Environmental Audit Committee Inquiry:
Green Investment Bank

Evidence from the Association for the Conservation of Energy – October 2010

Introduction

The Association for the Conservation of Energy was formed in 1981 by major companies active within the energy conservation industry, in order to encourage a positive national awareness of the needs for and benefits of energy conservation, to help establish a sensible and consistent national policy and programme, and to increase investment in all appropriate energy-saving measures. We welcome this opportunity to comment upon the proposed Green Investment Bank.

For further information please contact:

Jenny Holland
Head of Parliamentary Team
Association for the Conservation of Energy
Westgate House, 2a Prebend Street
London N1 8PT
(020) 7359 8000
jenny@ukace.org
www.ukace.org

Summary

- The new Coalition Government should make a clear and early statement that it remains committed to the creation of a Green Investment Bank (GIB) with a full range of powers. Although this was promised in the Coalition Agreement, no concrete proposals have subsequently been forthcoming. Furthermore, at the time of the Queen's Speech on 25 May, the Government stated that the forthcoming Energy Security and Green Economy Bill might be used as the legislative vehicle "to set up a Green Investment Bank". We are concerned that the latest pronouncements from the Department of Energy & Climate Change make no mention of the Bill being used for this purpose.
- The GIB should have a clear mandate to tackle the low carbon investment needs of the UK. The scale of the required investment is such that traditional sources of capital will fall well short of the sums required. Without such intervention, the UK's low carbon targets will not be achieved. Adequate levels of initial capitalisation – around £4-6 billion – will be required to ensure the Bank's success.
- Investment in energy efficiency should be a key feature of the Bank's activities. In particular, energy efficiency should be given the highest priority in the Bank's initial phase, as investment in demand reduction measures will reduce the level of total infrastructure required and enable the scaling-up of existing, proven technologies. Approximately £225 billion will be required to finance the requisite energy efficiency improvements until 2025 – this represents around half of the total low carbon investment required.
- Retrofitting the UK's building stock is a vital component in the delivery of our low carbon future. However, this involves large numbers of individual investments and small scale projects. The GIB can play a key role in aggregating these investment opportunities and providing upfront finance to householders and SMEs.
- Part of the GIB's remit should be to support the proposed Green Deal financing scheme. This will be especially important in the Green Deal's early market stage before significant scale of demand has been achieved. The support should take the form of upfront loans to able-to-pay householders, complemented by subsidies for households unable to pay.

Responses to individual questions

N.B. We have confined ourselves to responding to questions of relevance to the Association.

What is the significance of any barriers or 'market failures' requiring the establishment of a Green Investment Bank, and what are the risks of not getting this done quickly?

1. As identified by the Green Investment Bank Commission in its recent report[1], there are four key market failures and investment barriers which deter investment in low carbon infrastructure: market investment capacity limits, political and regulatory risk, the confidence gap, and the aggregation challenge.
2. Of these, the aggregation challenge is the most significant in relation to investment in energy efficiency, particularly as regards the buildings sector. This is because household retrofitting consists by definition of a multitude of individual investments and small scale projects. The GIB can play a key role in aggregating these investment opportunities.
3. The potential for energy efficiency refurbishment in the UK is enormous. A recent report by Ernst & Young[2] identified that the cost of retrofitting the UK's 26 million homes to a high energy efficiency standard would cost up to £225 billion between now and 2025. This broadly equates to the findings of the UK Green Building Council (UKGBC), which concluded in its August 2009 report[3] that in order to finance a comprehensive package of home energy improvements (as envisaged by the last Government in its Home Energy Management Strategy), investment of between £5bn and £15bn a year would be required through to 2020.
4. Despite this huge investment potential – and the short payback times of many energy saving measures – householder demand for energy efficiency improvements has failed to respond to over 15 years of subsidy through successive supplier obligations. A combination of factors is responsible for this. By and large, householders lack high quality information on their energy usage or about the potential for energy efficiency packages to save them money; they also have limited access to appropriate sources of capital. The situation in the UK compares poorly with that in Germany, where the KfW Banking Group

[1] Green Investment Bank Commission, *Unlocking investment to deliver Britain's low carbon future*, June 2010, pp. 5-6
[2] Ernst & Young LLP, *Capitalising the Green Investment Bank, Key issues and next steps*, October 2010
[3] UK Green Building Council, *Pay As You Save: Financing low energy refurbishment in housing*, August 2009

offers loans (backed by Government bonds) to householders at a rate of 2.65%. The resulting energy efficiency household loan programme is a resounding success story – delivering 100,000 household retrofits every year.

5. Following on from the previous Government's 'Pay as You Save' proposals, the new Government has announced its intention to use the forthcoming Energy Security and Green Economy Bill to introduce a new Green Deal financing framework, designed to incentivise householders and businesses to invest in energy saving measures that "pay as they save".
6. However, a low interest rate will be essential to the success of the Green Deal in delivering packages that pay back in energy savings in their lifetimes. As the UKGBC report on PAYS outlined, the ability of a package of measures to pay back is very sensitive to the interest rate[4]. The Government insists that all Green Deal energy saving packages must meet the 'Golden Rule' – in other words, that the charge should be exceeded by the value of the fuel bill savings over the lifetime of the charge. However, at commercial interest rates it is unlikely that higher-cost measures (beyond cavity wall and loft insulation) will be able to meet the Golden Rule. If the Green Deal is to deliver 'whole house' packages of the kind that we need to meet our carbon reduction targets, then the GIB must be enabled to play a significant role in maintaining Green Deal interest rates at the lowest possible level.
7. Significant market barriers also exist for SMEs wishing to invest in energy efficiency measures. The Green Investment Bank Commission correctly identified the main barriers as follows:
   - Energy is a relatively low cost or low priority for most businesses;
   - Financing is not available to SMEs on terms that make uptake attractive;
   - SMEs do not have the necessary technical knowledge and confidence to invest.[5]
8. As identified by Ernst & Young[6], the sheer scale of the investment required in securing our low carbon future is such that traditional sources of capital will be able to provide only a tiny fraction of what is required. Their analysis reveals that the UK needs a total of £450 billion of investment in both supply-side and demand-side measures until 2025. Traditional sources of capital (utility companies, other corporates, project finance and infrastructure funds) can only provide approximately £50-80 billion over the same period. This leaves an estimated funding gap for energy infrastructure of around £370-400 billion over the next 15 years. The role for the Green Investment Bank in plugging this gap is therefore huge.

[4] UK Green Building Council, op cit.
[5] Green Investment Bank Commission, op. cit.
[6] Ernst & Young LLP, op. cit.

What are the objectives and roles the Green Investment Bank should assume, what areas should it operate (and not operate) in, and how should its lending and investment decisions balance green benefits against financial risks?

9. Investment in energy efficiency should be a key feature of the Bank's activities. In particular, we agree with the Green Investment Bank Commission's conclusion that energy efficiency should be given the highest priority in the Bank's initial phase, as investment in demand reduction measures will reduce the total infrastructure investment required and enable the scaling-up of existing, proven technologies.
10. To deliver on our carbon reduction targets, energy efficiency investment will be needed to finance not only large-scale projects in the industrial and commercial sectors, but also small-scale community projects and individual household packages.
11. The Green Investment Bank Commission helpfully outlined the ways in which the GIB might operate to overcome the market barriers – for both households and SMEs – identified above.
12. For households, the main role of the GIB should be to aggregate the multitude of small investment opportunities that characterise the UK's retrofitting needs. But the GIB must also be able to provide readily available upfront finance to householders wishing to make significant energy efficiency improvements to their home. We are attracted to the proposals put forward by the Green Investment Bank Commission that this finance should come from a public/private blended capital programme (funded in part by green bonds raised by the GIB). This money would then be used to provide upfront loans (as near 100% as possible) for the able-to-pay, alongside near 100% subsidies for those unable to pay. A portion of the publicly sourced funds would then be held by the GIB in a "guarantee fund" and would be used to provide security for loans taken out under the Green Deal financing system.
13. As outlined in paragraph 6, the GIB will also have a key role to play in subsidising Green Deal interest rates in such a way as to allow meaningful 'whole house' retrofits that include higher-cost measures such as solid wall and under-floor insulation, and replacement windows.
14. As regards the SME sector, once again we commend the Green Investment Bank Commission's suggestion that the GIB should adopt a three-pronged approach towards addressing the market barriers identified in paragraph 7:
    - Incentivising business investment via a graded variation to business rates that ranges from a significant cut for the most efficient buildings to a significant increase for the least efficient buildings;
    - Building on the existing Carbon Trust SME loan scheme to provide low-cost (6%) loans to SMEs for investment in energy efficiency measures;

- Providing independent guidance and assurance to SMEs around the technology solutions that they implement.

What are the funding and governance structures required to create an effective and accountable body, including the role of 'green bonds'?

15. It is vital that the GIB be given all the tools necessary to enable it to drive forward the UK's successful transition to a low-carbon economy. There are four key elements that will be crucial to its success:

- It must have a sufficiently wide mandate to enable it to finance any measure that will reduce carbon emissions;
- It must be established by statute in order to ensure independence from the Government of the day. By the same token, it should be accountable to Parliament, perhaps via an annual report on its activities;
- It should be adequately capitalised: Ernst & Young[7] recommend an initial capitalisation level of £4-6 billion in the period to 2015;
- It should have a full set of powers, including the ability to issue green bonds, that will enable it to leverage the required levels of finance from the private capital markets.

In other words, the GIB must have the full powers of a bank, rather than simply be an agglomeration of existing Government 'green funds'.

16. Finally, we believe that the new Coalition Government should make a clear and early statement that it remains committed to the creation of a Green Investment Bank (GIB). Although this was promised in the Coalition Agreement, no concrete proposals have subsequently been forthcoming. Furthermore, at the time of the Queen's Speech on 25 May, the Government stated that the forthcoming Energy Security and Green Economy Bill might be used as the legislative vehicle "to set up a Green Investment Bank". We are concerned that the latest pronouncements from the Department of Energy & Climate Change make no mention of the Bill being used for this purpose.
17. We are also concerned that a flurry of recent media reports has pointed at significant Treasury resistance to the establishment of a fully-fledged bank of the kind described in paragraph 15. A limited fund designed merely to support a limited range of projects (and unable to raise bonds) would be wholly inadequate to deliver the levels of investment necessary to achieve our low carbon future.

[7] Op. cit.