

Lords Science and Technology Committee inquiry: Energy Efficiency Evidence from the Energy Retail Association, October 2004

1. Introduction

This paper has been produced by the domestic energy suppliers forming the Energy Retail Association (ERA). The Energy Retail Association established in October last year is the only dedicated trade association for UK energy suppliers. All the main energy suppliers operating in the domestic market in the UK are members of the association: British Gas, Scottish & Southern Energy, RWE npower, E.ON Powergen, EDF Energy and ScottishPower.

In terms of energy supply the greatest contribution to energy efficiency is the obligation to achieve energy savings through the Energy Efficiency Commitment, which is currently being re-assessed with a view to doubling the carbon savings targets. ERA members support the principle of extending the Energy Efficiency commitment from April 2005 and have played an active role in the work of the Department of the Environment, Food and Rural Affairs (DEFRA) High Level Advisory Committee and Target Setting Sub-Groups during the past year.

In addition, we have strongly supported the discussions that have taken place in the past 12 months and have contributed to the debate by producing various reports co-ordinated by the ERA.

We have welcomed the approach taken by DEFRA to elicit widespread input from the various stakeholders having an interest in energy efficiency and acknowledge that DEFRA has already made some modifications to its views on some of the key issues.

However, we remain extremely concerned that some of the assumptions made by DEFRA have not been fully validated and that insufficient consideration has been given to future price trends and the impact on energy costs, particularly for our disadvantaged customers.

Whilst there has been considerable debate about consumer apathy and the commercial reality of a stagnant market, it is apparent that DEFRA believes that energy suppliers can solve the problem. This is not a view that ERA members share.

2. Background

The Energy Efficiency Commitment began in April 2002 and requires energy suppliers to achieve a target amount of domestic energy efficiency improvements by 31 March 2005. Suppliers are currently required to spend the equivalent of £3.60 per customer on energy savings. This needs to increase by over £10 per fuel by 2008 under EEC2. The Government sets targets on how much energy savings must be achieved through the sale of a range of energy saving measures such as cavity wall and loft insulation, energy efficient light bulbs and heating system upgrades.

The ERA believes that the industry needs the widest flexibility in order to deliver energy savings and that the government will need to offer fiscal incentives to encourage house owners and landlords to invest in home energy efficiency measures. Recent research

shows that there is no consumer interest in insulating cavity walls and lofts at current market prices. The ERA is working closely with government officials to draw up a workable Energy Efficiency Commitment that provides the flexibility for innovation and sets realistic targets for energy savings.

The EEC requires electricity and gas suppliers to achieve targets for the promotion of improvements in energy efficiency in the household sector, with a particular focus on helping low-income consumers. The targets will be met by a combination of measures; however due to the inflexibility of the proposed scheme, the key ones are likely to be cavity wall insulation and loft insulation.

3. Key Concerns

ERA members have many concerns about the proposals, which even at this late stage in the statutory process are incomplete, but wish to highlight the following key concerns:

- Consumer appetite to buy products at the assumed costs and volumes required
- Loss of flexibility
- Dependence on insulation products, particularly cavity wall insulation & the reliance on the insulation industry (manufacturers & installers) to invest and grow at the required rate
- Base cost assumptions and exposure to future cost increases

These are examined in turn in the following pages.

3.1 Consumer appetite to buy products at the assumed costs and volumes required

Since the commencement of energy saving programmes what has been confirmed time and time again is the lack of interest from consumers in energy saving products and services. Home owners' latent desire to improve energy saving has had to be targeted by a range of inducements that has seen the price of measures to consumers fall while the cost of delivery and installation has continued to rise. In our collective judgement, this trend will continue throughout EEC2. This view is supported by the Energy Savings Trust in its Response to HM Treasury/Defra consultation on Economic Instruments to Improve Household Energy Efficiency.

The EST study confirmed that whilst consumers recognise the benefits of energy efficiency measures, they are not compelled to act. The reason for this was found to be that consumers believe that it should be the government and then energy suppliers who should take responsibility for tackling energy efficiency, ahead of them being required to do anything. In particular consumers become disengaged when the issue is linked to wider climate change. Research has also shown that consumers would be significantly more likely to invest in energy efficiency if the Government offered fiscal incentives.

Additionally, the cost of lead generation will face significant upwards pressure as campaigns aimed at target group customers not only have to capture the interest and imagination of customers but also compete with an array of marketing messages that

are increasingly sophisticated in order to elicit a positive response. It must be recognised that suppliers will find it increasingly difficult to absorb additional costs and this will need to be passed through to the customer.

The slump in demand during the summer months is characteristic of the market for all forms of household insulation and has traditionally resulted in high levels of unutilized capacity among installers. The ability of contractors more effectively to exploit this potential spare capacity is the key to improving productivity in the sector. The principal instrument to stimulate demand during summer months, and thereby keep crews busy, is marketing.

Addressing consumer apathy is the key to achieving the UK's energy efficiency targets. We, therefore, strongly recommend that fiscal incentives are developed and introduced during the first phase of EEC2. We continue to support the proposal put forward by the Energy Savings Trust and Association for the Conservation of Energy for stamp duty rebates for households that install energy efficiency measures. This proposal should be incorporated into the Home Information Packs currently being developed by the Office of the Deputy Prime Minister.

3.2 Loss of flexibility

Why have suppliers always met previous energy efficiency targets?

Flexibility has been a key factor towards success and suppliers must continue to be able to innovate. At the time EEC1 was introduced the market conditions and policy environment were different. For example,

- Earlier programmes were significantly smaller, focussed initially on electrically heated homes and insulation represented a much smaller proportion of the earlier schemes e.g. EESoP1 and EESoP2
- Emerging opportunities using energy efficient appliances and low energy lighting presented significant and viable alternatives to insulation products
- Earlier programmes included working with some business customers (up to 100kW i.e. not SME's) which widened the scope for products and customer targeting
- Timescales were more flexible allowing suppliers to take longer than the programme timescales if necessary and many suppliers needed to take advantage of this.
- Within a notional/assumed mix of measures suppliers had much greater flexibility to develop a wide range of schemes
- EESoP3 included gas customers for the first time widening the choice for suppliers to develop boiler schemes and more insulation work. Even greater interest was developed in appliance schemes and lower lamp costs meant greater volumes were delivered.

- In later programmes Local Authorities became much more interested which has opened up opportunities for greater volumes through joint working in social housing.
- Availability of social housing has been a key factor in ensuring targets for EEC1 will be met.
- In all previous programmes, suppliers felt able to endorse the targets because realistic assumptions had been made.

In summary, earlier schemes gave plenty of choices for suppliers via an array of new product options, a growing commitment from appliance manufacturers, retailers and social housing providers, a wider audience after gas homes were included and suppliers felt able to endorse the targets.

Flexibility was the key to success and this was verified at completion of the scheme, which showed that programmes were achieved but with a mix of measures that was very different to that envisaged in the original target models.

EEC2 is also the first programme that is greater than the current capacity of the energy efficiency industry

Why EEC2 is a different case?

Apart from the obvious difference of scale between EEC2 and earlier programmes the loss of flexibility and over reliance on cavity wall insulation are the main concerns.

There appears little prospect that anything new will be added to the product portfolio and some of the previous measures are unlikely to feature in EEC2 despite being included in DEFRA's target model.

The following factors illustrate loss of flexibility and increased challenges imposed by changes in targeting and accreditation:

In particular,

- Some 82% of EEC2 target is anticipated to come from insulation products
- Some 2M appliances are expected to deliver about 1% of target but the removal of the uplift factor and the inclusion of the heat replacement effect will seriously affect this channel as a viable option to suppliers
- Lighting schemes have become less attractive through the imposition of the heat replacement effect and additional constraints on targeting and verification currently being considered by OFGEM make direct mail and charitable schemes unattractive.
- Boilers, whilst still included, are less attractive and at this stage the details of the 1M "exception boilers" is unknown. Additional monitoring requirements proposed by Ofgem (testing of boiler interlocks) are also likely to close this channel as a viable option due to the increased cost.

- Additional verification requirements and correction factors make DIY loft insulation less economic
- Heating controls are less likely to be delivered unless linked to boiler upgrades

In summary, there will be too strong a dependence on Cavity Wall Insulation and little flexibility to make a contribution from other products.

3.3 Dependence on insulation products, particularly cavity wall insulation & the reliance on the insulation industry (manufacturers & installers) to invest and grow at the required rate

There can be no doubt that the high dependence on cavity wall and loft insulation poses a serious risk to the delivery of the energy savings target and also to the programme cost.

We have valid concerns about the capability of the insulation industry to grow at the required rate and are not convinced that sufficient infrastructure exists, as claimed. The insulation industry's position that 1000 machines is enough, so long as the demand can be lifted for delivery evenly throughout the year is in our view an implausible argument.

We do not believe it will be possible to smear demand in the way we would all wish, at the national volumes required.

Equally, we do not believe that the industry would have previously invested in a capacity capable of delivering annual volumes of some 600,000 installations when historically the annual demand has never exceeded about 300,000.

The ERA commissioned an independent study of the insulation industry. We understand that this is the only in depth assessment of the industry's ability to deliver at the rate anticipated by the targets.

The number of installations currently achievable using currently operational machines at full productivity is insufficient to fulfil the target number of installations. Even at maximum productivity, only around 70% of the required installations could be filled using the machines currently operational.

Assuming that **capacity** remains static, it is estimated that the **productivity** of existing crews would have to increase from 2.14 installations per day to 4.44 installations per day over the three years from 2004-05 to 2007-08 in order to achieve the EEC2 targets. This is significantly greater than 2.5 installations per day, the estimated maximum number of average daily installations. There appears to be only modest scope for achieving productivity improvements over the coming years (say 5% per year), unless there is a significant smoothing of demand across the year.

Assuming, conservatively, that there is no growth in the number of non-EEC installations (including new build and domestic non-EEC) over the period between 2005-06 and 2007-08, the EEC targets imply that some 2.1 million cavity wall installations must be carried out of which 1.7 million (more than 80%) will comply with the requirements of EEC2.

Whilst the sector expresses confidence in its ability to meet the EEC2 targets, it is unclear how the scale of change can be achieved given the challenges faced. Assuming that the contractor sector achieved annual growth in capacity and productivity of 10% and 5% respectively over the period between 2004-05 and 2007-08, it is estimated that the shortfall in installations compared with the EEC2 targets would be in the region of 400,000.

3.4 Price trends and risk to energy prices

As expressed previously, we are concerned that the base cost assumptions included in the EEC2 model prepared by DEFRA are vastly different from those experienced in the market place. Assumed future cost trends do not sufficiently take account of the investment that will be necessary in the insulation industry in particular.

The recent imposition of a 20% increase in the cost of loft insulation is a clear example of the volatility of the insulation sector and in our view this scale of increase is likely to be repeated on a frequent basis in the future.

There appears to have been of the order of 4-5% increases in the costs of cavity wall insulation in the space of around a year, in both the social and private segments of the market.

Loft insulation costs appear to have risen by even more (between 5% and 10% depending on grade of insulation) in the private segment, but there has not been a material change in cost levels in the social segment. ERA members have recently re-tendered for supplies of both CWI and LI for the EEC2 period – we understand that the tender prices received range from 10% to 35% above current EEC1 costs depending on the material and intended use.

4. Key factors for success

ERA members believe that for EEC2 to be successful in delivering its environmental target other factors must be taken into account:

- Meeting the energy savings target
- Mitigating the effects of fuel poverty
- Developing an efficient manufacturer/installer infrastructure
- Delivering high quality & safety standards
- Transforming the market for energy efficiency products & services
- Delivering good customer experience & supplier branding
- Within the budget forecasts

5. Actions/recommendations

- DEFRA should urgently review its target setting model in light of the comments noted above and in particular come forward with more reasonable target savings that can be met for the costs envisaged.
- We have indicated that the industry can achieve a maximum of 1.3m cavity wall insulation installations. We must either increase the spend to over £10 per customer per fuel or reduce the overall target.
- ERA members support the proposal to expand the initiative by energy suppliers to commission an independent review into the insulation industry with a view to provided DEFRA with more accurate information to inform its target setting.
- Further consideration needs to be given to the proportion of savings targeted at the priority group. Indeed, we do not believe that the current proposals are realistic and may not represent the most effective means of targeting priority customers.

6 Other issues:

Disability Living Allowance and Attendance Allowance

We believe that customers in receipt of the DLA or AA should be included within the definition of the Priority Group. It is very difficult to define the factors that contribute to fuel poverty, but low income is not the only symptom. Any improvement for vulnerable customers must be welcomed and the current qualifying criteria should be sustained. The less attractive option would be to reduce the priority group share in line with the number of households no longer eligible because otherwise the 50% target is unrealistic.

Interaction between EEC2 and Warm Front

ERA members are generally supportive of closer working so long as this is optional for individual companies and have contributed to recent discussions to establish suitable arrangements

Energy Service Enhancements

ERA members support Governments proposal to provide an incentive for energy services for the first year of EEC2 but believe this should be extended for the whole of EEC2. It is not yet clear to what extent energy services will contribute towards achieving EEC2 targets. Energy service packages require sustained investment by suppliers and any extension to the pilot allows time for the impact of the initiative to be properly assessed.

- DEFRA and Ofgem should urgently review their proposals to ensure consistency. In particular, Ofgem's proposals for additional monitoring, targeting and verification will, if implemented, effectively remove a number of measures

from EEC2 that DEFRA have included in their target model. Clearly, this does not represent a coherent approach to setting reasonable targets on suppliers for EEC2.

- We welcome the proposal for a high level advisory group to be established with the necessary powers to intervene and review EEC2 if necessary. ERA members look forward to playing a constructive part in defining the scope of the high level advisory group and setting realistic review implementation levels.