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Dear Leonardo

Consultation on the ECO Scheme allowance methodology in the default tariff cap

Thank you for the opportunity to respond to your consultation on how to set the ECO scheme allowance in the default tariff cap for Period 8 (April to September 2022) onwards.

Ofgem is proposing to use the latest available information from BEIS on the ECO4 scheme costs at the time it set the cap, which at this stage is BEIS' latest ECO4 impact assessment.¹ Ofgem also proposes to correct for any material under or over-allowance of these costs in Period 9 (eg if draft ECO4 legislation is not approved by Parliament, BEIS decides to not introduce ECO4, or the Government response and updated impact assessment indicate a material change in the costs of the scheme).

Broadly, we think these proposals represent a pragmatic way of dealing with the current uncertainty over the status of ECO4 and the scheme's likely costs.

However, we are concerned that Ofgem's methodology for the ECO allowance risks systematically understating the costs that suppliers efficiently incur, and we believe Ofgem should take this opportunity to correct this. The potential shortfall arises as a result of the approach that BEIS takes in its impact assessments to 'carry over' amounts.

BEIS's ECO3 impact assessment explained the situation as follows:

6.1 Carryover

"This impact assessment assumes excess actions from ECO2t count towards a suppliers ECO3 obligation target. Excess actions are listed in Ofgem's final determination report and show energy companies achieved excess actions of 8% and 7% against their respective CERO and HHCRO obligation targets.

¹ BEIS (2021), ECO4 consultation stage impact assessment.
<https://www.gov.uk/government/consultations/design-of-the-energy-company-obligation-eco4-2022-2026>

Suppliers deliver excess actions for several reasons:

1. to insure the energy company against non-compliance (1.07% of all HHCRO measures notified had their savings revoked or refused for non-compliance)
2. to allow carryover toward a successive obligation in order to prevent a delivery hiatus should suppliers complete early against a current obligation target.

The cost of excess actions are attributable to the obligation period they were carried out in, not the obligation they count toward and this is reflected in the way delivery costs are reported in official statistics. This means the subsidy costs of excess actions that carry over to ECO3 are counted against ECO2t delivery costs.

There was a delay between the start of ECO3 and the end of ECO2t as the previous scheme ended on 31st September, but ECO3 didn't come into force via regulations until 3rd December 2019. Any measures delivered after the end of ECO2t (from 1st October 2019) **do** count toward ECO3 delivery costs as these are not counted as excess actions from the previous scheme. Household energy statistics provide further detail on actual ECO3 delivery that is costed (see table T6.1) and counted (see table T2.1) from 1st Oct 2019.”²

When a supplier undertakes excess actions towards the end of an ECO phase with a view to carrying them over to the next ECO phase, it will treat the cost of these actions as part of its cost in delivering the actions for the following ECO phase – and this is how it will be reflected in its accounts. The costs of these excess actions should therefore be reflected in the total ECO cost that Ofgem uses in setting the price cap allowance for that next ECO phase.

However, as explained in the extract from the BEIS IA quoted above, BEIS's policy is to attribute these excess action costs to the *previous* ECO phase, rather than the ECO phase whose obligations they are satisfying. By the time these costs have been allocated to the previous ECO phase it will be too late for them to be reflected in the price cap, since a previous version of the IA (without these excess costs) will already have been used in setting the allowance in previous price cap periods. Ofgem's allowance for the next price cap period will be based on BEIS's IA for the next phase of ECO which does not include these costs.

Ofgem should discuss this matter with BEIS to determine the best way of addressing this issue, bearing in mind that Ofgem is using the BEIS IA for a purpose for which it was not originally intended. It may, for example, be possible for Ofgem to amend its methodology so that it takes the value from the latest ECO IA, *plus* any amounts that have subsequently been added to previous IAs (or otherwise quantified by BEIS/Ofgem) to reflect the cost of excess actions.

²https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/842280/ECO3_Improving_Consumer_Protection_Final_Stage_Impact_Assessment.pdf

Yours sincerely,

A handwritten signature in blue ink that reads "Richard Sweet". The signature is written in a cursive, flowing style.

Richard Sweet
Head of Regulatory Policy