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# Round table on an Energy Efficiency Scheme for SMEs

3<sup>rd</sup> May 2019

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## Introduction

On 3<sup>rd</sup> May a round table was held at ADE's offices, to discuss the proposals from BEIS for an energy efficiency scheme for SMEs. The round table was organised by ADE, in co-operation with the Energy Institute, Energy UK, the Energy Systems and Technologies Association (ESTA) and the Mineral Wool Insulation Manufacturers Association (MIMA).

This note represents a summary of the key points raised during the discussion. It does not necessarily represent a consensus view of all the organisations involved in the event.

## The proposals for an SME energy efficiency scheme

The meeting started with a presentation from BEIS on the proposals they have put forward for an energy efficiency scheme for SMEs. The presentation covered the context for the scheme. This included:

- The Clean Growth Strategy, and how the 20% improvement in energy efficiency is going to be met
- The call for evidence on business energy efficiency published in summer 2018 and the government's response to evidence submitted, published in March 2019
- The call for evidence on Energy Performance Certificates (EPCs) and the government response to this, expected soon
- Consultations and calls for evidence that will emerge later this year, including Private Rented Sector (PRS) regulation trajectories, Part L of the building regulations, the buildings missions and work from the Better Buildings Partnership
- Building the market for energy efficiency; the BASEE competition, Trustmark and PAS for non-domestic customers, smart meters and associated data access
- Industrial processes; evaluation of Climate Change Agreements (CCAs) and the Energy Saving Opportunities Scheme (ESOS), funding for industrial heat recovery and the industrial energy transformation fund, new guidance on combined energy/carbon reporting.

The presentation also set out the crucial role for SMEs in meeting the 20% improvement ambition: SMEs are responsible for around 50% of business energy use.

The proposals for discussion were set out. These were: an auction; an Energy Company Obligation for SMEs, and improved access to finance via loans and Energy Services Company (ESCo) offerings.

## Discussion

In addition to responding to the three proposals in the government's consultation document, participants also discussed the more general context of SME energy use; how to target the scheme and how it would link to the Minimum Energy Efficiency Standards for non-domestic properties in the private rented sector; future-proofing the scheme; and a range of ideas for additional actions that would be needed.

### SMEs and energy use

All three of the options presented in the consultation are about financing investments, they say little about how to build demand amongst SMEs. There were many comments throughout the round table about how SMEs operate and how they view energy use, which can help inform actions to build demand. These are summarised here. Suggestions for approaches to building demand are included in the section on 'additional measures', below.

### Drivers for SME action

SMEs are driven by many factors, but cash and profitability are key. There are three key financial drivers of SME decision making; it may be possible to make use of the last of these in designing incentives:

- Cost
- Cash flow
- Tax liabilities

There is a lot of churn in the SME sector: the average SME lasts perhaps five years. Their primary concern is about how to stay in business, and they are not thinking about energy efficiency. Things like 2050 targets are not relevant in this context. If there is a very tangible financial gain to be had, then there will be interest. If an investment takes two years to pay back, then it won't be attractive.

SMEs can be driven by regulation. A good example is the introduction of condensing boilers: without the regulatory requirement, small installer businesses were not using them, but the regulations forced all plumbers to install them.

There may be differences in drivers between SMEs that operate in a business-to-business environment and those who are customer-facing. Schemes will need to work for both.

### Barriers to SME action

SMEs are not part of any process or structure around energy efficiency at the moment (e.g. ESOS) so they are not receiving any messaging and awareness is low. In Scotland and Wales there are advisory services, but in England this has been lost.

The lack of time for SMEs has to be taken into account: why would they spare the time to look at energy efficiency investments when they are not sure about the returns?

SMEs lack energy expertise (many rely on brokers for energy contracts), but they don't like relying on energy suppliers – there are issues of trust and confidence to be overcome.

Rising energy prices makes selling energy efficiency savings to SMEs difficult as they might not see any actual reduction in their energy bills.

Banks don't tend to lend to SMEs.

### **Complexity in the sector**

The variability of opportunities within the sector must be recognised: for example, it is much more complex to determine the biggest wins at a manufacturing site than to calculate savings from a pub that needs insulation.

### **How will the scheme be targeted?**

The precise definition of SME and the scope of the scheme is yet to be fully defined. Two key considerations are where the greatest potential lies and how the scheme will sit alongside the Minimum Energy Efficiency Standards (MEES) for properties in the PRS.

The greatest potential within the SME sector seems to lie in industrial buildings, as these tend to be larger and also tend to be owner-occupied.

There was discussion about the link between this scheme and the PRS MEES: are we aiming to target the SMEs, or the owners of buildings in which SMEs operate? There was support for the principle of addressing building owners through regulation in the case where the SME does not own the property it occupies, but differing opinions on the likely effectiveness of the regulations and whether or not additional measures are needed to drive energy efficiency improvements in these buildings. It is possible that enforcement is not as big an issue in the non-domestic sector, as compliance is driven more by a refusal by property lawyers to complete transactions unless compliance is demonstrated. Equally, it is possible that incentives for the SME occupiers of the buildings could drive faster progress than reliance on the regulations alone.

### **Future-proofing the scheme**

There needs to be consideration of how this scheme will interact with decarbonisation of heat, and also with the technical change happening in areas such as storage and onsite generation.

The scheme should be developed by considering what sort of market can / should be created and what the exit strategy will be. It also needs to be considered alongside the review of the future regulation of the energy retail market. We are asking how we get a market that optimises customer satisfaction and promotes innovation whilst ensuring fair prices and there is a view that obligations are distorting the market. Can obligations sit with energy suppliers in the future?

### **Responses to the proposal for an auction**

Elements of the detailed design of an auction scheme that are still to be determined include who would participate (SMEs, providers, both), how it would be funded and who would run the auction.

One of the main concerns about the auction proposal was the potential for it to drive price competition rather than quality. It would be important to have a framework that provided incentives for bidders to deliver quality, but this can be hard to capture. Designing a metric that includes quality as well as price is not only important for the auction option.

Solutions for businesses are often quite bespoke, and one fundamental issue with an auction (and with ECO) is that you create a generic price and then installers try and fit jobs to these prices. You can try and bolt on quality elements, but if the scheme encourages people to work to a generic price, the market is not able to do its job.

There is also the risk that promised investment is not actually delivered. How do you design it such that there are penalties for those who bid unrealistically and then don't deliver?

Lessons can be learned from the reasons why the ECO brokerage auction has not worked. It is more difficult to learn from auction successes in Germany, because this operates in the context of massive, top-down, government-driven policy on energy efficiency.

It is difficult to see how the participants in the auction would engage with SMEs: SMEs are less likely to engage with energy suppliers; and the technical companies who have the solutions for SMEs are not attracted to the idea of putting forward and then delivering an auction bid. There are lots of contractual issues and a lack of trust in the development of the market.

**It is unlikely that SMEs would engage directly with an auction; they may not understand its complexities (this applies equally to SMEs within the energy efficiency supply chain). Responses to the proposal for an ECO for SMEs**

ECO may be considered as an option for the smaller end of the SME market. At the smaller end of the SME market you have a lot of businesses in buildings that are very similar in form to housing. An ECO scheme for these businesses could effectively be an extension of what has been done so far in the domestic sector. There may be low-hanging fruit in this part of the market, with low costs of acquisition. An ECO could be regressive if the activity targeted only the larger end of the SME market.

The experience of ECO in the domestic sector is that it has been successful in delivering a volume of savings, relatively cost-effectively. However, the recent rate of installations has slowed considerably, indicating that the success of an obligation scheme is contingent on the right framework. Energy companies are good at channelling money into investment, with efficient scheme administration. But it also suppressed the development of a genuine market amongst able-to-pay households and has suffered from the focus on price over quality (see above). Hence an SME ECO perhaps should not be open to medium sized businesses. However, this would limit the energy saving opportunity per business approached and hence would increase scheme costs.

It is important to look back to earlier energy supplier obligations (EESoP, EEC) for useful barometers of what could work, as simplicity is key to efficient and effective delivery. It is also important to recognise that financial incentives can effectively be a marketing tool (if built into the prices charged) rather than a genuine cost to the scheme.

How does the interaction between SMEs and energy suppliers, and the use of brokers, differ from the interaction between households and energy suppliers, and are there any particular characteristics of this interaction that make an ECO more or less likely to be effective than in the domestic sector?

Without measures to increase engagement and demand amongst SMEs, an ECO could end up costing a lot of money – the energy suppliers may deliver the savings, but they will have to spend money trying to persuade a reluctant audience to participate. It could also result in the most engaged and well-resourced businesses taking advantage of the opportunity, leaving behind those who may derive relatively greater benefit but are unable to commit resources.

Are all the options put forward too outputs- rather than outcomes-focused? ECO tends not to link well with innovation, as it does not reward based on a fair price for real savings delivered.

Where should the obligation sit? You could have the situation where one building has supply from a number of different energy suppliers. Should the obligation sit with the Distribution Network Operator / Gas Distribution Network (DNO/GDN)? Perhaps, but then you have the barrier that there is no existing relationship with the customer.

An obligation scheme or an auction would require funding which raises questions over the legitimacy of different options to obtain these funds. A levy through energy bills may be considered regressive compared to general taxation if it places financial pressure on those unable to benefit from the scheme, such as the smallest businesses without access to finance for match

funding. Further, if costs are placed on bills, it is important to consider how to most appropriately balance this across gas and electricity costs.

### **Responses to the proposal for improved access to finance, including through ESCos**

Energy Services Companies (ESCOs) tend to target the bigger industrial processes. Even here, it takes time to determine the best investments, and then there is a three to five year wait to see if the investment pays back and indeed whether the business continues to trade over this period. For smaller businesses, the ESCo model looks very difficult: the economics do not really stack up. Combining the ESCo approach with ECO or an auction could improve the economics, but would price uncertainty be a barrier to sign-off on energy services agreements? The price variability in auctions or ECO is not a good fit with the requirements of benchmarking and verification.

Bundling projects across a number of SMEs is one way that the value of a project could become attractive to service providers, and drive value through competition. You could cluster SMEs on sector type or on energy intensity. Industrial sectors would potentially still be most attractive, as in addition to greatest value, there is also a better ability to implement measurement and verification.

An obligation on DNOs/GDNs to report on energy flows at a local level could enable a local capacity market in which energy use reduction could effectively be paid for. This could promote an ESCo approach.

Zero interest loans are also an option to consider supporting. These are used in Wales, with a very low default rate. For private finance, we need to think about it from the investment company perspective – what is the ownership model?

We need to move away from the ESCo terminology, as this will not engage SMEs.

### **Additional measures that are needed**

#### **Verification of savings**

Some consideration must be given to estimation and verification of savings: the PRS regulations and Part L over-emphasise theoretical savings; in practice these depend on how technologies are installed and operated. The development of a sustainable market will depend on reality matching the savings that are promised. Everyone needs to be happy with what is delivered, not only those who experience best practice. It does not seem likely that an auction or ECO, without supporting measures, would deliver this.

#### **Regulation**

If regulations were in place that required SMEs to take action, then some of the proposed schemes could work. This could also drive supporting action from energy efficiency technology manufacturers, who would be more inclined then to invest in sales efforts that would drive awareness. We may be able to learn something from the SME response to previous requirements, for example the introduction of 'Making Tax Digital'. There was some discussion about whether there were any examples where a lack of interest amongst SMEs had been transformed into engagement without the need for regulation, and the suggestion that for some issues, for example the smoking ban, success had been a matter of other factors lining up in advance of regulation. We may have an opportunity here with the focus on a climate emergency. The question is, how can government best help SMEs respond to this?

#### **Incentives**

Any incentives offered should be cash-flow positive for the SME.

Fiscal incentives should be possible: a business rates incentive could be revenue neutral given that greater energy efficiency should lead to more growth and hence more taxes. It is also possible that Treasury is more receptive to proposals around fiscal incentives than they have been until recently. A tool that gives you tax relief if you do something is very simple and hence may have reach way beyond the options proposed here. This type of tool could be the cheapest and most effective way to get SMEs to act on energy efficiency themselves.

If owner-occupier SMEs are a key target, the asset value of their property could be a driver: there is a link here with the PRS MEES, as mortgage lenders could downgrade a valuation on the basis that the property could at some future point move into the PRS.

### **Supply chain initiatives**

Supply chain initiatives could have a role to play: could the funding available to larger organisations to support energy efficiency investments be linked to obligations to include energy performance in procurement standards, for example? There may be useful learning from the construction sector, for example from the 'Considerate Contractor' scheme. The challenge for policy makers with this type of approach is whether you can track definite delivery of the carbon savings that the government needs. There is also a larger issue around how you get SMEs into procurement frameworks without imposing undue burdens.

### **Benefits of energy efficiency**

There is a tendency to focus on cost; what about the non-monetary benefits of the improvements? Engaging SMEs may not be about talking about energy savings: where landlords receive complaints related to poor energy performance, these may be more focused on a lack of comfort (too hot, too cold, lack of fresh air) than on the size of the energy bill. Having said that, there may still be value in pointing out the extent of savings that are simply being ignored.

### **Routes to market**

The role of a trusted voice will be critical in developing this market. If advisory services were provided, this would at least give SMEs confidence that there was support and somewhere to turn for impartial information and advice.

There may need to be a framework for suppliers of efficiency measures, to help build trust and confidence amongst SMEs that the suppliers have been vetted and will deliver. There are examples of this approach: in Germany there is a website listing all the companies that are qualified / certified to install energy efficiency measures. However, there was some concern expressed about cynicism around frameworks and the difficulty for smaller, local suppliers of efficiency measures to deliver compliance paperwork and hence participate in schemes using frameworks, although perhaps a framework could be designed that is not too onerous. This may be particularly pertinent here as there was a sense that SMEs are more likely to do business with people they know and hence have a preference for local suppliers.

This implies a need to work with local networks. The best way to build confidence will vary across sectors: engaging with the trade bodies in some sectors may be effective and where structures and systems of due diligence are needed, these bodies could be interested in running a scheme, although the limits on their resources must be recognised. The use of established and trusted local intermediaries (Chambers of Commerce, Local Enterprise Partnerships, Federation of Small Businesses) should be considered. However, the extent to which they are engaged with energy issues does vary geographically. Community based energy CICs are another potential route to market.

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**Appendix 1. List of attendees**

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Dan Alchin	Energy UK
Jenny Boyce	EON
Andrew Cooper	Evora Edge
Nigel Donohue	CIGA
Steven Heath	Knauf
Sarah Higham	Centrica
Lily Frencham	The ADE
Richard Gow	Drax
James Griffiths	The ADE
Glyn Mountford	GEP Environmental
Falah Mousa	Uniper
Stephanie Parker	BEIS
Martin Pearce	EDF
Mervyn Pilley	ESTA
David Robson	Instagroup
Esin Serin	Energy Institute
Margaret Sutherland	BEIS