E.ON submission – Bright Blue report on energy efficiency

Executive Summary

- A key reason for the failure of the Green Deal was the lack of sufficient market testing of the financial product. The process for taking out a loan was complex and interest rates were not sufficiently compelling to make the Green Deal attractive for customers.
- Government should focus effort on addressing a market failure in terms of how homes are valued. To achieve this, the Government should make changes to Stamp Duty so that the tax paid by home buyers varies according to the EPC rating of the property. Moreover, the mortgage industry should look to improve the way they forecast the ongoing energy costs which a prospective new home owner will incur.
- To decarbonise the domestic heat sector needs to see the take-up of a range of low-carbon technologies. The electrification of heat will play an ever-important role in the 2020s and we also believe that district heating systems can, and should, play an important role in decarbonising the sector.
- There needs to be much greater ambition around energy efficiency in order to limit the amount of demand for heat by households and businesses in the first place.

1. Why did the Green Deal fail? In particular, what mistakes were made in the design of the finance mechanism and the communication of the scheme?

DECC were very ambitious about the number of homes the Green Deal would make more energy efficient. The reality was somewhat different, with demand for Green Deal finance falling well below expectation: only 14,000 households took out Green Deal loans by the end of 2015.

During the design of the scheme a number of industry participants believed that the projected numbers were optimistic and that the Green Deal needed to be market tested. The decision to not test the financial product with households was one of the biggest reasons why the scheme failed.

If such testing had been undertaken, it may have become apparent early on that the original design was not going to sell in the volume of Green Deal Loans that Ministers had hoped for. For example, the process that households had to go through in order to take out a loan was complex, and markedly different to the customer experience for taking out other loans for investments in the homes like kitchens, bathrooms and double glazing. The Golden Rule condition also meant that the type of measures that would qualify for a Green Deal Loan was restricted without additional subsidised support, for example, Solid Wall Insulation (SWI). Getting the customer journey right is a pre-condition for being able to sell the product.

The other key failing in the design of the scheme is that relative to other consumer loan products and mortgages, the interest rate being offered to households was not sufficiently compelling. When administration charges were taken into account, the effective interest rate was around 10%. Offering a much lower interest rate or interest free – as some local authorities and the Scottish Government have promoted – may generate more interest.

Even if the interest rate is sufficiently attractive, there needs to be a much greater demand pull from households to want to invest their disposable income on energy efficiency. Much greater consideration needs to be given as to how to market this to households, learning lessons from other industries, where people believe it improves the appearance, level of comfort and therefore value of the property. Any successor scheme also needs to be attractive to the wider value chain and particularly providers of capital.

2. **How should Green Deal-style loans for the able-to-pay sector be financed in the future? Is it necessary for the Government to provide any subsidy to the scheme?**

We believe that the Government should focus effort on addressing a market failure in terms of how homes are valued. Specifically, where there are two identical properties that only differ in terms of their energy efficiency, as rated by the Energy Performance Certificate (EPC), the market does not place a premium on the more energy efficient home. If such a premium was placed on properties by estate agents, we believe it would help to underpin a sustainable market for retrofitting properties with insulation measures.

To achieve this, the Government should make changes to Stamp Duty so that the tax paid by home buyers varies according to the EPC rating of the property. Properties with an EPC rating which exceeded a set benchmark would receive a Stamp Duty discount, whereas less energy efficient homes would be liable for a tax premium. Variable Stamp Duty would send a clear signal to the property market, which estate agents would take into account when valuing properties. The design of the tax scheme would not only provide stronger incentives on current home owners to consider energy efficiency measures that would protect or increase the value of their property, but could also be designed to be fiscally neutral for HM Treasury.

To complement this tax reform, the mortgage industry should look to improve the way they forecast the ongoing energy costs which a prospective new home owner will incur. We understand that the current methodology for forecasting these costs is not robust, and is potentially underestimating the energy costs that the new owners will incur. For banks, this has the effect of increasing their risk that a customer will default on their repayments.

It is in their interests to minimise such risk, and so we believe the mortgage market should take steps to improve their forecasting capabilities. In doing so, we believe this could create opportunities for the mortgage industry to offer new products that could support energy efficiency investments, which new home owners could make at a relatively low interest rate. Nationwide already offer their customers the ability to top up their mortgage with a loan at competitive rates where they are investing in energy efficiency measures. The industry could build on this concept by varying the amount someone could borrow according to the EPC, but allowing the applicant to increase this amount where they committed to increase the EPC from the current rating to an agreed higher rating. The additional borrowing at the set mortgage rate could help fund the investment, which would increase the value of the property (reduce the loan to value ratio in the process in most cases), and reduce ongoing energy bills. Such an approach is akin to a pay-as-you-save scheme but is driven by the market.

We understand that some local authorities are offering low or zero percent loans to support energy efficiency investments for the able to pay market. We are supportive of this, local and regional governments can tailor their schemes to meeting their local communities' needs in a way that Whitehall is not very effective at doing. The devolution agenda in England provides an opportunity for local pay-as-you-save schemes to be designed.

3. **What lessons do you anticipate from the Bonfield Review about quality assurance in the supply chain? How can these be incorporated into a Green Deal successor scheme?**

Customers need to have confidence that when they invest in energy efficiency the quality of the installation is there and it delivers the savings for customers that have been assumed. One of the problems with the industry to date has been the lack of a robust quality assurance scheme. This has led to Ofgem requiring energy suppliers to police the insulation industry when installing measures under the Energy Company Obligation (ECO), which imposes significant administration costs on suppliers. Instead we hope that the Bonfield Review will grasp the issue and promote a way forward which everyone has confidence in, and leads to the installation industry effectively policing itself through a quality assurance scheme which has teeth and takes robust action against installers that are not meeting the required standards. Better consumer protection is a key requirement for putting the insulation industry onto a sustainable basis.

4. **How can a Green Deal successor scheme be successfully communicated to consumers?**

As we set out above, we believe there are market solutions where the financial community, energy companies and estate agents will be the key proponents for encouraging households to invest in energy efficiency measures. In our view these bodies are more likely to be successful in communicating to their customers the benefits of taking out a loan to invest in energy efficiency as opposed to HM Government. However, there may be a role for local government to promote such schemes, recognising that they may be a more trusted intermediary compared with central government.

5. **What are the best options for decarbonising the domestic heat sector?**

The proposed fifth carbon budget requires an increase in take-up of low-carbon heat. At this stage it is not clear what the best approach should be, however, we believe the electrification of heat will play an ever-important role in the 2020s and beyond. A one size fits all approach is unlikely to work, and the extent to which heat will be electrified may be impacted by geography.

We believe that in major cities and some high and low density new build developments, district heating systems can, and should, play an important role. District heating can harness lower carbon heat supplies as and when the technology becomes economically viable. For those households and businesses located off the gas grid, renewable heating solutions including heat pumps are more likely to feature in the decarbonisation of heating. However, there are competing technologies, including the potential for biogas and hydrogen, which may provide an alternative way of decarbonising heat in sub-urban areas. Policy makers should keep a number of options open at this stage for decarbonising heat as opposed to picking a particular technology.

A no-regrets position to take is to pursue policies which limit the amount of demand for heat by households and businesses in the first place. Much greater ambition around energy efficiency is required to realise this objective, and should underpin all other policies for meeting the fifth carbon budget.

6. **How can the Government incentivise the take-up of renewable heat technologies within a Green Deal successor scheme?**

Our proposed market solution based on improving the EPC of a property should provide credits for households that choose to invest in a renewable heating solution, since these will typically improve the rating of the property. It is unlikely that the Renewable Heat Incentive in its current guise will be around beyond 2020. Taking steps today to improve the functioning of the housing market could therefore help to support long run renewable heating technologies where they are cost effective, with the costs added of the investment added onto the mortgage.

The recent reforms to the Renewable Heat Incentive outlined by DECC also provide for the equivalent of “rent a roof” propositions, which may lead to players coming into the market offering customers renewable heating solutions without having to provide the upfront costs. The subsidy in this case would go directly to the third part provider, as opposed to the household, and may provide a compelling alternative to adding the cost of the renewable heating solution to the mortgage.