

'Beyond the ECO' – and beyond

Why we need three different policies to replace the Energy Company Obligation (and why the next supplier obligation should be nothing like the ECO)

A briefing paper from the Centre for Sustainable Energy

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This paper revisits our [Beyond the ECO](#) report (published in December 2014). The report called for a significant change in the Government's approach to the next obligation on energy suppliers to achieve energy savings with domestic energy consumers, due to be introduced from 2017 when the current Energy Company Obligation (ECO) runs out.

Alongside achieving energy savings, the explicit aims of our approach were to reduce the costs and regressive distributional impacts of this obligation on consumers and to realign energy supplier interests with other policy imperatives, such as the successful introduction of smart meters. We recommended a new type of obligation – an Average Customer Consumption Reduction Obligation (ACCRO) – which achieves these goals, but has a much narrower focus than the ECO.

Here we seek to address the two policy areas which are addressed by the ECO but which were explicitly and deliberately excluded by our recommended narrower focus for the new obligation:

- how to establish an effective and adequately funded programme to improve the energy performance of the homes of the fuel poor;
- how to stimulate the development of the solid wall insulation market in privately-owned homes.

The ECO was originally designed to address both of these challenges in one policy instrument, together with the central policy goal of achieving carbon-reducing energy savings. In *Beyond the ECO* we examined why these very different challenges needed separate policy approaches. Given the focus of that study, we explained in detail how to achieve the policy objective of reducing consumer energy demand through a new type of obligation on energy suppliers. However, we left for further work how these two additional and important policy objectives would best be tackled.

This short paper seeks to start that further work. This is for two reasons. The first is to re-iterate our finding in *Beyond the ECO* that, in spite of the superficial attraction of having a single policy instrument or rolling forward something like the current ECO approach, it is poor and ultimately inefficient policy-making to oblige energy suppliers to undertake activities for which they are poorly placed or ill-equipped.

The second and more important reason is that these other policy areas need addressing in their own right and with a more sophisticated approach than is possible or desirable through an ECO-like energy supplier obligation. To be comfortable that the next energy supplier obligation has our proposed much narrower focus requires that these other policy challenges are separately and convincingly resolved.

We also revisit here our recommendation of introducing the ACCRO in 2017 and respond to some of the questions and comments we have received to date on this proposal.



Funding a fuel poverty alleviating insulation and heating programme

In *Beyond the ECO* we proposed that, unlike with the HHCRO¹ element of the ECO, the delivery of insulation and heating improvements to low income households should not be the responsibility of energy suppliers. When compared with other agencies like local authorities, social landlords, and charities, the energy suppliers are not well placed to identify and reach such households or develop and deliver packages of measures tailored to individual household needs. In addition, this activity is poorly aligned with core energy supplier business. We argued that the need for these improvements to be funded and delivered should in future be addressed separately and not be included in the energy supplier obligation beyond 2017.

We also contended in *Beyond the ECO* that such improvements should be funded from general taxation rather than energy bills (as was introduced with the ECO). This is because funding these high cost heating measures from fuel bills tends to have regressive distributional impacts; the modest extra costs on bills carried by everyone (including those on low incomes) are unlikely to be sufficiently offset by the significant benefits for a relatively small number of low income households.

Some commentators, worried that the funding from general taxation would not be forthcoming at this time of spending cuts, have suggested that retaining an obligation on energy suppliers is the only option for both funding and delivery. We do not agree. The funding mechanism is a *separate* matter from any obligation to deliver the improvements and we have not heard a convincing argument as to why energy suppliers are best placed (or even well-placed) to lead on delivery. Below we outline our proposed solution.

- **The delivery mechanism: a competitive bidding process to a central funding pot**

In terms of delivery, our preference would be for there to be a central funding pot which would be subject to periodic competitions for delivery contracts for heating and insulation improvements in low income homes.

The competition would be open to all sorts of organisations (so energy suppliers could bid, alongside local authorities, charities, and others, if they felt they had the will and capability to deliver). It would be managed by a separately commissioned central agency (such as Ofgem e-serve) which would set quality standards, and give guidance on indicative prices for different measures in different types of property and on targeting and eligibility criteria. This agency would award, monitor and enforce delivery contracts.

Bids should be judged against criteria weighted towards (a) targeting and identifying fuel poor households and those at risk of under-heating their homes and (b) leveraging support for their needs beyond the insulation and heating measures, such as tariff advice, benefits take up, behavioural interventions etc. This would ensure scheme contractors have explicit interests in linking up with local efforts to alleviate fuel poverty and the risks of cold homes and with other types of assistance.²

Delivery contracts should be available at many different scales, to enable innovative local initiatives to compete alongside national providers. There would need to be robust contractual requirements to deliver installations (and tough penalties for failure to deliver) so as to ensure measures are installed as contracted and to recreate the delivery certainty inherent in a supplier obligation.

1 The Home Heating Cost Reduction Obligation

2 As recommended, for example, by the new NICE guidance on tackling the health impacts of cold homes. See <http://www.nice.org.uk/guidance/ng6>.

Unlike under ECO, the targeting and eligibility criteria for households to receive improvements should have some (limited) flexibility, based on proposals from bidders. This approach would avoid resorting to a fixed and rather crude set of national eligibility criteria which are known to result in poor targeting.³ It would also enable more effectively the use of health-based criteria alongside household income and housing condition, building out of local initiatives engaging the health sector in identifying at-risk households.⁴

After two years, the geographical distribution of the installation of measures could be examined (against household-related need) to see if additional, specifically targeted competitions were needed for particular areas to ensure comprehensive national coverage.

- **Funding the central funding pot: beyond a solitary source**

The advantage of establishing the central funding pot that would be subject to competitive bidding is that it can potentially be funded from a variety of sources. This could include:

- general taxation via different departments (e.g. DECC to meet fuel poverty objectives, DoH on an ‘invest to save’ basis to reflect the health benefits and NHS cost reductions associated with reducing the risk of cold homes) and devolved nations;
- a fixed levy on fuel bills (collected by energy suppliers but given to the pot for distribution rather than spent by the energy suppliers on their own schemes);
- hypothecated funds from, for example, energy supplier fines levied by Ofgem, or new levies imposed on, energy-profligate appliances,⁵ or penalties on private landlords who fail to improve their energy inefficient properties in line with targets.

The fixed levy on energy bills to fund this central pot, while having some potentially regressive impacts,⁶ has the advantage of establishing in advance the amount of funding available, enabling the competitive process described above to be completed and delivery to proceed on a timely basis.

The need for these measures is significant so we would hope that these different funding sources can, in combination, achieve a pot of at least £750 million a year (preferably more).

3 Poorly targeted eligibility criteria work both ways: some households who most need measures are not eligible and some who are eligible have less significant needs.

4 These issues were explored in work undertaken for Citizens Advice by ACE, CAG, CSE and Dr Joanne Wade (see [here](#))

5 Such as patio heaters, hot tubs, over-sized appliances etc

6 Regressive impacts can be reduced by charging the levy per kWh consumed rather than per customer.

Developing the solid wall insulation market in privately-owned homes

In *Beyond the ECO* we emphasised how, by the end of ECO in 2017, most of the simple low cost insulation measures in the UK housing stock – lofts and cavities – will have been installed. Delivering these measures has dominated energy supplier obligations over the last 15 years, with considerable success. But with these measures largely ‘done’, a shift away from this approach in the energy supplier obligation is necessary.

The next major insulation measure for improving the energy performance of our housing stock – solid wall insulation (SWI)⁷ – is a completely different challenge, particularly in the privately-owned housing market.

Unlike cavity and loft insulation, SWI is complicated, relatively high cost building work. It requires careful specification of the right materials, attention to building-specific detailing (particularly for older buildings), and a range of appropriately skilled trades-people. And in the UK it’s still in what technology innovation academics would call the ‘early adoption’ stage – still relatively unusual and only taken up by the most committed, willing to take a few risks and to ‘learn by doing’, often alongside their chosen, typically local SME builders. SWI supply chains, particularly to serve the individual private householder, are in their infancy and proving reluctant to grow and establish.

This makes it a market which is particularly unsuitable to intervention through an obligation on energy suppliers to ‘do a certain number’ of SWI installations, as required by the ECO. Energy suppliers typically do not have the capabilities to procure complex building works or to reach into local SME supply chains which characterise the required building trades. Moreover, to do so typically has no direct or beneficial relationship with a supplier’s core business. In addition, this stage of ‘early adoption’, with supply chains in their infancy, requires a more sophisticated policy approach than can be offered by an obligated quota of SWI in ECO or its successor.

So, if a different approach is needed, what should be done?

Our recommendations below are based on our experience at CSE of developing local, small-scale initiatives to encourage take up of solid wall insulation amongst owner-occupiers and to develop supply chains based on skilled local building trades, typically SMEs or even micro-businesses. Our recommendations also draw on our observations of national efforts to stimulate this market.

The first step to take is to think of SWI as complex building work rather than insulation work. The second step is to acknowledge its ‘early stage’ nature. As such it is largely unsuitable for the approaches adopted so far:

- Offering large numbers of sizeable Green Deal Home Improvement Fund grants at random intervals creates a market that comes to ‘expect’ grants and subsidies and then waits for them to appear. It also creates ‘feast and famine’ patterns of demand for the under-developed supply chains. Both of these are disincentives to the SME building trades that need to be at the heart of the SWI supply chain and which are (a) already busy with their normal home improvement and refurbishment building work and (b) wary of subsidy and grant programmes as they aren’t a feature of their current markets and imply unwelcome paperwork and official scrutiny.

7 The Committee on Climate Change estimates that 3.5 million homes will need to be fitted with SWI by 2030 to enable the UK to meet its carbon budgets.

- Complex accreditation schemes suit large social housing building contractors (which typically don't serve the private household market) and 'simple' insulation contractors (which typically don't have the skills for SWI). They don't suit the busy SMEs that typify the building trades needed for SWI supply chains and which have the required skills but no appetite for the paperwork.
- Large area-based schemes led by a single contractor procured and funded on the basis of lowest unit cost will sacrifice quality and typically overlook potential local supply chains.

Instead, our experience suggests an approach based on:

- i. Small grants to householders which say 'this is an important step to take and we want to take some of the pain out of being an early adopter' but avoid creating a market dependent on subsidies.
- ii. Quality control which targets specifications and installations, rather than relying solely on accreditation certificates and paperwork. In other words, focusing on the desired outcomes (decent, well specified installations) rather than procedural inputs (completed forms).
- iii. Green Open Homes events (see www.greenopenhomes.net) to stimulate local interest and demand and to make SWI more 'normal' as a home improvement measure.
- iv. Government- funded support to establish local schemes focusing initially on high quality work and local supply chain development rather than large scale and least cost. Such funding should be open to a wide range of potential local 'orchestrators' rather than just local authorities.
- v. Making the most of movers, by offering incentives (such as a stamp duty rebate) for home movers who improve their home within a year of purchase.⁸

⁸ This can be designed to be revenue neutral, as outlined in Croft, D. and Preston, I. (2013) *Taxing carrots and sticks: Incentivising efficiency through property taxes*, ECEEE

The next energy supplier obligation – the ‘ACCRO’

In *Beyond the ECO* we recommended a new **Average Customer Consumption Reduction Obligation** (ACCRO) on energy suppliers, to take over from the end of the ECO in 2017.

Unlike previous energy saving obligations on energy suppliers, the ACCRO shifts away from an obligation to install a certain number of energy saving insulation measures to an obligation which requires energy suppliers to reduce, year on year, the average energy consumption of their own domestic customer base.

This easily measured, outcome-based approach leaves to energy suppliers the choice of interventions to stimulate real reductions in their customers’ demand. It also removes the current need for a bureaucracy to ‘pre-qualify’ (or disqualify) measures which ‘count’ towards the obligation, to establish ex ante estimates of delivered energy savings, or to monitor whether installations have really happened.

Beyond the ECO explains how the ACCRO would align the interests of the energy suppliers with the success of other key policy objectives, such as the introduction of smart meters and improved energy efficiency standards for household appliances and lighting. This reduces the risk of policy failures in these other areas.

Such an obligation:

- goes directly with the grain of the transformation of energy supplier business models towards the lower, more responsive domestic demand required by broader energy policy objectives;
- ensures energy suppliers have a direct business interest in helping their own customers achieve real energy savings in their homes;
- focuses energy suppliers on low cost energy saving measures and interventions to engage their customers with reducing their energy consumption, resulting in lower overall system cost (and therefore lower bills).

The ACCRO also increases the market attractiveness of lower-than-average consumption households (which tend to be lower-than-average income), creating a potentially progressive dynamic in the retail energy market.

Reflecting further on this proposal and feedback we have received since *Beyond the ECO* was published, we suggest that further consideration should be given to:

- A separate ACCRO for households using electricity as their main source of heating.
- A ‘know-your-customer’ responsible marketing requirement on energy suppliers to ensure that interventions to stimulate demand reduction are not encouraging inappropriate or risky behaviour (e.g. financial rewards for reducing demand are potentially inappropriate for households already struggling to keep adequately warm in winter).
- Imposing an ACCRO on the suppliers of other domestic heating fuels such as heating oil (to avoid leakage from gas and electricity demand to higher use of these other, generally higher carbon fuels).

Beyond the ECO – Frequently Asked Questions

We have been interested by the comments and questions we've received about our recommendations in *Beyond the ECO*. Here are some of the more common questions and our responses. See also Section 6.3 and Chapter 7 of [Beyond the ECO](#) for more detail on our thoughts on policy design.

- **What sort of things would energy suppliers do to secure demand reduction with their customers?**

We believe one of the strengths of the ACCRO is that it will require energy suppliers to develop for themselves effective strategies to engage their customers with reducing their energy use. That will require innovative thinking and imagination that has been largely absent from ECO, but which is more in keeping with the sorts of businesses which the UK needs energy suppliers to become to meet wider energy policy objectives.

We imagine a range of strategies emerging: from tariffs which reward demand reduction and services which make effective use of smart meter data to programmes to support for LED lighting and more efficient appliance acquisition. We also anticipate some suppliers may actively promote low carbon housing refurbishment (though not necessarily with hefty grants as with ECO) since such households will tend to see large reductions in consumption. Some suppliers may develop marketing strategies specifically targeting customers with lower-than-average consumption (thus reducing their customer base average) as well as strategies to target interventions at their own higher-than-average consumption customers. Overall, we anticipate suppliers' ACCRO delivery strategies will become core to their customer retention and acquisition strategies.

- **Wouldn't the energy suppliers just put up their prices to reduce demand?**

This question surprised us, given: (a) the evidence that energy demand is rather insensitive (or 'inelastic') in its response to price changes so it would be a rather blunt strategy by energy suppliers to stimulate demand reductions, and; (b) the expectation that the energy market is competitive enough that some suppliers would follow more imaginative strategies that cost their customers less and thus sustain or gain market share.

- **Isn't domestic energy demand reducing year on year anyway, so wouldn't the ACCRO approach risk giving the energy suppliers a free ride?**

We believe that one of the toughest tasks in introducing the ACCRO will be calibrating the obligated level of reduction year on year. It will not be possible (nor desirable) to set a specific target for energy suppliers' actions (since the impact of their actions will be effectively indistinguishable from the impact of those of other actors and policies). The ACCRO reduction target will therefore have to take account explicitly of other policies already in place to reduce demand and then add something 'extra' for suppliers to do. We are relatively relaxed about the idea of energy suppliers 'taking advantage' of downward trends in household energy demand and seeking to make the most of them; such a 'win win' is good policy making and keeps costs to customers to a minimum.

- **Wouldn't the metered average customer consumption need to be 'degree-day' corrected each year so energy suppliers weren't helped (or undermined) by a particularly warm (or cold) winter?**

Degree-day correction (which adjusts consumption to take account of actual external temperatures) would add some minor complexity to the overall calculations of whether targets had been met in any given year. It would also significantly reduce uncertainty and risk for the energy suppliers and, as such, would be a sensible feature of target monitoring. Such complexity need not be reflected in communications with consumers.

- **Shouldn't it be a carbon reduction obligation rather than an energy consumption one?**

We're interested in keeping things simple – and energy consumption is routinely metered (even more routinely with the introduction of smart meters). While the carbon 'content' of the energy being used can be calculated, there are many other policies already driving its reduction, most of which are beyond the control of households. Energy demand reduction is a valid goal in itself, contributing to all of the UK's energy policy priorities, including carbon reduction.

- **What would be the cost on bills of the ACCRO?**

The ACCRO should reduce rather than increase bills on average. One of the main rationales for the ACCRO is that, unlike the ECO, the energy supplier obligation should focus on delivering energy saving activities which are cheaper than supplying energy to customers. We believe that there is considerable potential for such activity and that this potential distributes widely across the customer base. This latter factor tends to mean that many households are likely to benefit from supplier interventions, ensuring most end up with lower demand. Of course, suppliers will need to recover their fixed supply costs across a smaller number of units sold. This suggests an increase in prices per kWh (compared with the counterfactual), but an increase in unit price which will be more than outweighed by the reduction in consumption of kWhs for most customers, leading to lower bills overall.

- **How would a fuel poverty scheme be funded and delivered if it wasn't included in the next energy supplier obligation?**
- **How will we stimulate further improvements in the energy performance of the UK housing stock without something like another ECO?**

These two questions were the main reasons for writing this additional briefing. Our responses are outlined above.



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