that all suppliers would have a target that was directly proportional to their customer numbers.

58. A number of suppliers made comments, some of which were confidential. There were differing views on the existence of economies of scale in respect of either large or small companies and on whether any threshold of customer numbers should be taken into account in determining supplier's targets. The Government has considered the matter further and takes the view that the argument for economies of scale is no longer valid for larger suppliers within the EEC. As a result, the Government proposes to remove the adjustment factor altogether. In order to avoid disadvantaging very small suppliers, and to reduce barriers to market entry, it also proposes to raise to 50,000, from the 15,000 originally proposed, the threshold of customers below which a supplier would not be subject to an EEC 2005-08 obligation. While this would affect the determination of suppliers' individual targets, it does not affect the overall obligation on all suppliers of 130 TWh.

Incentives for energy services and innovative action

59. Energy services: the consultation document invited views on a proposal that the incentive for energy services under the EEC 2002-05 should be maintained for the first year of the EEC 2005-08 period, in order to allow suppliers to offer energy services under similar conditions to an Ofgem pilot to test removal of the 28-day rule for domestic energy service contracts. Of the respondents that commented on this issue, the majority supported this proposal and of these a number suggested that the incentive should be extended to the whole of the EEC 2005-08 period.

60. The Government considers that energy services are potentially an effective way to improve energy efficiency in all sectors. It considers that it would be supportive for this market to apply an incentive for the full EEC 2005-08 period, but that the definition of energy services should be more consistent with that of the 28-day rule pilot. It therefore proposes that suppliers should be accredited with an additional 50% of energy savings for measures provided under an energy services agreement.

61. In order to encourage suppliers to set up energy services schemes on a larger scale, this incentive only applies if at least 5% of a supplier's target is met in this way (while the maximum remains at 10%).

62. Innovative action: while proposing to wait for the results of field trials on micro CHP and conclusions about fiscal incentives before making a decision about the appropriateness of an incentive for micro CHP, the consultation document invited views on this issue. About 40% of the respondents suggested that the EEC 2005-08 should include incentives for new technologies, including micro CHP. In the light of its wish to encourage new energy efficient technologies in the household sector, including micro CHP, and of the consultation responses, the Government proposes an incentive of 50% of energy savings for innovative measures, including micro CHP.

63. While take up of the above incentives by suppliers would reduce the overall energy benefits and carbon savings of the EEC 2005-08 programme, this should be outweighed by increased energy savings in the longer term. However, in order to limit the effect on the current programme, it is proposed that the above incentives should apply up to a maximum of 10% of suppliers' targets.

Implementation and enforcement

64. The Regulator, Ofgem, will be responsible for the operation of the EEC, including monitoring and enforcement. The draft Order provides for this. The procedures that suppliers will follow in order to achieve their energy efficiency targets are set out in Ofgem's Administration Procedures for the Energy Efficiency Commitment 2005-08. Ofgem published a consultation document on these procedures in July 2004. The final version of the Administration Procedures is expected to be published early in January 2005.

Monitoring and evaluation

65. Progress on the EEC 2005-08 will be reviewed in 2007 as part of the Government's consideration of the overall target for the EEC for 2008-11. Key monitoring information will come from Ofgem's annual reports to the Secretary of State, as proposed in the draft Order. In order to report to the Secretary of State, Ofgem has proposed that it will require quarterly progress reports from each supplier. A wider framework for monitoring of issues likely to affect EEC activity will also be developed.

SUMMARY

66. The draft Order proposes that the EEC for 2005-2008 be pursued with an overall obligation of 130 fuel-standardised lifetime-discounted TWh resulting in carbon savings of about 0.7MtC in 2010.

67. The EEC 2005-2008 as proposed will make a significant contribution to the Government's UK Climate Change Programme. It provides financial and welfare benefits for consumers, particularly those on low incomes, and works alongside other relevant Government policies, in improving domestic energy efficiency.

68. The proposed level of obligations should stimulate a significant increase in energy efficiency improvements without placing onerous costs on the energy supply companies – or the consumer. The EEC will continue to provide energy suppliers with the freedom and incentive to develop the most innovative and cost-effective programmes of energy efficiency measures.

69. The Government considers the option of EEC 2005-08 as proposed in option 1 is most likely to contribute effectively to energy efficiency in the domestic sector and to carbon abatement targets, at reasonable cost to suppliers and consumers and taking account of the practical capacity of the energy efficiency industry in the relevant period.

DECLARATION

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs

Signed by the Minister Responsible: **Lord Whitty**

Date: **4th November 2004**

Parliamentary Under Secretary of State, Department for Environment Food and Rural Affairs

Contact point:

Janet Miller
Defra
Ashdown House
123 Victoria Street
London, SW1E 6DE

Tel: 020 7082 8710
e-mail: Janet.Miller@defra.gsi.gov.uk

ANNEX

ENERGY EFFICIENCY COMMITMENT POST 2005 CONSULTATION SUMMARY OF KEY POINTS IN RESPONSES

Extension and expansion of the Energy Efficiency Commitment

About two-thirds of respondents supported the EEC and the proposed expansion. Seven stated that they did not fully welcome the proposals or had concerns about them, including: that the carbon savings were not higher in view of the increased level of activity; that EEC should instead be provided as funding for which LAs could bid.

Level of the overall energy efficiency target

The majority of respondents were supportive of the proposed size of the target for the next phase of the EEC. Over 50 respondents suggested that the proposed target for the next phase of the EEC should be increased. Energy suppliers considered the proposed target to be too high, and that it should be reduced to reflect market conditions. A number of suppliers expressed concerns about the capacity of the insulation industry to meet the increased demand that would be required by EEC. The insulation industry did not consider that there would be capacity constraints.

Social focus

The majority of respondents who commented on the issue supported the proposal that 50% of energy savings should be directed to the priority group of low-income consumers (those in receipt of benefits or tax credit/pension credit). Some suppliers considered a 50% priority group to be a challenge, and a level that should not be exceeded. Two respondents suggested that the priority group share of savings should more accurately reflect the balance of benefit recipients in the community, at a level of about 40%, and one that there should be an increase in the share to reflect the increase in the numbers on tax credit/pension credit.

The majority of respondents who commented agreed with the proposal that low-income recipients of Attendance Allowance and Disability Living Allowance should be included in the priority group.

EEC interaction with fuel poverty

There were a range of differing opinions about the contribution EEC could or should make to alleviation of fuel poverty. 18 respondents stated that the EEC should make an increased contribution to fuel poverty, while 8 stated that it should not. Some respondents were concerned that since the EEC mechanism could lead to increased costs being passed to customers, fuel poor households could in effect subsidise activity in non-fuel poor households. Some suggested that EEC should include fuel poverty targets and/or that the priority group should be focused on the fuel poor.

There was strong support for improved interaction between EEC and Government fuel poverty programmes. Some respondents wished to see more drive from Government to achieve this cost-effectively and some wished to see ground rules established.

Determination of energy suppliers' targets
Several respondents, mainly energy suppliers, contended that the size of a supplier's target should be directly proportional to the size of its customer base. One supplier considered that targets should be regressive, so that larger companies would have a lower target in proportion to their customer numbers.

Interaction with social landlords
A range of respondents, including some industry and local authority interests suggested that energy suppliers should not be credited with the total energy savings resulting from partnership schemes with a social landlord. This was in order to encourage suppliers to work in the private sector, where it was believed that more fuel poor were found. Others, including suppliers and some industry bodies and charities considered that contributions from social landlords should not reduce the energy savings credited to suppliers, continuing the arrangements of the current EEC.

Incentives for innovative technologies and other measures
About 40% of respondents suggested that the EEC should include incentives for new technologies/innovation including, for example, mCHP. About 13% of respondents suggested that incentives should only be included where there is assessment and evidence of energy saving performance and barriers to market entry or dissemination. They believed that products should only be supported under the EEC when they had passed the development stage and needed market support. One respondent suggested that development of a methodology by Ofgem, for inclusion of new technologies into the EEC, when they were ready, would be helpful. One suggested that it was unlikely that any new measures would be ready in time for inclusion in the next phase of the EEC. One respondent considered that evidence of significant carbon savings and cost-effectiveness was needed if the EEC were used to support innovation.

Three respondents suggested that there should be EEC incentives for early boiler replacements. Other respondents sought support for energy advice provision, maintenance, appliances, insulation materials, heating controls, Benefits Health Checks and hard to treat homes.

Energy Services Incentive
10 respondents proposed that the current incentive for energy services should be maintained, and most of these believed that this should be for the full three years of the next phase of the EEC. Three respondents suggested that the incentive should be removed.

Qualifying measures for the EEC
A number of respondents suggested that the EEC should include renewables as eligible measures, while 2 suggested that the supply of "green" energy should not be covered by

an EEC obligation. Other respondents sought inclusion of measures such as energy advice provision, domestic windows, solid wall insulation, hard to treat homes and one suggested that consideration should be given to the accessibility of the EEC to small independent retailers.

Monitoring/review of the EEC
A number of respondents suggested that the performance of EEC measures and the actual costs to suppliers should be kept under independent review. Some suppliers proposed the establishment of a High Level Group of stakeholders with the power to intervene if markets, costs or other issues impacted on delivery of the EEC.

EEC for business
One respondent supported the consultation proposal not to extend the domestic EEC to small businesses. Three respondents sought continuing consideration of an EEC for business, especially those that do not pay the CCL.

Consumer demand
Those who responded on this issue welcomed the comments in the consultation document. Over half of respondents sought further help, including from Government, to increase customer demand, via marketing, national campaigns and fiscal incentives, in order to support the increased EEC targets.

Administration of the EEC
Some respondents suggested that the administrative arrangements designed by Ofgem could lead to additional burdens or costs on suppliers, the energy efficiency industry or other stakeholders. Some suggested that the administrative arrangements could have a negative impact in some areas, such as Scotland, or on some products, such as CFLs.