Title:	Impact Assessment (IA)
Consultation on raising the threshold for energy supplier participation in social and environmental programmes	**IA No:** DECC0048
Lead department or agency: DECC	**Date:** 25/03/2011
Other departments or agencies:	**Stage:** Final
	Source of intervention: Domestic
	Type of measure: Other
	Contact for enquiries: Dawn.Armstrong@decc.gsi.gov.uk Luke.Davison@decc.gsi.gov.uk

Summary: Intervention and Options

What is the problem under consideration? Why is government intervention necessary?

Ofgem and Government are concerned about barriers to entry in retail energy markets. One potential barrier is the impact on small suppliers of complying with environmental and social programmes. The Carbon Emissions Reduction Target (CERT) and Community Energy Saving Programme (CESP) place disproportionately greater burdens on smaller suppliers than large ones. Currently small suppliers with fewer than 50,000 domestic gas customers and fewer than 50,000 domestic electricity customers are not required to participate. However, Government is concerned that this threshold is too low and proposes to increase it to 250,000 domestic customers for these programmes. A threshold for mandatory participation in the new Warm Home Discount (WHD) scheme has already been set at 250000 domestic customers, in order to reduce potential burdens on smaller suppliers and promote competition.

What are the policy objectives and the intended effects?

To improve the level of competition in the retail energy supply market by minimising burdens on small energy suppliers. This is to be achieved by addressing compliance costs associated with CERT and CESP that have a disproportionate impact on small suppliers compared to large suppliers. The intended effects are to increase the competitive pressures in the retail energy market to achieve the consumer benefits associated with more robust competition. Overall, increased competition should drive reductions in retail energy prices, efficiencies in suppliers' business activities and increase incentives for innovation.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

Option 1 is to re-specify the threshold for compliance with feed in tariffs (FITs), CERT and CESP from 50,000 domestic gas or 50,000 domestic electricity customers to 100,000 domestic customers.
Option 2 is to raise the thresholds for compliance with CESP and CERT to 250,000 domestic customers, but to maintain the current 50,000 electricity customer threshold at which suppliers must pay FITs.
Option 2 is our preferred option as evidence presented during consultation showed that in order to exempt small suppliers from the obligations of CERT and CESP and realise the associated benefits the threshold would need to be raised to 250,000 domestic customers (a company's electricity license customers plus its gas license customers). FITs already have a mechanism for compensating small suppliers and therefore do not place such a disproportionately large burden on them. The threshold at which suppliers are obliged to pay FITs will form part of the wider review of FITs announced on 7 February 2011.

Will the policy be reviewed? It will not be reviewed. **If applicable, set review date:** Month/Year

What is the basis for this review? Not Applicable. **If applicable, set sunset clause date:** Month/Year

Are there arrangements in place that will allow a systematic collection of monitoring information for future policy review?	No

Ministerial Sign-off For consultation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsibleMinister:  Date: 16/05/11

Summary: Analysis and Evidence

Policy Option 2

Description: Raising the threshold on CERT and CESP from 50,000 domestic gas customers or 50,000 domestic electricity customers to 250,000 domestic customers (electricity and gas together) whilst maintaining the current threshold level for FITs

Price Base Year 2009	PV Base Year 2010	Time Period Years 2	Net Benefit (Present Value (PV)) (£m)		
			Low: -0.01	High: 1.45	Best Estimate: 0.72

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	N/A	1	0.006	0.006
High	N/A		0.009	0.009
Best Estimate	0.00		0.007	0.007

Description and scale of key monetised costs by 'main affected groups'

There is the potential for a very small increase in FITs costs as a result of an increase in the growth of small suppliers.

Other key non-monetised costs by 'main affected groups'

No carbon or other benefits will be lost from CERT or CESP, as relative to the existing threshold, the obligation will merely be transferred to larger suppliers if small suppliers would have breached the current threshold in the counterfactual. This is a transfer relative to the counterfactual but it is important to note the the six largest energy suppliers currently face all of the CERT and CESP obligation as no firms have yet passed the current threshold.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	N/A	1	0	0
High	N/A		1.46	1.46
Best Estimate				

Description and scale of key monetised benefits by 'main affected groups'

There are potential resource costs savings that are generated by ensuring that small energy suppliers who would face a relative cost premium to comply with programmes such as CERT and CESP are excluded from the schemes.

Other key non-monetised benefits by 'main affected groups'

It is not possible to quantify the benefit arising due to more robust competition and reduced barriers to entry. However, we can expect this to contribute towards downward pressure on retail energy prices, producing the benefits associated with more competitive markets.

Key assumptions/sensitivities/risks **Discount rate (%)** 3.5

Key sensitivities are the growth rates of small suppliers.

The faster small firms grow in the counterfactural the larger the resource cost saving. However, at the same time, faster growing firms in the counterfactual weaken the case for non-monetised competition benefits.

There is also the key question of whether in the absence of government action small firms would deliberately limit their growth rates. If this is the case then the monetised resource cost savings could be reduced or eliminated.

Direct impact on business (Equivalent Annual) (£m):			In scope of OIOO	Measure Qualifies as
Costs: 0.004	**Benefits:** 0.38	**Net:** 0.38	Yes	OUT

Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?			Great Britain		
From what date will the policy be implemented?			July 2011		
Which organisation(s) will enforce the policy?			Ofgem		
What is the annual change in enforcement cost (£m)?			0		
Does enforcement comply with Hampton principles?			Yes		
Does implementation go beyond minimum EU requirements?			N/A		
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** 0	**Non-traded:** 0	
Does the proposal have an impact on competition?			Yes		
What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?			**Costs:** N/A	**Benefits:** N/A	
Distribution of annual cost (%) by organisation size (excl. Transition) (Constant Price)	**Micro**	**< 20**	**Small**	**Medium**	**Large**
Are any of these organisations exempt?	No	No	No	No	No

Specific Impact Tests: Checklist

Set out in the table below where information on any SITs undertaken as part of the analysis of the policy options can be found in the evidence base. For guidance on how to complete each test, double-click on the link for the guidance provided by the relevant department.

Please note this checklist is not intended to list each and every statutory consideration that departments should take into account when deciding which policy option to follow. It is the responsibility of departments to make sure that their duties are complied with.

Does your policy option/proposal have an impact on…?	**Impact**	**Page ref within IA**
Statutory equality duties[1] Statutory Equality Duties Impact Test guidance	No	
Economic impacts		
Competition Competition Assessment Impact Test guidance	Yes	13
Small firms Small Firms Impact Test guidance	No	
Environmental impacts		
Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance	No	
Wider environmental issues Wider Environmental Issues Impact Test guidance	No	
Social impacts		
Health and well-being Health and Well-being Impact Test guidance	No	
Human rights Human Rights Impact Test guidance	No	
Justice system Justice Impact Test guidance	No	
Rural proofing Rural Proofing Impact Test guidance	Yes	16
Sustainable development Sustainable Development Impact Test guidance	No	

[1] Race, disability and gender Impact assessments are statutory requirements for relevant policies. Equality statutory requirements will be expanded 2011, once the Equality Bill comes into force. Statutory equality duties part of the Equality Bill apply to GB only. The Toolkit provides advice on statutory equality duties for public authorities with a remit in Northern Ireland.

Evidence Base (for summary sheets) – Notes

Use this space to set out the relevant references, evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Please fill in **References** section.

References

Include the links to relevant legislation and publications, such as public impact assessment of earlier stages (e.g. Consultation, Final, Enactment).

No.	Legislation or publication
1	Government Response to the Consultation on the Warm Homes Discount
2	Thresholds Consultation Document
3	Thresholds Consultation Stage Impact Assessment
4	CESP website
5	CERT website

+

Evidence Base

Ensure that the information in this section provides clear evidence of the information provided in the summary pages of this form (recommended maximum of 30 pages). Complete the **Annual profile of monetised costs and benefits** (transition and recurring) below over the life of the preferred policy (use the spreadsheet attached if the period is longer than 10 years).

The spreadsheet also contains an emission changes table that you will need to fill in if your measure has an impact on greenhouse gas emissions.

Annual profile of monetised costs and benefits* - (£m) constant prices

	Y_0	Y_1	Y_2
Transition costs	0	0	0
Annual recurring cost	0	0	0.007
Total annual costs	0	0	
Transition benefits	0	0	0
Annual recurring benefits	0	0	0.73
Total annual benefits	0	0	0.73

* For non-monetised benefits please see summary pages and main evidence base section

Evidence Base (for summary sheets)

It is important to note throughout this impact assessment the precise meaning of a domestic customer. Where referred to specifically as a “gas customer” this represents a customer that is covered by the gas supply license of a company. Similarly with electricity, where referred to specifically as an “electricity customer” this represents a customer that is covered by the electricity supply license of a company. Where customers are referred to generally this will mean the sum of customers covered by a company’s gas and electricity supply licences. So in this case someone with a dual fuel bill will appear separately on a company’s electricity license and on a company’s gas supply license and so would be counted as two customers.

Policy background

The **Carbon Emissions Reduction Target (CERT)** is a carbon saving obligation placed on gas and electricity suppliers with more than 50,000 domestic gas customers or more than 50,000 domestic electricity customers. Participating suppliers are allocated a proportion of the total target of 293 million lifetime tonnes of CO_2 (to be achieved by December 2012) based on their market share of the domestic energy market. They are required to meet these targets through the promotion of energy efficiency measures to households, for example by establishing schemes to encourage (usually with subsidy) the installation of loft or cavity wall insulation. These schemes can be delivered through third parties but suppliers must monitor the schemes and report to Ofgem. Ofgem both approves the schemes and also monitors compliance. Ofgem has the power to impose a financial penalty of up to 10% of company turnover if a supplier fails to achieve its target. It also sets sub obligations on energy suppliers to ensure distributional equity to lower income groups, and going forward, to require a minimum percentage of activity from professionally installed insulation. Energy suppliers can pass on the costs of the scheme in their consumers energy bills, but have a natural commercial incentive to deliver their obligation at least cost so as to remain competitive. CERT was recently extended until the end of 2012.

The **Community Energy Saving Programme (CESP)** applies to suppliers with more than 50,000 domestic gas customers or more than 50,000 domestic electricity customers and also to generators producing over 10 TWh/year on average. These businesses are required to deliver energy savings measures to domestic consumers in specified low income areas. Ofgem sets them targets based on their market share, approves proposals, monitors compliance and enforces CESP. As with CERT, energy companies can contract out their obligations or transfer or trade them to other obligated parties.

Suppliers with more than 50,000 domestic electricity accounts must pay **Feed in Tariffs (FITs)** to generators and other suppliers can opt-in on a yearly basis. Participating suppliers must verify the eligibility of generators, the accuracy of the information they provide and submit details to Ofgem for entry on the central FIT register. They must also manage the relationship with generators, calculate and make the payments due to them, and help to prevent and mitigate abuse of the scheme. All licensed suppliers, not just those who are mandatory or voluntary participants are required to make payments to support the costs of the scheme and a levelisation process distributes this burden between them according to market share. Suppliers paying FITs may claim administration costs as part of “qualifying FITs costs” from the levelisation process. This takes account of the likely difference in costs for mandatory and voluntary participants’ administration costs, to reflect their higher per customer administration costs.

The Government has consulted on proposals to introduce the **Warm Home Discount (WHD)** scheme, which requires suppliers above a threshold to provide support to vulnerable customers through their energy bills. At the time of publication of that consultation, Government was consulting on what an appropriate threshold level would be for existing and proposed

schemes (including WHD). Therefore the Warm Home Discount consultation did not include a proposal for the level of the threshold. Running from 2011/12 to 2014/15, the scheme obligates suppliers to contribute to the policy on the basis of their share of total domestic energy accounts. The total obligation rises from £250 million in 2011/12 to £310 million in 2014/15. A proportion of this expenditure will be targeted at households that are identified by government, while suppliers have discretion to set the household eligibility criteria for the remaining expenditure - subject to approval from Ofgem. The scale of a supplier's obligation under the scheme will be determined based on their share of total numbers of domestic gas and electricity customers. To prevent an unfair obligation falling on suppliers with a disproportionately high number of customers identified by Government as eligible for support, a reconciliation process will re-distribute funds on the basis of the share of total numbers of domestic gas and electricity customers after payments have been paid to these households. The Government has since decided to make clear in its response to the Warm Home Discount consultation that the threshold at which suppliers will be obliged to participate in the scheme is at 250,000 domestic customers (for the avoidance of doubt, this threshold is based on either gas, electricity or a combination of both types of customers and is calculated by considering the total number of domestic customers of all gas and electricity licensees connected to each other by virtue of being in the same company). This avoids placing disproportionate administration burdens on small suppliers.

Problem under consideration

The Government is concerned about barriers to competition in energy markets. There are many potential barriers to competition in retail energy markets. These include:

- **Pricing policies of the six largest energy suppliers** – new entrants and small suppliers seeking to grow do not possess the historic endowment of a large base of stable, inactive customers. Small suppliers therefore have to compete for the part of the market who are more sensitive to price and more likely to switch away again. The incumbents are able to use their historic customer base to achieve greater aggregate profitability than new entrants.

- **Lack of liquidity in the wholesale markets** – Small suppliers' wholesale market requirements differ markedly from those of larger suppliers. They need to purchase smaller volumes and shapes of power which are not easily available in the wholesale market creating additional risk of not matching their demand profile exactly. This is a significant competitive disadvantage compared to large vertically integrated firms.

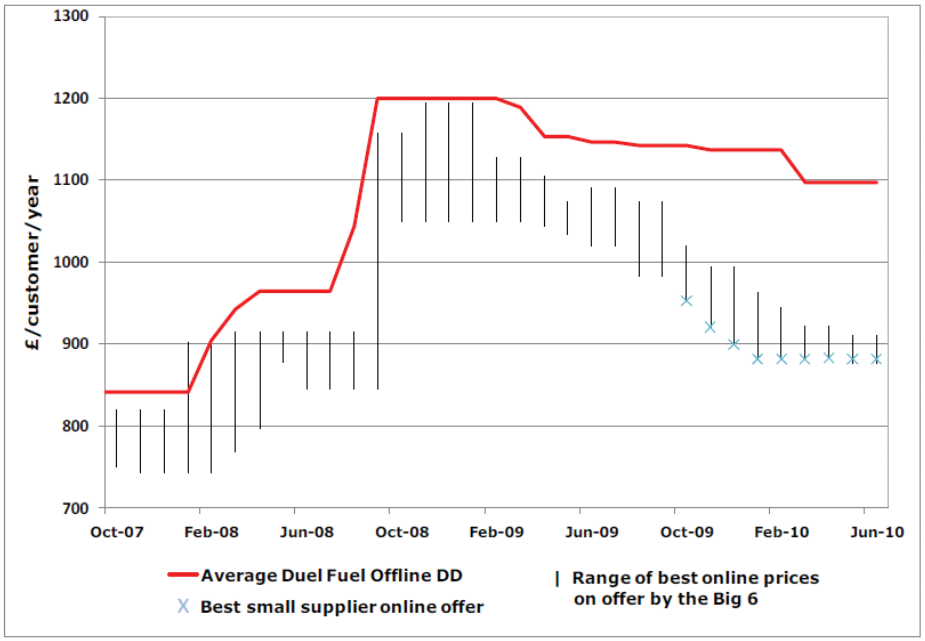
- **Cash-out regime** – supplier firms in the market who are out of balance i.e. the demand from their customers is larger or smaller than their contracted positions, have to buy or sell their imbalance at the system sell or system buy prices. These reflect the cost of the actions taken by National Grid as system operator to balance the system. Small suppliers find it harder to forecast the demand of their customer base, and the lack of liquidity makes it harder for them to fine tune their position as 'gate closure' approaches.

- **Regulatory requirements** – government programmes can place significant fixed costs (e.g. administration and the costs of new systems) on suppliers. These costs weigh more heavily on small suppliers because they are unable to spread the fixed costs of compliance over a large customer base, and as such they cannot exploit economies of scale. The threshold at which many of these programmes apply is currently set at 50,000 customers so growth beyond this point is harder.

Removing barriers to entry and growth is important for fostering greater competition in the retail energy market through placing a competitive constraint on the pricing and behaviour of the incumbents in the market. There is evidence that the current set of small suppliers are influencing the pricing strategies of the largest 6 firms. The chart below shows that in 2009 and

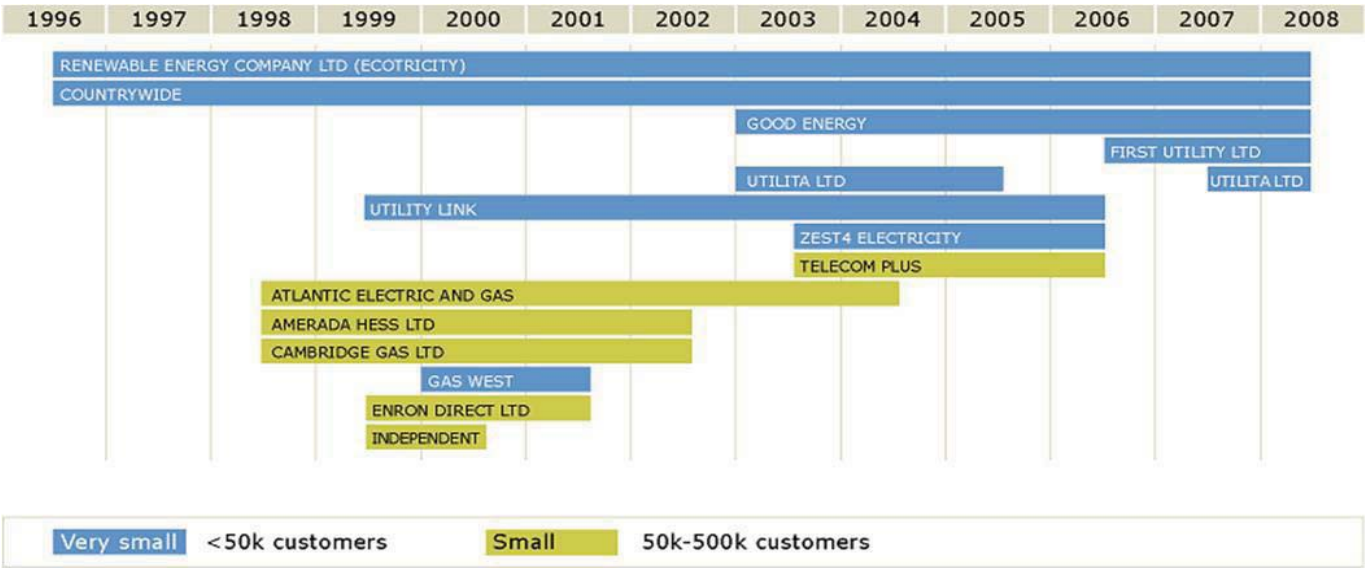
2010 prices fell from the highs of 2008 in the online market for all suppliers due to the aggressive pricing of small suppliers. Offline deals (e.g. standard credit) in which small suppliers do not compete as vigorously remained high, highlighting the advantage the larger incumbent suppliers have in terms of maintaining their profitability.

Figure 2.5 National average dual fuel offline bills vs. best offer online bills



Source: Ofgem analysis

There has been a high level of entry and exit of small suppliers since 1996, with exit being driven by bankruptcy or aqusition by larger companies. There have in the past been suppliers with customer numbers greater than the current threshold for government programmes of 50,000 customers but still significantly smaller than the six largest fimrs are today. There are currently no suppliers in this range today so our information on the costs of firms this size is limited.



In this context the Government is keen to minimise the effects of programmes that could be detrimental to the state of competition in the retail energy supply market. Whilst we recognise that there are a number of other issues such as liquidity that can act as barriers to entry or competition this policy directly addresses issues relating to regulatory requirements. Ofgem is currently looking to take action on other issues such as liquidity following it retail market review.

Rationale for intervention

A number of small suppliers are approaching the threshold level of accounts for mandatory participation in government programmes and two have a realistic chance of breaching the threshold before the expiry of the CERT and CESP. Some government programmes including CERT and CESP may place a disproportionate cost on smaller suppliers to the detriment of competition in the market.

Policy objective

The objective is to remove a potential barrier to entry and growth in the retail energy markets by setting the threshold for mandatory participation in CERT and CESP at a level that will exclude small suppliers. The intended effects are to increase the competitive pressures in the retail energy market to achieve the associated benefits of more robust competition. Overall, increased competition should drive reductions in retail energy prices, efficiencies in suppliers' business activities and increase incentives for innovation.

Description of options considered

Two options have been considered against a counterfactual of no action.

Option 1 is to re-specify the threshold for compliance with (FITs), CERT and CESP from 50, 000 domestic electricity customers or 50,000 domestic gas customers to 100,000 domestic customers total.

Option 2 is to raise the thresholds for compliance with CESP and CERT to 250,000 customers, but to maintain the current 50,000 electricity customer account threshold at which suppliers must pay FITs.

Option 2 is our preferred option as evidence presented during consultation showed that in order to exempt small suppliers from the obligations of CERT and CESP and realise the associated benefits the threshold would need to be raised to 250,000 domestic customers. FITs already have a mechanism for compensating small suppliers and no evidence was presented as part of the consultation to suggest that they place such a disproportionately large burden on them.

Projected length of programmes:

CERT and CESP both expire at the end of 2012. The Government has announced its intention to implement an Energy Company Obligation (ECO) alongside the Green Deal from late 2012 onwards. The exact design of this policy has not yet been finalised. However, it is intended that this programme will be designed to minimise the negative competition impacts and it will be the subject of a separate impact assessment. Therefore we will assume for the purpose of this impact assessment that the negative competition impacts are eliminated once the CERT and CESP programmes expire. FITs are currently under review.

Growth of firms in the counterfactual:

For the purposes of this IA we need to assess the likely course of action of firms in the absence of government intervention.

We consider that if a firm, would in the absence of programme costs, expect to grow to or only slightly over the current threshold level for CERT and CESP before the last measurement date in December 2011 they would take action to stay below the level. This is supported by evidence from small suppliers provided in the consultation process.

For a firm that could grow far beyond the current threshold before the expiry of CERT and CESP it is more uncertain the course of action that they would take as to whether they would try

to stay under the current threshold or not. Based on evidence provided by a supplier as part of the consultation process we have taken a probability weighted approach. Evidence presented sets a 50% chance that they would try to stay under the current threshold level and a 50% chance that they would continue to grow through the threshold.

Programme Costs

The cost of complying with these programmes is estimated to be currently around 3% of a customer bill and this is dominated by the cost of CERT. DECC estimates show that an average domestic electricity price including the cost of environmental obligations is £122/MWh and £118/MWh excluding CERT, CESP and FITs costs. For gas the corresponding numbers are £36/MWh including environmental obligations and £35/MWh excluding CERT and CESP costs.

This means small suppliers passing through the 50,000 customer threshold will have to put their prices up by at least 3% in order to maintain the same margins.

Retail electricity price breakdown

£/MWh (real 2009 prices)	2010
Estimated average price without policies	107
Price impact of CERT	4
Price impact of CESP	0
Price impact of Future Supplier Obligation	0
Price impact of Better Billing	0
Price impact of Smart Metering	0
Price impact of the Existing RO	4
Price impact of the Extended RO	1
Price impact of EU ETS impact on wholesale price	6
Price impact of CCS	0
Price impact of FiTs	0
Price impact of Security Measures	0
Estimated average price with policies	122
Estimated impact of policies	15
% impact (on baseline)	14%

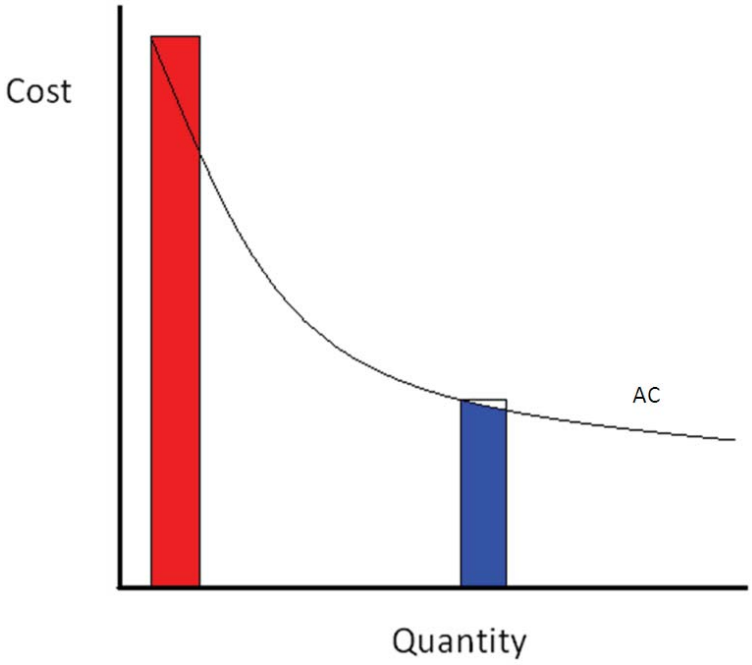
Source: DECC 2010

Retail gas price breakdown

£/MWh (real 2009 prices)	2010
Estimated average price without policies	35
Price impact of CERT	1
Price impact of CESP	0
Price impact of Future Supplier Obligation	0
Price impact of Better Billing	0
Price impact of Smart Metering	0
Price impact of RHI	0
Price impact of Security Measures	0
Estimated average price with policies	36
Estimated impact of policies	1
% impact (on baseline)	4%

Source: DECC 2010

Further to this, small suppliers cannot exploit the economies of scale in administering the programmes that larger suppliers can. It is likely that their costs of delivering these programmes will be higher, putting these suppliers at a competitive disadvantage. If a number of small suppliers each have to deliver a small amount of an obligation they will each have to set up the systems and processes to provide the required services. Each will incur fixed costs and will have to operate at the top of the average costs curve.



Given that there are currently no firms operating just over the 50,000 customer threshold it is not possible to estimate the average cost, and hence the full impact of complying with the obligations for a small firm. It is possible that small firms could contract out of meeting the obligations to an organisation that could exploit the economies of scale. However, evidence provided by two small suppliers about their estimated costs of delivering CERT obligations from the consultation suggested that even contracting out the delivery of CERT they could face a 50% or more cost premium compared to DECC's estimate of costs for larger suppliers detailed above. We have taken the 50% figure for our calculations although the premium could potentially be higher.

The cost disadvantage this gives smaller suppliers means that these firms will be less able to expand and exert competitive pressure on incumbents in the market. They will also find it harder to survive as they will have moved from having a regulatory cost advantage to having a regulatory cost disadvantage. This step change in costs increases risks to the sustainability of these businesses. Therefore we believe this could result in a retail market with fewer smaller suppliers.

Although the cost disadvantage applies to the administration of CERT, CESP and FITs, we believe it is less likely to create a barrier to growth in the case of FITs. This is because payments are made to suppliers to administer FITs which are deemed to be cost reflective and reviewed annually. Currently the FITs programme pays out £30-35 more (depending on whether the generator is new that year or continuing from a previous year) per FITs generator to small suppliers than to larger suppliers to reflect their higher administration costs.

There was no evidence presented as part of the consultation process that FITs were a significant constraint on growth. We therefore do not currently consider it necessary to increase the threshold level for mandatory participation in FITs. The wider review of FITs announced on 7 February will consider further the threshold at which suppliers are obliged to participate.

Costs and benefits of each option

Option 1

Option 1 is to re-specify the threshold for compliance with feed in tariffs (FITs), CERT and CESP from 50, 000 domestic electricity customers or 50,000 domestic gas customers to 100,000 domestic customers (just gas or just electricity or a combination of both).

CERT and CESP

The consultation showed that a re-specified threshold would be slightly less stringent for CERT and CESP because it would be any combination of 100,000 domestic customers (just gas or just electricity or any combination of both) rather than just 50,000 gas or 50,000 electricity customers. However, under our assumption that small suppliers have 90% dual fuel accounts[2] implementing option 1 would have a negligible effect. Based on our 90% dual fuel assumption the current threshold of 50,000 just gas or just electricity customers is broadly equivalent to 95,000 gas and electricity customers taken together. This option was considered to be too close to current situation to have the desired effects. This option is therefore not preferred.

Feed-in-Tariffs

Doubling the threshold for FITs would have a negligible impact

During the consultation no evidence was presented to suggest that FITs acts as a constraint on the growth of small firms. However, we expect there to be very small implications for the resource costs associated with increasing the threshold for CERT if firms grow faster than would have otherwise been the case. As Option 1 will not affect the growth rates of small suppliers we expect there to be no change in costs associated with FITs.

Option 2

Option 2 is to raise the thresholds for compliance with CESP and CERT to 250,000 domestic customer (just gas or just electricity or a combination of both), but to maintain the current 50,000 domestic electricity customer threshold at which suppliers must pay FITs.

CERT and CESP

In relation to CERT and CESP this will create no additional costs relative to the baseline counterfactual. No carbon savings are expected to be lost as a result of the change as the total target for CERT and CESP would not change.

By raising the threshold to a level that ensures that no existing small suppliers are caught in the last year of CERT and CESP there are avoided costs. The monetised **benefits are equal to the avoided cost premium** that small suppliers would face were the Government not to act.

The cost of providing CERT and CESP is currently estimated at 3% of a bill. Evidence from the consultation suggests that small suppliers face a 50% or greater per customer premium on the cost of carrying out CERT. This cost estimate is based on a cost of outsourcing the obligations. In the absence of more information on small firms' costs we will assume it to be representative of additional resource costs of small businesses. We assume that the costs of complying with CERT are as detailed above at £4 per MWh for electricity and £1 per MWh for gas. We assume that average consumption figures for domestic gas and electricity remain constant at the average of 2006 to 2008; this is 4.48MWh of electricity and 16.62 MWh for gas. We also assume that the small suppliers maintain their current level of 90% of customers being dual fuel customers.

Based on growth projections provided by small suppliers there are two companies that have a serious prospect of breaching the current threshold[3] of 50,000 customers for CERT prior to the last measurement date[4] in December 2011. They are referred to as supplier A and supplier B.

[2] This is supported by evidence from the consultation

[3] This is 50,000 electricity customers or 50,000 gas customers. The gas and electricity customers are covered under separate licenses and are therefore considered separately.

Supplier A would expect, in the absence of a threshold, to just exceed the current threshold. However, there are incentives to scale back growth ambitions and remain under the threshold for the last measurement date. Given that supplier A does not expect to grow far beyond the threshold staying below for a short period would not be too stressful to their business. As such, we do not believe there would be any avoided cost for supplier A. This is because in the counterfactual and in option 2 the supplier does not participate in the CERT and CESP programmes and as such there is no change in costs.

Supplier B would expect to breach the current threshold level by a considerable margin. We therefore find it less credible that supplier B would act to stay under the threshold as this would be a very large disruption to their business plans. Following conversations with supplier B we established that there is a 50% risk they would act to avoid customer acquisition and stay under the current threshold and a 50% chance they would try and grow through it.

Based on this direct evidence from supplier B we have decided to take a probability weighted approach for our counter factual, to produce an expected value (best estimate) of the benefit to business.

In the absence of government intervention there is a 50% chance that no small supplier would pass through the threshold as they deliberately act to stay under. In this case there are no cost premiums incurred and so no cost premiums that are avoided as a result of government intervention. Alternatively there is a 50% chance is that one firm grows through the threshold.

For this case we take a conservative view and use the “low” growth scenario projections provided by supplier B as part of the consultation process. These estimates are that they will have 180,500 customers.

This would mean supplier B would face a CERT obligation in the year 2012 based on the 180,500[5] customers they would expect to have in December 2011. Based on previous DECC estimates on the costs of suppliers complying with CERT that are covered in the consultation stage IA this would cost a large supplier £3.12m.

This is calculated on 95,000 electricity customers with an average consumption of 4.48MWh/year and a CERT cost of £4/MWh together with 85,500 gas customers with an average gas consumption of 16.62MWh and a CERT cost of £1/MWh.

This would therefore, based on the 50% premium discussed earlier, cost an additional £1.56m for a small supplier to carry out (i.e. £1.56m = £3.12 * 0.5). This is a cost in 2012, therefore in present value terms is £1.46m.

Although we have used conservative growth projections to calculate the cost savings, we have used a higher growth projection to calculate the threshold number of customers in order to ensure that small suppliers are excluded. Government intervention to raise the threshold to 250,000 domestic customers means that this supplier is not caught before CERT expires and therefore these costs are avoided and represent the monetised reduction in costs to business which are all realised in the year 2012.

Given the uncertainty about the counterfactual we use a probability weighted approach. Based on the 50% probability of exceeding the threshold, as estimated by the company, this means that the expected value of the avoided costs is £0.73m.

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[4] Energy companies are assessed on their customer numbers for December 2011 which sets their obligation for 2012, if a company is under the threshold at that time it will not have to comply with CERT obligations.

[5] This assumes the 90% dual fuel billing. Thus 95,000 electricity customers and 85,500 gas customers.

Feed-in-tariffs

As stated earlier, it is the change of growth rates that has the potential to affect the costs of administering FITs. Raising the threshold on CERT and CESP to remove the potential barrier to growth should allow firms to achieve their central growth projections.

Supplier A's central growth projection is only just over the current threshold and therefore moving the threshold will not have a serious effect on their growth. We therefore do not expect this to impact on the number of FITs installations that they administer. Supplier B has the ability to grow much more than under the counterfactual and therefore will have more accounts.

This means that compared to our counterfactual 50% of the time there are an additional 79,000 electricity accounts served by small suppliers and 50% of the time there are an additional 120,000 electricity accounts served by small suppliers[6].

We assume that FITs installations take up is even across suppliers in proportion to their share of the electricity market. Thus an increase in accounts with small suppliers will mean a corresponding and linear increase in FITs installations administered by small suppliers. We estimate based on the additional account numbers above there will be approximately 200 to 300 more FITs installations being administered by small suppliers.

In order to assess the impact on the administration costs associated with FITs we make the following further assumptions:

- **The number of FITs installations is unaffected by this policy** - If a customer wanted to receive FITs and they were with a supplier that didn't offer FITs we would expect them to switch to one that did.
- **The administration costs associated with FITs are £35 more for a new generator to a small supplier and £30 more for a continuing generator to a small supplier**– these are the current level of 'cost reflective' payments paid to firms from a 'levelisation' fund in order to cover the administration costs for FITs. The levelisation fund is paid into by all licensed suppliers in proportion to their market share.
- **If a firm voluntarily chooses to supply FITs payment in the counterfactual they will continue to do so if the threshold is raised.**

Option 2 does affect the growth of firms in 2012. This means that we expect small suppliers to be slightly larger. This increase in the size of small suppliers and the assumption that they continue to receive higher cost reflective administration payments means that there is a very small increase in the costs of administering FITs. Our best estimate of these additional costs in 2012 has an NPV of £7400.

Warm Home Discount

As part of this consultation the Government gathered evidence on the threshold at which suppliers should be required to participate in the Warm Home Discount Scheme. The Government has since made clear in its response to the Warm Home Discount consultation that the threshold at which suppliers will be obliged to participate in the scheme at 250,000 customer accounts. Government has also laid the draft Warm Home Discount Regulations (2011), which will set the threshold at 250,000 domestic customers (just gas or just electricity or a combination of both), subject to their passage through Parliament. This is move should avoid significant admin burdens for smaller suppliers. Setting the threshold at 250,000 domestic customers

[6] This is based on 1 supplier that already offers FITs voluntarily growing based on a central scenario rather than a low scenario due to the removal of CERT and CESP costs. These numbers are based on growth projections provided in the consultation process.

should ensure that only suppliers that are better able to bear the fixed costs are obligated by the scheme.

Distributional Impacts

We also consider the distributional impacts that option 2 would have. The cost that large suppliers face for carrying out obligations that might otherwise have been carried out by small suppliers will be passed on to their customers. Essentially large suppliers will face the same costs as they do currently but have a slightly smaller customer base. Based on the £3.12m CERT cost being spread across more than 49m domestic customers implementing option 2 would add less than 20p to a large supplier's dual fuel bill per year. This is considered to be de minimis.

Competition

Implementing Option 2 should allow small firms to compete more vigorously in the market as they will not face disproportionate costs from complying with Government programmes.

Improved competition should drive reductions in retail energy supply prices, efficiencies in suppliers' business activities and increase incentives for innovation.

However, these effects are likely to be small. The CERT and CESP programmes expire in 2012 and many small suppliers are unlikely to be affected as they are not likely to breach the current threshold before the programmes expire. Those firms that can breach the current threshold should have a competition impact however; as this is only likely to be two firms the impacts will be small.

As a result of these changes to policy we would expect that some small energy suppliers increase in size. In the longer term if the energy market has more medium sized firms there is the potential for resource cost implications. These will depend heavily on the pace at which the average costs of growing firms decline towards the costs of the six largest firms. We would also expect that small firms growing will mean that they are exerting more competitive pressures in the market place.

Risks and assumptions

Key sensitivities are the growth rates of small suppliers and their behaviour when faced with a threshold on CERT and CESP for a single year. If small firms would grow through the threshold in the counterfactual then there will be a resource cost saving associated with the preferred option. However, the larger these resource benefits the weaker the competition argument for the policy intervention is.

Summary and preferred option with description of implementation plan

The preferred option is to raise the thresholds for compliance with CESP and CERT to 250,000 domestic customers but to maintain the current 50,000 domestic electricity customers threshold at which suppliers must pay FITs, subject to the review of FITs.

Net Costs to Business

This policy places no new costs on business. It is deregulatory in nature and is equivalent to a reduction in Equivalent Annual Net Costs to Business of **£0.38m** based on a 2 year appraisal period, a discount rate of 3.5% and an NPV of £0.72m

Rural Consumers

The proposal will not preclude rural customers benefiting from the help provided by the various schemes to which the new threshold will apply.

Annexes

Annex 1 should be used to set out the Post Implementation Review Plan as detailed below. Further annexes may be added where the Specific Impact Tests yield information relevant to an overall understanding of policy options.

Annex 1: Post Implementation Review (PIR) Plan

A PIR should be undertaken, usually three to five years after implementation of the policy, but exceptionally a longer period may be more appropriate. A PIR should examine the extent to which the implemented regulations have achieved their objectives, assess their costs and benefits and identify whether they are having any unintended consequences. Please set out the PIR Plan as detailed below. If there is no plan to do a PIR please provide reasons below.

Basis of the review: [The basis of the review could be statutory (forming part of the legislation), it could be to review existing policy or there could be a political commitment to review
Review objective: [Is it intended as a proportionate check that regulation is operating as expected to tackle the problem of concern?; or as a wider exploration of the policy approach taken?; or as a link from policy objective to outcome?]
Review approach and rationale: [e.g. describe here the review approach (in-depth evaluation, scope review of monitoring data, scan of stakeholder views, etc.) and the rationale that made choosing such an approach]
Baseline: [The current (baseline) position against which the change introduced by the legislation can be measured]
Success criteria: [Criteria showing achievement of the policy objectives as set out in the final impact assessment; criteria for modifying or replacing the policy if it does not achieve its objectives]
Monitoring information arrangements: [Provide further details of the planned/existing arrangements in place that will allow a systematic collection systematic collection of monitoring information for future policy review]
Reasons for not planning a PIR: [If there is no plan to do a PIR please provide reasons here] There is no plan to review this policy change as the Government programmes to which it applies end in 2012.