

Supplier responses on the development of domestic energy efficiency policy

1. In their responses to Brian Wilson's follow up letter to the meeting on 18 April between Ministers and supply company Chief Executives, suppliers explained their support for the Government's energy efficiency programmes. They considered that their past experience would put them in a good position to carry out future energy efficiency schemes. Some suggested that energy efficiency offered good business opportunities for their supply activities, and brought benefits to their branding.
2. Suppliers' comments fell broadly into four main themes that have provided the structure of this paper: short-term issues, medium to long-term issues, institutional barriers and other market barriers. The issues which are of particular significance to the consideration of future policy options in the context of the forthcoming Energy White Paper are considered in the medium to long-term section.

Short-term issues

3. Most suppliers welcomed the fact that the Energy Efficiency Commitment (EEC) gave them more freedom to develop ideas on how energy efficiency services were delivered to customers. Some noted that this freedom allowed them to consider technologies that were not previously accredited with an energy saving under the Energy Efficiency Standards of Performance (EESoP) programmes. There were some that mentioned that the structure of the EEC was too tightly defined, but other suppliers at the meeting to discuss this paper commented that this statement was a throw back to the former EESoP programmes. Ofgem agrees that the suppliers have a lot more flexibility to meet their targets under the EEC than the former EESoP programmes. Ofgem acknowledges the interest suppliers have expressed in new technologies including, for instance, micro-CHP. We are working with developers to ensure that new measures can be accredited with an energy saving under EEC when they come to market.
4. Suppliers emphasised that the EEC targets will not only be difficult because of the large increase in work that is required from them, but also because of the shortfall in the number of suitable installers and output from manufacturers of energy efficient equipment. It was considered important for the suppliers and the Government to work together to ensure that the insulation industry had the right incentives to undertake training of new installers and that manufacturers of energy efficient products were given a clear signal to accelerate production.
5. Most suppliers expressed concern about how effective the current definition of the priority group was at targeting the fuel poor. They suggested that their experience to date showed that there were large numbers of fuel-poor consumers who fell outside the priority group. It was also noted that suppliers are expected to achieve half of their energy savings in a minority group of householders that is already targeted by the devolved Governments' Warm Front/Warm Deal/Welsh HEES programmes. Suppliers commented that the definition of the disadvantaged group under the EESoP 3 programme had allowed greater opportunity to directly target the fuel poor. A reconsideration, by DEFRA, of the priority group definition in relation to the Government's fuel poverty target is therefore recommended if the EEC is continued after 2005.

6. Some suppliers further commented that it was administratively inefficient to have two programmes (EEC and Warm Front) targeting the same group of households. Suppliers noted that it would be operationally more efficient if they were allowed to install measures for the Warm Front programme. It was considered inappropriate just to allow the Warm Front Managing agents to sell to the EEC obligated suppliers without any reciprocal arrangement. One supplier also mentioned that the development of future energy efficiency policy should consider the interactions with the policy frameworks of the devolved Administrations.

7. Some suppliers noted that energy efficiency programmes were doing little to help hard to insulate homes. It was recognised that, for instance, solid wall homes were more costly to insulate, but it was considered that there were many of these homes that needed attention. It was suggested that further work was needed to find a cheaper way to insulate these homes or, failing that, that the Government should provide additional grants to act as an inducement. Alternatively it was felt appropriate that insulating solid wall homes should become part of the Warm Front, Warm Deal and Welsh HEES programmes.

8. There was widespread agreement amongst suppliers about the benefit fiscal measures could have on the take up of energy efficiency. It was considered that these measures could take several different formats, including the requirement for an energy survey on application for a mortgage, or reduced council tax or stamp duty payments for more energy efficient households. Suppliers also felt that VAT should be reduced on energy efficient consumer goods and boilers. They felt that this would increase the take up of the more efficient models and could also accelerate replacement rates. Ofgem notes that the HM Treasury published a consultation paper on economic instruments to improve household efficiency on 16 July. HM Treasury invites views on possible applications of economic instruments to improve household energy efficiency.

9. Before any decision is made about the future of the EEC after March 2005, and particularly about increasing it, suppliers considered it would be important for the Government to undertake an appraisal assessing how suppliers have progressed against the current EEC targets, which require at least a threefold increase over the EESoP 3 programme. Suppliers considered that they have not yet demonstrated whether they are capable of increasing the level of work required to meet their targets under the EEC, which only commenced on 1 April 2002. Additionally some suppliers noted that it was important to consider the implications of increasing the cost of energy to consumers and the effect any increase in targets would have on the levels of fuel poverty. One supplier in particular considered it important to make an assessment of the impact on fuel poverty before any increase is set.

Medium to long-term issues

10. The main focus of the discussion on the medium to long-term issues revolved around whether the Government would incorporate the cost of environmental externalities into energy prices as part of its response to global warming. Most suppliers reflected that energy services and the Renewables Obligation incentivise diversity, technological innovation and security of supply and that to reach any carbon emissions target efficiently a consistent approach was required for the valuation of a tonne of carbon. Several suppliers

highlighted that the cost of mitigating a tonne of carbon via the Renewables Obligation was far higher than that of the cost using domestic energy efficiency. They suggested a comparison of £300/tonne compared to £50/tonne. It was further pointed out that both of these figures were considerably higher than the value of carbon traded on the Emissions Trading Scheme of £18/tonne. Because the cost of mitigation through energy efficiency was so much higher than the cost of the emissions trading scheme, suppliers noted that there was no incentive for them to over achieve on the energy efficiency targets. However, some suppliers noted that there would be a large incentive to over achieve on energy efficiency targets if they were allowed to trade their over achievement against their renewables target.

11. Ofgem provides some analysis of the figures quoted in the paragraph above in an annex to this paper. Even if there is scope for debate about the precise numbers, it seems likely that the overall hierarchy of cost effectiveness between these mechanisms is correct. However, it should be noted that these figures do not take account of the consumer benefits that accrue as a result of energy efficiency. The Energy Saving Trust has argued that for domestic energy efficiency the mitigation cost may even be negative. It is clear, therefore, from the figures above that the cost to the economy in reaching any carbon emissions target will vary considerably depending on which policy mechanism the government decides to implement. If the Government is considering transforming the UK economy, in line with the recommendations of the Royal Commission on Environmental Pollution, then serious consideration should be given to appraising the cost of each policy route. Ofgem's view is that the choice of mechanisms should be determined by those which achieve any defined level of environmental improvement at minimum cost to consumers. Separate evaluation of other benefits of such mechanisms is highly desirable, if practical. This will be discussed further in Ofgem's response to the current Energy White Paper consultation process, following the PIU report.

12. Not all suppliers felt that this was a medium to long-term issue. One supplier in particular considered that the Government should address the issue of trading carbon savings between renewables and energy efficiency in the short term. Other suppliers noted that in theory they were allowed to trade carbon savings onto the emissions trading scheme, but that the mechanisms that would account for the trades of domestic energy efficiency are still to be finalised. They commented that it would be helpful if Government were to put these mechanisms in place as soon as possible. In the meeting to discuss the draft paper there was general recognition that any development of EEC post 2005 needed to take account of broader carbon trading schemes, introduced by the EU or others, contemplated by them.

13. It should be noted that not all suppliers considered it was appropriate to allow suppliers to trade energy efficiency services against renewables targets. These suppliers (including those with existing investments in renewables or plans for expansion into renewables) considered that the two policies were aimed at different objectives and that to allow the trading of energy services against the Renewables Obligation would undermine the position of those suppliers in the market who had invested in a long-term view of renewables generation. In response, it was suggested that the Government should give careful consideration to transitional arrangements when unbundling current policies in favour of a market mechanisms in the longer-term.

14. Many of the longer-term comments were targeted at achieving coherence between the EEC and Renewables Obligation. One supplier noted that the Energy Efficiency Commitment did not allow suppliers to 'buy-out' from their obligation, as is possible under the Renewables Obligation, and that even if energy efficiency did not fit in with a supplier's business plan, they were required to meet an energy efficiency target. Ofgem points out that, while it is not possible to 'buy-out' of the EEC, a supplier can trade its obligation with another supplier as well as any excess measures. In effect this ensures that the overall energy saving target is reached, but enables any supplier who does not wish to provide its own energy efficiency programmes effectively to 'buy-out' of its obligation by contracting with another party. (In response to Ofgem's comment one supplier noted that not many suppliers would be eager to take on a higher obligation given the problems in the supply of energy efficiency measures highlighted in paragraph 5 above.)

15. Many of the suppliers also noted that they would prefer energy efficiency targets to be set for a longer time frame. The main reason was that this would allow them more time to plan their work, and consequently allow more time to devise innovative approaches. A further reason for setting a longer time frame was that, as energy efficiency programmes continue, the potential for installing measures diminishes, and suppliers will need more time to find the requisite number of homes.

16. If the Government is going to implement carbon valuation over time in order to price in the environmental impact of carbon, then in Ofgem's view it will be essential to consider the coherence of the policy mechanisms used to do this. Earlier and current programmes such as the EEC and the Renewables Obligation may well need to be phased out over time to take account of the contribution of a broad carbon valuation mechanism. Ofgem recommends that the Government should consider, in preparing the Energy White Paper, what should be said about the future of existing schemes if coherence of broader economic mechanisms is to be achieved at lower cost to consumers.

Institutional Issues

17. Most suppliers highlighted the fact that consumers lacked motivation for energy efficiency, and that the apathy had increased as a result of falling prices. Consequently, there was a call for the Government to be more proactive in this area and to consider how it might improve the education of consumers about the benefits of energy efficiency. Suppliers suggested that many consumers do not make the link between their consumption and emissions, and that more should be done to inform consumers about the benefits and cost savings possible from energy efficiency. Suppliers likened the required change in consumer perception of the environment and their use of energy as being like the change that has occurred in the unacceptability of drink driving. For the suppliers to undertake this role for the Government it was considered that it would need to become commercially attractive. However, one supplier commented that the Government's publicity work could only ever be a secondary activity in terms of delivering an energy efficiency target.

18. Concern was also expressed about the fact that the responsibility for energy efficiency and energy policy is split between DEFRA and DTI. Suppliers felt that this prevented holistic decision-making. In addition, they suggested that more should be done to induce local authorities to respond to energy efficiency initiatives, especially those that

are targeted at the fuel poor. One solution proposed was the private members bill that would put a legal obligation on local authorities to meet an energy efficiency target. Ofgem notes that this bill has now been withdrawn.

19. Views were split about consumer perception of suppliers. Some considered that suppliers were not fully trusted by customers and as a result that it was more difficult to market energy efficiency. Others suggested that the consumer would judge suppliers on their marketing activity, and not the action of the government and regulator, and consequently that it was up to suppliers to market energy services.

Other market barriers

20. Most suppliers suggested that the 28-day rule had a detrimental effect on the commercial risk of offering energy service packages to domestic customers. They suggested changing this rule in relation to energy service offerings. Ofgem considers that it is important that customers should be able to switch supplier, for example if they receive poor service or face uncompetitive prices, and points to the flexibility in relation to energy efficiency within the existing regulatory framework. Ofgem does not agree that there is a serious commercial risk surrounding energy service contracts, if suppliers continue to offer good service and competitive prices. One supplier said that the transfer of customers should be blocked for any outstanding debt on an energy service package and then went on to suggest that the numbers affected by this would be 'modest'. In Ofgem's view, if there is only a modest risk regarding the numbers of consumers who would look to switch in an energy service contract then the associated commercial risk would also be modest.

21. Some suppliers mentioned that they are not allowed, by primary legislation, to use pre-payment meters to recover investment in energy efficiency measures. Suppliers suggested that if this barrier were removed they would carry out more work with householders with prepayment meters. Ofgem is sympathetic to this proposal, but notes that the DTI put this condition in the Utilities Act because of concern that consumers should have protection from suppliers wanting to collect debts for services other than for the supply of energy.

22. One supplier commented that work on smart metering was progressing slowly, and consequently that there was little incentive to invest in new metering. The supplier further considered that the use of smart meters would allow the consumer to understand better their consumption and that this could lead to energy savings. Ofgem agrees that there might be potential for more advanced metering to contribute in this way, and notes that with the introduction of competition in metering it is now open to suppliers to pursue any commercial opportunities which may be available.

Ofgem
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Annex: Comparing the cost of mitigating a tonne of carbon

1. Comparisons of the cost of mitigating a tonne of carbon through different mechanisms are difficult to make. The cost of carbon mitigation for electricity in the note provided by suppliers has been derived from one of the more efficient CCGTs. It is appropriate to make this comparison for new capacity that might be added to the network. However, at present there is over capacity and it would seem likely that new renewable generation would replace the marginal plant, which since the recent increase in gas prices has become gas. It would therefore be fair to expect the price of mitigation to be marginally below the £300/tC as the renewable generation would replace the worst performing CCGT. If the price of gas were to fall relative to coal then coal would once again become the marginal fuel. The cost of mitigating carbon emissions against coal-fired generation would be roughly £120/tC.
2. The cost figures for energy efficiency are based on DEFRA's estimates used to set the target for the Energy Efficiency Commitment. Within this figure, therefore, there is the assumption about comfort levels that will be taken by consumers. More work is required, especially from gas heated homes, to ensure that these figures are robust.
3. Finally the figures from the Emissions Trading Scheme are initial figures from a market that has just been set up. As more organisations sign up to this scheme and carbon is traded more frequently a more robust figure will become available.