

Energy Efficiency Scheme for Small & Medium Sized Businesses: Energy UK response

8 May 2019

Introduction

Energy UK is the trade association for the GB energy industry with a membership of over 100 suppliers, generators, and stakeholders with a business interest in the production and supply of electricity and gas for domestic and business consumers. Our membership covers over 90% of both UK power generation and the energy supply market for UK homes. We represent the diverse nature of the UK's energy industry – from established FTSE 100 companies right through to new, growing suppliers and generators, which now make up over half of our membership.

Our members turn renewable energy sources as well as nuclear, gas and coal into electricity for over 27 million homes and every business in Britain. Over 680,000 people in every corner of the country rely on the sector for their jobs, with many of our members providing long-term employment as well as quality apprenticeships and training for those starting their careers. The energy industry invests over £12.5bn annually, delivers around £84bn in economic activity through its supply chain and interaction with other sectors, and pays £6bn in tax to HMT.

This is a high-level industry response to BEIS's call for evidence; Energy UK's members may be best placed to answer certain questions and provide evidence directly. We would be happy to discuss any of the points in further detail with Government, or any other interested party if this is beneficial.

Executive Summary

The Government has a key role to play in creating the consumer demand necessary to drive and sustain an energy efficiency market in the domestic, business and industrial sectors. Energy UK believes that the Government must pursue policies that create the consumer demand for an energy efficiency market to thrive, without a heavy reliance on subsidies from the energy sector. We therefore, welcomes the call for evidence on an energy efficiency scheme for small & medium-sized businesses (SMEs).

Energy efficiency offers significant benefits for domestic and non-domestic energy users alike, from cost savings on energy bills, to improved comfort, health and productivity. BEIS research has identified significant opportunity to reduce energy use among SMEs. The 2014-15 Building Energy Efficiency Survey (BEES) estimated an abatement potential of around 27,000 GWh per year, which at a relative level was greater than abatement potential for larger organisations.¹

¹ BEIS (2016), Building Energy Efficiency Survey (BEES),
<https://www.gov.uk/government/publications/building-energy-efficiency-survey-bees>

SMEs are generally aware of the benefits that improved energy efficiency can bring. A survey by the Federation of Small Business (FSB) in 2017 found that 90% of small businesses want to be energy efficient and 86% see the direct benefits from energy efficiency.² A recent B2B survey published by Energy UK and PwC found that the cost of energy remained the primary consideration for SMEs when thinking about their environmental and sustainability plans.³

However, as the call for evidence document outlines, there are a number of barriers and market failures that discourage SMEs from investing in energy efficiency improvements. Smaller businesses are less likely to have the time and resources to consider their energy use and prioritise energy efficiency over other business concerns. The tenure of premises is also a key barrier, as many SMEs rent their premises, limiting the improvements they can make themselves. The FSB survey also found that 45% of SMEs consider that leasing or renting their premises is a barrier to improving their energy efficiency.⁴

Our recently published Future of Energy report sets out our overarching positions on energy efficiency.⁵ Strong, timebound regulations for the energy efficiency of both domestic and non-domestic buildings are crucial to drive demand for energy efficiency measures, and provide certainty around the need to improve. This should then be backed up by a comprehensive suite of incentives that make it easy and attractive to meet higher minimum standards. Support via public investment should be available to support those less able to pay for energy efficiency improvements, while investment in innovation is necessary to help new types of measures and installation methods reach widespread adoption. Energy efficiency measures must also be backed up by a comprehensive quality and standards framework to build trust in the industry, and ensure measures perform to their expected standards.

As part of a comprehensive strategy to drive demand and encourage uptake among SMEs, we could support an energy efficiency scheme for SMEs that incorporates elements of Option 1 to help fund cost-effective investment in energy efficiency and promote innovation, and Option 3 to provide better pathways for SMEs to fund improvements themselves. However, we consider that without a wider policy framework, it is not clear that a scheme for SMEs on its own will successfully contribute to the Government's Clean Growth Strategy target to reduce energy use in the non-domestic sector by 20% by 2030. It is also important that alongside support to SMEs, building owners and landlords take responsibility for improving the fabric of their buildings, as this is an area where many SMEs have limited direct ability to make improvements.

We do not support Option 2 to create an obligation-based scheme through the energy sector. As the domestic ECO shows, funding energy efficiency policies in this way is highly regressive, and disproportionately impacts those least able to pay for measures. The energy efficiency needs of SMEs are also highly heterogeneous, and efficiency solutions will differ significantly depending on the type of business. This differs significantly from the domestic ECO, where simple and low-cost measures have been deployed at scale to achieve cost-effective delivery.

² Federation of Small Business (2017), The Price of Power: Energising small business in the next UK carbon plan, <https://www.fsb.org.uk/docs/default-source/fsb-org-uk/energy-report--jan-04-2017.pdf?sfvrsn=1>

³ PwC & Energy UK B2B Survey: The transformation of how businesses manage their energy needs, <https://www.pwc.co.uk/industries/power-utilities/insights/b2b-smart-energy-survey.html>

⁴Ibid.

⁵ Energy UK (2019), Future of Energy, <https://www.energy-uk.org.uk/our-work/future-of-energy.html>

There would also be practical and market barriers to an obligation scheme for SMEs. Many suppliers in the B2B market are not experienced in delivering obligations, while there would be difficulties in obligating suppliers based on their SME market share. Obligations also risk creating competitive distortions between SMEs, as the ability to deliver measures to a given SME may depend solely on the building fabric of its premises.

When developing a preferred solution, it is also important that BEIS fully assess the technical potential for energy efficiency among SMEs, and target support appropriately to ensure that the underlying demand for energy efficiency in the non-domestic sector is met, and the scheme does not duplicate existing regulatory frameworks, such as the Minimum Energy Efficiency Standards for the Private Rented Sector.

Detailed responses to the questions set out in the BEIS call for evidence document are outlined below.

Detailed responses to questions

Option 1: Energy Efficiency Auction

Q1: To what extent do you think that competitive tendering could be an effective mechanism to achieve energy savings through energy efficiency? What do you see as the pros and cons?

The energy industry has prior experience with auction mechanisms, primarily through auctions for Contracts for Difference (CfD) to drive investment in renewable generation capacity, and the Capacity Market, which uses an auction mechanism to ensure security of supply. Our members' view of both of these mechanisms has been broadly positive, and that they deliver competitive and efficient outcomes.

An auction-based approach has the potential to help grow the market where it is unclear what the price should be for a product or service. A well-designed competitive auction system can act as an effective mechanism for price discovery, and limits the risk of overpaying through incorrect setting of a fixed price.

Another advantage of an auction-based approach is that they can be used, if the design allows, to drive innovation in new technologies. The Capacity Market has operated with a technology-neutral approach, which encourages participants to find ways of delivering capacity at lower costs. CfD auctions take a different approach, where recent rounds have specified the type of generation technology eligible for bids. An auction approach could also promote engagement with a broad range of expert delivery partners.

The CfD and Capacity auctions have included strict entry requirements to ensure those entering bids are capable of delivering on their contracts, and is a feature that would likely be required for an energy efficiency auction. One of the risks an auction-based approach can be its complexity compared to other mechanisms that offer more direct subsidies and support, such as a traditional tendering approach or obligation. An auction system runs the risk of potential participants being unwilling or unable to commit the time and resources needed to prepare bids.

An auction-based system also relies on sufficient demand in the market to submit bids, otherwise a lack of bids risks leading to a higher clearing price and overall costs, as well as a lower level of overall delivery. A BEIS research paper on the non-domestic energy efficiency services market in 2018 noted that while the sector is large in absolute terms, it is comparatively small relative to GDP compared with markets in other countries such as the

United States, Germany and Canada. This may prove a barrier to running successful auctions if there is not sufficient liquidity in the market. We consider that improved financing and ESCO models, as detailed in Option 3, could be used to drive liquidity in an auction approach.

Q2: What are the different ways of designing an auction, and which would be the most appropriate for energy efficiency measures targeted at SMEs?

We consider that an auction-based scheme has the potential to grow the market for energy efficiency measures among SMEs. It is important that any such scheme is set up in a way that encourages bidders, is transparent, successfully attracts co-funding and supports innovative business practices. The lessons learnt from the CfD and Capacity Markets, as well as comparable schemes in other countries should be applied to a SME auction scheme.

The right auction model for energy efficiency measures targeted at SMEs will depend on demand in the market. A market without significant liquidity or depth risks higher prices for efficiency measures, as there will not be enough competition to secure the lowest price. BEIS research in 2018 estimated the size of the energy services industry market at £349m in 2017, which is relatively small compared with other countries.⁶ Government will need to carefully consider this when developing this option further.

Mechanisms can also be put in place as part of the auction design itself to ensure there is sufficient demand from bidders, to avoid deadweight loss from higher prices in the absence of sufficient competition. This was achieved in the Swiss energy efficiency auction model by stipulating that the full auction budget can only be awarded if the total bids for a round totalled more than 120% of the funding being auctioned to ensure sufficient competition.⁷

Measures to ensure sufficient demand and competition should also include robust information and awareness campaigns to ensure SMEs and other parties are aware of the scheme, and have the necessary information to participate in auctions. We consider that this could even be built into the design of an auction, using a two-pot process. The first pot would seek to procure energy efficiency auditing, assessment and information services to offer to SMEs free of charge, while the second pot would to match SMEs with energy efficiency measures identified by their audits. This approach would address the well-known barriers among SMEs around information and awareness, while underpinning the demand for the delivery of measures through pot two.

Given SMEs encompass a range of business types and sizes, not all businesses will have the capacity or resource to participate in an auction directly. We are supportive of the suggested approach for an auction to be targeted at consortiums or delivery agents to submit bids. This would allow delivery agents with experience in delivering energy efficiency measures to deliver to a collection of SMEs, or for bids that are not successful in one auction round to combine to form a larger bid in later auctions. In the Swiss model, separate auctions are run for project-based and programme-based bids, while German auctions feature separate “slots” for single and bundled projects. It is important that a broad range of third-parties are encouraged to bid to ensure market liquidity.

⁶ BEIS (2018), The Non-Domestic Energy Services Market, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/725393/PA_Advisory_Final_Report_NDEESM_Research_MAIN_180517.pdf

⁷ Radgen et al. (2016), Competitive tenders for energy efficiency – lessons learnt in Switzerland, https://www.eceee.org/library/conference_proceedings/eceee_Industrial_Summer_Study/2016/1-policies-and-programmes/competitive-tenders-for-energy-efficiency-8211-lessons-learnt-in-switzerland/

The timing of auction rounds should also be carefully considered. Switzerland's auction scheme implemented biannual rounds for projects after delivery agents reported the risk of having to wait a full year for the next auction round in the event of an unsuccessful bid would unreasonably delay projects, and possibly encourage a less efficient solution to be implemented instead.

In both CfD and Capacity Market auctions, the price paid for all successful bids is raised to the level of the highest accepted bid. This is to disincentivise bidders attempting to game the auction by under-bidding to secure a contract, and running the risk of not being able to deliver. Assuming there is sufficient market liquidity, a similar approach may be desirable for an energy efficiency auction.

Appropriate controls should also be part of any auction design. Proper contracting and auditing arrangements are needed to ensure successful bidders follow through on their contracts, and sufficient penalties, including the requirement to return funding is built into delivery arrangements for successful bids.

The design of an auction should align with existing regulatory frameworks for energy efficiency in non-domestic buildings. Therefore, eligibility for an auction should exclude work that could be completed within the £3,500 cap for improvements under the Minimum Energy Efficiency Standards (MEES). We also consider that the auction design should consider the balance between targeting measures that would not otherwise be completed, such as those with long payback times, and measures with shorter payback time where there are potentially measures that would likely have been completed anyway.

Q3: What approach should Government consider for funding a business energy auction scheme?

Further consideration is required in relation to how an auction could be funded; however we note that the IEA broadly identifies three ways of funding energy efficiency auctions:⁸

- General taxation.
- Levies.
- Carbon revenue recycling.

We would urge the Government to consider public funding or funding through carbon revenue recycling of a business energy auction scheme. As detailed further in our responses to Option 2, funding programmes and schemes through the energy sector is regressive and puts pressure on customer bills.

All of these options will ultimately be for the HM Treasury to consider and decide upon as part of the upcoming Comprehensive Spending Review. We do not consider that the Government would want the policy to result in a significant increase in energy bills.

Q4: What level of co-funding would maximise the value for money from the auctions and minimise competitive distortions, while providing a sufficient incentive for SMEs to take up the measures?

Others will be better placed to respond to the specific level of co-funding desirable to drive value for money while not discouraging uptake from SMEs. However, we note that

⁸ International Energy Agency (2017), Market-based instruments for energy efficiency: Policy choice and design, https://www.iea.org/publications/insights/insightpublications/MarketBased_Instruments_for_Energy_Efficiency.pdf

establishing an equitable level of co-funding is important to the design of an auction scheme. We note that experiences in the Swiss and German models with flexible levels of co-funding, where bidders specify the level of funding they are seeking, has incentivised bidders to structure their bids to request lower amounts of funding to boost their chances of winning a bid. Such an approach would allow the amount of funding for an auction to go further than a fixed co-funding level, as well as ensure that high levels of subsidy do not undermine the perceived value of energy efficiency.

We also consider that with greater availability and uptake of financial products, as detailed in Option 3, SMEs could be positioned to either fully fund or part fund energy efficiency measures themselves.

Option 2: A business energy efficiency obligation (EEO) – Business ECO

Q5: What are the pros and cons of implementing a new business EEO?

Energy suppliers have extensive experience delivering obligations over the last 25 years. However, these have focussed almost entirely on domestic properties, delivering high volumes of low-cost, standard insulation measures to households. The domestic ECO operates on market-based principles, where suppliers are incentivised to deliver their obligation at the least-cost to remain competitive.

We do not support a business EEO for SMEs. There are a number of disadvantages to the obligation model, especially when applied to SMEs. The funding model for the current domestic ECO means costs are ultimately passed on to energy customers. This is regressive compared to a funding approach through general taxation, as customers pay towards the scheme regardless of ability to pay.

The energy efficiency needs of SMEs are also substantially different to those of a domestic household, not to mention different SMEs in different subsectors, which calls into question the feasibility delivering energy savings required in the non-domestic sector under an obligation model. Domestic energy efficiency improvements have largely been made through improvements to building fabric and heating. While the BEES survey estimated that around 27% of the abatement potential in the non-domestic sector was through these types of measures, over half of the total abatement potential was through lighting, carbon and energy management and building instrumentation and control. These are typically more bespoke measures that will require detailed energy assessments and technical solutions for each business.

There is also an issue around competitiveness of SMEs within the same sector. Under a scheme where the full cost of deploying energy efficiency measures are met by obligated parties, there is a significant risk that individual SMEs may be able to adopt more energy efficiency measures and achieve greater cost compared to their direct rivals, simply due to the material characteristics of their premises. Energy suppliers will have to pass on the costs of these measures to their customers meaning that in these scenarios SMEs in direct competition with each other will perversely be funding a reduction in their rivals' overheads.

There are differences with the way the non-domestic energy market operates compared with domestic customers, and the Government should assess these factors carefully. Unlike in the domestic market, there is no duty on suppliers to offer terms of supply to businesses. A non-domestic EEO may create unintended consequences if suppliers are obligated based on their share of the non-domestic (or SME) market, and may create a disincentive to pursue growth in this area. There would also be difficulties in obligating a supplier based on their share of the SME market, as there is no accepted industry definition of an SME.

Obligations also have a distortionary effect on the energy sector. There is a high-upfront additional cost to suppliers in delivering and administering ECO. This is recognised by Government policy, which exempts smaller suppliers beneath a customer or electricity/gas supply threshold from having to participate in the scheme. While a way to encourage growth in new suppliers, it also creates a two-tiered market, where some participants are subject to the costs of obligations, while others are not. This has also meant that the costs of ECO have fallen on a smaller proportion of customers over time with the growth in smaller suppliers that are exempt from obligations under the existing customer threshold. In addition, some suppliers who would participate in a non-domestic EEO would have no previous experience in managing such a scheme. This would put them at a competitive disadvantage to suppliers who are familiar with such a scheme due to domestic obligations.

Additionally, it is our view that obligations will become more of a barrier to innovation in the retail energy market into the 2020s, as the market potentially shifts to utilise new models such as energy as a service that would encourage market participation from a wider range of suppliers. As such, the creation of an obligation scheme for SMEs appears at odds with the overall policy direction for retail energy markets.

Obligations have also held back a sustainable private market for energy efficiency measures. The lesson from ECO, and previous schemes such as CERT and CESP, is that supplier obligations alone have not created demand, rather, they have artificially maintained a market and supply chain through heavy subsidy. Energy UK is concerned that the growth of a sustainable non-domestic energy efficiency market might be stifled if an obligation on suppliers was introduced as experienced in the domestic energy efficiency market.

Q6: What are the relative merits of placing the obligation on suppliers, network operators, generators or other bodies?

As detailed in our response to the above question, we do not support an obligation approach.

Q7: What models of EEOs would minimise costs while delivering efficiencies?

If an obligation were to be introduced for SME energy efficiency, a key feature should be flexibility of delivery. As noted above, SMEs are more likely to require bespoke solutions than households, that consider operational use as well as building fabric improvements.

To minimise costs per obligated party and reduce distortions in the market, we consider that any potential SME obligation should not make use of thresholds that exempt certain portions of the market from contributing. In analysis we have shared with BEIS on the future of funding domestic energy efficiency policy, we have set out that a process of cost levelisation, similar to the Warm Home Discount, could be utilised to ensure all parties contribute to the cost of an obligation, while minimising the impact of high upfront costs.

As developing energy efficiency solutions for SMEs will require more bespoke solutions and technical expertise, any obligation model would need to make full use of mechanisms to open up delivery to a wider range of delivery partners than under the existing domestic scheme. A business EEO could make greater use of an ability for obligated parties to pay the cost of their obligation into a central pot in lieu of delivering, or trade some or all of their obligation to other obligated parties or delivery agents. This could encourage more innovative delivery from other partners such as Energy Service Companies and construction firms.

Q8: A number of countries operate EEOs, what can we learn from their experiences?

EEOs are relatively common across EU countries. In 2017, the IEA reported that 12 EU countries had an obligation in place with an additional three due to commence at the time of writing. Ireland's Energy Efficiency Obligation Scheme is a model that may be useful to consider, as 75% of the delivery in that scheme is to non-domestic customers. It is important to note, however, that eligible measures under the Irish scheme cover the same low-cost and scalable measures used in ECO in the UK. As stated elsewhere in this response, a large proportion of energy efficiency opportunities for SMEs in the UK fall outside of these types of traditional measures, which calls into question the appropriateness of an obligation-based model.

Q9: What level of co-funding would maximise the value for money from an EEO and minimise competition distortions, while ensuring a sufficient incentive remains for SMEs to take up the measures?

As stated in the response to Question 4, we agree that a level of co-funding is desirable to minimise distortions while not discouraging participation. Information about co-funding in the domestic ECO is very limited. Obligated suppliers are aware that eligible households are sometimes asked to contribute to the cost of receiving measures, and that this can act as a barrier to uptake. However, this information is usually withheld by the supply chain for reasons of commercial sensitivity, and previous attempts by BEIS and Ofgem to develop a database of co-funding payments have been unsuccessful. It would be important that any co-funding arrangements are transparently set out and reported as part of any non-domestic EEO.

Option 3: Expanding access to finance options to SMEs

Q10: How could the ESCO 'pay as you save' model be adapted for SMEs?

There are a number of finance options including ESCO 'pay as you save models' already in existence. Options for improving the attractiveness of these options and encouraging take up need to be considered.

Overall, we consider that some of the key barriers to SMEs taking up energy efficiency measures are access to robust information and advice, along with the overall cost of financing. We do not see any reason that a pay as you save model could not be better utilised among SMEs.

However, it is worth noting that to improve take-up, finance products need to be easy to understand and access. Complex initiatives to provide financing options for energy efficiency measures, such as the domestic Green Deal, saw relatively low uptake.

There also needs to be underlying demand. A sustainable private market for energy efficiency is needed alongside any expanded access to finance. Given a large proportion of SMEs rent their premises, this must include strong minimum energy efficiency regulations backed up by proper enforcement mechanisms, and incentives to encourage uptake among non-domestic landlords. We would also encourage the Government to consider how pay as you save models could be utilised in the other options presented in call for evidence, particularly for an energy efficiency auction.

Q11: Do ESCOs and banks see additional risks operating in the SME market?

Others are better placed to answer this question.

Q12: Do you believe a scheme encouraging and helping lenders develop more innovative and attractive finance products will help generate interest amongst SMEs?

More innovative and attractive finance products would be welcome, and we believe more can be done in this space to encourage lenders to provide greater support for energy efficiency among SMEs and landlords. In 2018, the Bank of England published a series of recommendations for lenders to take more account of climate change impacts in their risk assessments. It noted that energy efficiency presented a credit risk to lending in private rented sector as the MEES gradually prohibits new leases on lower EPC band properties.⁹ With the right incentives in place, banks and other lenders should be encouraged to minimise these risks by offering bespoke finance arrangements for energy efficiency measures.

To drive interest among SMEs themselves however, a more comprehensive package of initiatives is required to ensure businesses are aware of the support available and have the sufficient incentives to make efficiency improvements. This must include a comprehensive advice and assessment service for SMEs on what improvements they could make. Better information about the energy efficiency of buildings would also be welcome, and we support the implementation of Green Building Passports so tenants can see the potential for further efficiency improvements. This would provide SMEs with useful information to encourage landlords to make their premises as efficient as possible.

Q13: What types of innovative finance products or banking initiatives would attract SMEs into taking action on energy efficiency? Please provide examples.

Zero-interest loans for SMEs to make energy efficiency improvements have proven extremely popular when implemented in Wales and Scotland. The Carbon Trust's loan scheme for businesses in Wales has consistently been oversubscribed, while zero-interest loans developed by the Scottish Government and Zero Waste Scotland have also included cashback incentives to further encourage uptake. This approach also exists in the public sector through Salix Finance, and could be extended to support SMEs.

There have long been calls to link business rates to EPC ratings to give businesses a financial incentive to place greater value on more efficient buildings, and push landlords to make improvements. This would be a welcome support, as there is concern that the valuation regimes used to determine business rates currently disincentivise investment in energy efficiency, as improvements lead to higher asset valuations that in turn attract higher business rates.¹⁰

For landlords, consideration should be given to incentives similar to the previous Landlord's Energy Savings Allowance, to incentivise investing in energy efficiency improvements in non-domestic buildings.

⁹ Bank of England (2018), Transition in thinking: The impact of climate change on the UK banking sector, <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/report/transition-in-thinking-the-impact-of-climate-change-on-the-uk-banking-sector.pdf>

¹⁰ The Association for Decentralised Energy (2015), ADE's response to HM Treasury's discussion paper on Business Rates review, <https://www.theade.co.uk/assets/docs/nws/ADEresponseToHMTreasurydiscussionpaperonbusinessratesreview.pdf>

Other options

Q14: Do you have an alternative model for the business energy efficiency scheme that we should consider?

The Government could explore grant schemes targeting advice, funding and ongoing support to businesses to improve their use of energy. There are already a number of examples of grant-based schemes operating at local authority level, supported by the European Regional Development Fund. These schemes typically offer free energy efficiency advice to businesses, as well as grants for measures funded in part by co-funded contributions:

- Worcester City Council runs the Business Energy Efficiency Programme (BEEP) for SMEs. BEEP provides grants of up to £20,000 to help small businesses reduce their energy costs while improving their environmental impact. The Programme supports businesses throughout the entirety of the process, offering free energy efficiency assessments of a business's equipment, premises, processes and performance to find opportunities for improvement. Businesses are then invited to make a grant application, where support can cover a wide range of efficiency measures and technologies, including building fabric and operational improvements. Energy savings are subsequently monitored to record energy efficiency improvements.
- Derby City Council runs D2 Energy Efficiency Audits and Grants, which operates similarly to BEEP. Free efficiency surveys are offered, along with additional advice and support for businesses that do not apply for, or do not receive, grants. Grants can be up to £15,000 towards the cost of energy efficiency measures (comprising up to 65% of the total cost).
- Suffolk County Council and Norfolk County Council support Business Energy Efficiency Anglia (BEE Anglia). The scheme offers free energy efficiency advice, and fixed value grants of £1000 for projects over £2000.

If you would like to discuss the above or any other related matters, please contact Steve James on 020 7747 2969 or at steve.james@energy-uk.org.uk.