



energy retail association

**Energy Suppliers response to DEFRA's  
modelling assumptions as discussed at the  
High Level Advisory Committee meeting 12  
February 2004**

**A report by the Energy Retailers Association**

**March 2004**

# Cost implications for delivering EEC2 (2005-2008)

## 1. Executive Summary

The Energy Retail Association (ERA) has serious concerns over the modelling assumptions used by Defra in their latest EEC2 projections. The ERA believes that the projected product volumes are unrealistic and the costs vastly understated.

It is the view of the ERA and its members that the following key modelling assumptions should be amended.

- **The number of cavity wall installations should be reduced to 1.3m.** Defra's current model assumes 1.79m cavity wall insulations, requiring growth rates of between 40-45%. This is unrealistic.
- **Overall programme costs are vastly understated, particularly for insulation.** Based on Defra's model, costs are understated by £2.31 per customer per fuel, which is equivalent to a deficit of over £300m
- **The priority Group should not exceed 50% of the total energy saving target.** Also there should be no changes to eligibility criteria.
- **Leverage in the private sector should be 75% for supplier's contribution and 25% for consumers.** Defra's assumption of a 60/40 split does not adequately recognise the need to maintain the retail price at a level which will generate desired consumer demand.
- **Leverage in the public sector should be 70% for supplier's contribution and 30% for social housing providers.** This recognises the current and projected competitiveness of this marketplace.
- **Energy savings should be amended to reflect the lower savings achieved in then average house type in social housing** ie a 2 bed end terrace property.
- **Incentives should be maintained on A+ and A++ rated appliances.** This will ensure that the process of market transformation continues
- **There should be no limit imposed on the level of energy savings that suppliers are permitted to carry over.** This is essential to ensure continuity and build trust with delivery partners

## 2. Introduction

In August 2003, the Energy Retailers Association (ERA) commissioned IBM Business Consulting Services (BCS) to assist them in preparing a report **"Potential cost implications of delivering energy efficiency measures post 2005"** \* that set out the current costs of measures obtained by suppliers in the marketplace and the impact that changes in the market would have on the cost impacts arising from a doubling of EEC1 activity for a possible EEC2 programme.

This clearly identified that for the insulation industry substantial cost impacts were inevitable given the scale of investment needed to expand the industry at growth rates varying from 25% to 37%, dependent on the energy target that might be set by DEFRA.

DEFRA subsequently discussed their initial modelling scenario with energy suppliers in the December HLAC target sub-group meeting and following a useful exchange of views, the ERA responded with their opinion of what might be achievable for EEC2 in their report **"Energy suppliers views on the feasibility of delivering an EEC2 obligation and likely costs post 2005"**\*. DEFRA then tabled a further scenario at the main HLAC meeting in February, based on their latest views on capacities, costs and taking account of the work done by suppliers.

DEFRA asked suppliers for a response to their latest modelling scenario and this paper has been produced by the ERA and represents the views of all its members. Of particular concern, are the mixed messages emanating from the insulation industry and their seemingly optimistic view on what they feel can be achieved.

Both of these reports can be obtained via the Energy Retailers Association's website:

[www.energy-retail.org.uk](http://www.energy-retail.org.uk)

### 3. Key Points

In this paper, we have responded to DEFRA's request that we consider key points only but wish to point out that this does not mean that we endorse any of the provisional conclusions made by DEFRA that we have chosen not to include.

We have therefore focussed on the following:

- Cavity wall insulation
- Priority group
- Leverage
- Incentives
- Energy savings
- Programme Administration Procedures
- Overall programme cost

#### Cavity wall insulation

It is worth restating the following key points:

- An annual rate of some 600,000 CWI's is required given DEFRA's current assumptions
- Less than 250,000 retrofit CWI's per annum have ever been fitted in the last 10 years
- The full available capacity has never been fully utilised, particularly in summer months. Neither suppliers nor installers have successfully overcome this difficulty. Greater emphasis on private sector working will only exacerbate this problem.
- With current volumes, the typical delay from customer enquiry to completed installation is about 2 months and significantly longer in some parts of the country where there is a shortfall in available capacity

By addressing the following questions, ERA members have considered whether 1.79M CWI's can be achieved in line with all of the related assumptions made by DEFRA:

- **Are there sufficient cavities left to be filled?**

We understand that the findings of the Home Condition survey indicates that some 8M cavity walls remain unfilled although, there will be a proportion of these that are unsuitable, particularly those located in coastal regions, in both private and social housing. In theory, there should be sufficient in a condition to accept wall insulation to meet the volumes required.

However, the challenge is enormous and penetration rates will be extremely high. Indeed, nothing of this magnitude has been attempted before.

- **Is there sufficient manufacturer/installer capacity available?**

We know that there isn't sufficient installer/manufacture capacity and ERA members have serious doubts that the industry can expand at the required rate.

During 2004, suppliers anticipate completing some 250,000 installations whereas the industry capacity is about 360,000 the balance covering some 40,000 Warm Front and 60,000 new build installations. Even if all of the capacity was available for EEC2, a growth rate of about 40% to 45% would be required.

We believe that more work needs to be done to establish a realistic view of what is needed and what might be achieved.

- **Can ERA members identify sufficient volumes to interest customers to seek quotations working?**

At present, only about 50% of customer enquiries lead to quotations being given and some are subsequently not accepted. The scale of marketing involved to reach the volumes envisaged will need significant investment and the final cost will be unknown until the programme is completed.

We have already experienced declining response rates to campaigns in the electricity sector through the previous programmes and the same is now happening within the gas sector.

- **Will sufficient non-priority group customers be motivated enough to pay towards the cost?**

Whilst DEFRA has acknowledged ERA members concerns by increasing their leverage assumptions, we believe that still more funding will be required as the scheme progresses.

Some suppliers have already subsidised prices by up to 70% and the greater competition amongst suppliers to reach declining volumes, coupled with the need to tackle "less responsive customers" will increase the likelihood of even higher subsidies being needed in the future.

- **Will Local Authorities have the funding available for the volumes required?**

Whilst it is thought that some 2M homes are left to be insulated in the social sector, suppliers current experience of working with Local Authorities indicates that this may be considerably over-stated. Some suppliers are reporting that loft top up work is all that is available currently. Suppliers cannot confirm that match funding will be available at the

required rate and some of the properties will be unsuitable, particularly those in coastal regions.

ERA members have consistently challenged the capacity and growth rate issue for insulation measures and recognise that DEFRA has responded positively to our views. We will continue to work to establish a clearer view on what might be achievable but remain unconvinced that the necessary action will be taken in time.

To successfully meet increased energy saving targets, regardless of the scale of increase proposed, requires recognition of the importance of consumer demand. We are pleased that Defra is to undertake supportive action and evaluate what part government can play to stimulate increased activity.

However, we remain pessimistic about just how successful any campaign might be given the general apathy in the market place and the time taken for any major campaign of this type to have any real impact.

The cost of cavity wall insulation assumed by DEFRA has we believe, been based on that assumed for EEC with an addition of 12.5% for inflation and a further 5% real terms to reflect growth. We understand that the insulation industry anticipates a real term's increase of 5% for each year of EEC2, which is more in line with ERA assumptions made last August.

At present, we do not believe that it will be possible to deliver 1.79M cavity wall installations during EEC2. Even if it were possible the unrealistic assumptions on direct costs and leverage present a lower overall programme cost as presented by DEFRA than that modelled by ERA members.

## **Priority Group**

ERA members believe that the main purpose of the EEC programme should be to assist Government in meeting its climate change objectives whilst recognising that it can make a useful contribution towards alleviating fuel poverty.

We support the view that equity should be applied to ensure that disadvantaged customer groups contributing to the programme through their energy bills have the opportunity of receiving a fair share of the energy savings benefits.

We believe that the priority group share should be maintained in the target model and should not exceed 50%. We would not agree that any alternative definition or constraints should be applied such as a minimum SAP rating for the Priority Group.

To identify eligible customer in the private sector will be difficult enough and this is bound to be reflected in the indirect costs that will be incurred. To introduce a SAP rating criterion could add £40/£50 for each successful property improved and unnecessary indirect costs for those that did not subsequently qualify under the priority group definition as modified.

## Leverage Assumptions

### Private Sector

Defra have recognised that EEC1 leverage assumptions for the private sector will need to be adjusted from the current EEC1 model (50/50) to reflect increasing market penetration and to overcome customer apathy. Defra have suggested leverage of 60/40% in favour of the supplier contribution for the private sector. ERA has previously argued that this figure should be at least 70/30%. However in light of recent analysis, ERA now believes this figure to be incorrect and that this should be changed to 75/25%

The table below shows the current position for EEC1 and forecasts for EEC2 based on previous ERA reports.

	Average Insulation Costs* (including indirect costs)	Average Weighted Customer retail price#	Leverage	
			Supplier	Customer
EEC1	£395	£175	56%	44%
EEC2	£508	£125	75%	25%

\* Average insulation cost based on a 3 bed semi-detached house – source ERA paper on EEC2 costs 29/9/03

- EEC1 current costs: average price £305. Additional 10% uplift has been applied to this figure to account for recent installer price increases (Jan 2004), not factored into ERA cost model. Total current cost therefore is £335
- EEC2 costs: Base/Current price adjusted to include 10% increase in installer prices (Jan 2004) £335. ERA paper (mid point cost scenario) suggested a 30% increase in installer costs, taking total predicted cost for EEC2 to £435
- Indirect costs of £60 have been estimated for EEC1. Again it is likely that this will increase during EEC2 as more expensive marketing channels are used to generate required volume, and traditional low cost channel e.g. bill account enclosures, become saturated. Assumed increase of 20% taking total indirect costs for EEC2 to £72.

- # Current CWI retail price based on weighted average across all suppliers
- EEC1: Current CWI retail price based on weighted average across all suppliers
- EEC2: Based on supplier's estimate of retail selling price necessary to generate demand for 1.3m cavity wall installations (against 690k in EEC1). As the key CWI proposition is unlikely to change (Energy services is the only key exception, but this is unproved), price is the only mechanism by which demand can be stimulated.

## Public Sector

Defra have indicated that they intend to maintain the EEC1 public sector leverage assumptions for EEC2 (50/50). This fails to take account of the competitive nature of this market, both currently under EEC1 and that envisaged for EEC2. The social sector provides a steady market for cost effective energy savings and is therefore very attractive to all suppliers (54% of CWI's delivered in social sector for EEC1).

Social housing is also a finite resource, as we know that work will decline in this sector during EEC2. The combination of these factors will drive increased competition in this sector, leading to increased supplier subsidies. Evidence of this competition is already evident, suppliers report that match funded deals (50/50) are the exception rather than the norm. Taking these elements into consideration the leverage suppliers can expect from social housing providers will inevitably decline. The following table shows suppliers expectation for leverage in the social sector for EEC2.

	Leverage	
	Supplier	Social Housing Provider
EEC1*	50%	50%
EEC2	70%	30%

\* Based on DEFRA's original assumptions for EEC1 – this does not relate to actual market conditions

## Incentives

Incentives have played a significant part in developing consumer demand for energy efficiency products.

## Appliances

A success story has been the appliances market. We would not wish to see the market for A rated appliances diminish or the benefits achieved reduced and this possibility needs to be

given consideration. The emerging A+ and A++ appliances should be supported by programme incentives (60% uplift factor) in order that a market for these appliances' may be established.

### **Energy Services**

The energy services product has yet to emerge as a market contender. To achieve desirable progress in this area the pilot proposed and forming part of OFGEM's consultation must integrate with EEC. Consumer demand remains at the level that requires stimulation with subsidised energy efficiency products. Such an approach would associate energy services with energy saving opportunities for the consumer.

### **Energy savings**

Previous ERA papers have indicated that the average social housing property into which cavity wall insulation is installed is a 2 bed end terrace, 26% lower savings than the private sector 3 bed semi. Defra's current model does not represent the difference in energy savings between the private and social sector. This is to over-state the potential energy savings in the model with a measure that is already constrained by industry capacity. Current trends in this sector confirm our previous position. Unless Defra accept this position suppliers will have to initiate further activity in order to achieve the level of energy savings indicated. Clearly this has implications for the programme's overall cost.

## **3. Programme Administration Procedures**

Suppliers' are keen to see synergy between the administration procedures to be established for EEC2 and the focus and direction resulting from the informal and formal consultations undertaken by Defra. Failure to recognise this objective has the potential to significantly affect the achievement of carbon saving targets and the cost incurred by suppliers.

Having achieved a level of activity through the current EEC programme suppliers' are of the view that it is essential to maintain this activity in order to launch into EEC2. To achieve continuity we consider there should be no limit imposed on the level of energy savings suppliers are permitted to carry-over from EEC into EEC2.

One particular area for concern is the application of additionality for EEC2. Suppliers feel that this in itself represents a potential threat to the delivery of energy savings. For example in markets where Defra currently indicate that maximum delivery capacity is to be utilised to achieve the volumes indicated in DEFRA's model.

It is essential therefore that OFGEM accurately translates the modelling assumptions finally set by DEFRA, into working procedures that do not impact operational or cost aspects not fully taken account of within the statutory instrument.

## 4. Overall programme cost

We have recalculated the energy savings with the new volumes of measures and revised energy savings where appropriate. However on the basis of the assumption that EEC II will deliver 1.79 million cavity wall installations (which we do not consider achievable) we believe the cost of this measure will rise beyond the level indicated in our paper in January. The work carried out by IBM for the ERA in September 2003 would suggest a cost of £374. We also believe the energy savings from cavity wall installations in the social sector are over estimated, which has the effect of increasing, the level of activity suppliers would have to achieve to deliver their targets.

Applying the leverage in the social housing sector and the above factors we anticipate the cost of delivering 125.8TWh would be £9.73 ex vat. It is necessary to uplift this cost in line with the proposed target of 132.8TWh which would cost £10.27 ex vat

	DEFRA	ERA
Energy saving (TWh)	132.8	132.8
Carbon saving (MtC/y)	0.79	0.79
Cost (per customer per bill)	£8.06	£10.27
Cost including VAT (per customer per bill)	£8.47	£10.78

## 5. Conclusion

Whilst ERA members recognise that DEFRA has, with the benefit of having more data and information available, responded to ERA members views on some of the key issues, we are nevertheless concerned that over-optimistic assumptions have still been made.

We cannot agree that the volumes of cavity wall insulation will be achieved due to the substantial growth rates required in infrastructure as well as, the extent of awareness raising and marketing that will be needed.

Members believe that direct cost and leverage assumptions remain too low and that the theoretical programme cost would be nearer £11 per customer per fuel per year, much higher than that assumed by DEFRA.