

Decision

Response to consultation on licence fee cost recovery principles

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In January 2024 we published a licence fee cost recovery principles consultation related to the recovery of heat networks regulation set up and ongoing costs. This decision document summarises the responses to our consultation and outlines our final decision on the proposed changes to the licence fee cost recovery principles. The responses confirm our proposed changes to the cost recovery principles in order to recover set up costs and initial period regulatory cost for heat network regulation through the licence fee cost recovery mechanism. Following this, we will make the proposed changes to the Licence Fee Cost Recovery Principles and publish the updated principles. The first invoice to relevant licensees will be issued in June 2024 regarding the set-up costs for heat network regulation that are incurred in the 2024/2025 financial year.

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1. Introduction

Background

1.1 On 26 October 2023, the Energy Act 2023 achieved Royal Assent and formally named Ofgem as the regulator of Heat Networks in Great Britain. This legislation provides Ofgem with the power to recover the regulatory costs associated with this new role. These costs will be recovered initially through the licence fees paid by certain gas and electricity licensees, and later, also through fees that will apply to authorised heat networks ¹. The government decided on this approach in 2022, following a consultation in 2021 ².

1.2 In August 2023, Ofgem and DESNZ consulted on how Ofgem's regulatory costs would be recovered in the initial year of heat networks regulation, specifically that heat networks regulatory costs should be recovered from gas and electricity licensees only in the initial year of regulation, and not from those operating heat networks.

1.3 In January 2024, we consulted on making changes to the licence fee cost recovery principles ("the principles"), which set out how the amounts payable to Ofgem under the gas and electricity transmission and distribution licences are calculated and billed ³. In that consultation, we proposed to extend the cost recovery approach mentioned above and to apply it from financial year 2024/25, to recover the costs of setting up the new regulatory framework, estimated to amount to around £7.3 million in the financial year 2024-2025.

1.4 The main proposed change was to update the list of costs being recovered through the licence fee to explicitly include heat networks regulation. The proposed changes do not affect the underlying calculation methodology of the cost. In addition, there were a few other minor changes made to the document to update various departmental naming conventions.

1.5 The main changes proposed related to paragraph 2.4 of the principles and are set out below in bold.

Paragraph 2.4

Ofgem's costs, being the net of:

¹ The exact mechanism for long term recovery of Ofgem costs from heat networks has not yet been developed and will be the subject of future consultation

² [Recovering the costs of heat networks regulation - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/consultations/recovering-the-costs-of-heat-networks-regulation)

³ [Consultation on Licence Fee Cost Recovery Principles - Jan 2024 \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/consultation/consultation-on-licence-fee-cost-recovery-principles-jan-2024)

- All Ofgem's own costs, **including Ofgem's set up and ongoing costs related to the regulation of heat networks**, less Ofgem's exceptional costs (see paragraph 2.5) and less Ofgem's own costs that will be recovered by means other than through the use of the 'Payments by Licensee to the Authority' or 'Licensee's payments to the Authority' SLCs (see Appendix 1); and
- All Ofgem's own income. For the purposes of these principles Ofgem's own income excludes the income recovered through the 'Payments by Licensee to the Authority' or 'Licensee's payments to the Authority' SLCs;
- The costs of the Secretary of State and Office for Product Safety and Standards within the **Department for Business and Trade (DBT)** which relate to statutory metrology services;

Our decision-making process

1.6 We received 8 responses to our consultation. We asked interested parties to provide answers to two questions and considered all views and evidence presented to us.

Our Decision

1.7 We have considered the responses to the consultation and concluded that:

- We will make the changes to the Licence Fee Cost Recovery Principles that it set out in the consultation document and publish them as soon as possible.
- Ofgem costs in respect of set up for heat network regulation and for regulation during the initial period, will be recovered through the licence fee cost recovery mechanism.
- The first invoice will be issued in June 2024 in respect of heat network regulation set up costs to be incurred in the 2024/2025 financial year.
- We will keep this approach under review and consult further on the approach of cost recovery as the policy thinking progresses.

2. Summary of the responses to our consultation and Decision

Question 1:

Do you have any views or comments on our proposal to recover heat network regulation set up costs and ongoing costs through the licence fee cost recovery mechanism?

2.1 In total there were eight respondents to this question, with seven respondents broadly in favour of the proposals and one respondent opposing the proposal.

2.2 Among seven respondents who were in favour, two respondents mentioned that Ofgem should develop and consult on longer term solutions. Three other respondents that said the approach should be time bound or kept under review. There was one respondent that was content to see the approach become an enduring one.

2.3 Two respondents wanted Ofgem to be transparent about the costs incurred through set up and steered Ofgem to publish more detail on its website.

2.4 Two respondents wanted Ofgem to keep costs low and ensure they were incurred efficiently. One respondent, although in favour, warned against adding other costs to the licence fee such as those that might be incurred by local authorities in the administration of zoning policy.

2.5 Other comments included mention of the low impact this would have on gas and electricity bills and the high impact that recovery from heat networks would have on heat network customer bills.

2.6 The respondent who opposed the proposal acknowledged that Ofgem could not yet recover costs from the heat networks sector and that the impact on gas and electricity customer bills would be low but indicated that Ofgem should consider other options. The response noted a pattern of Ofgem initiatives that they considered might over time lead to inequities and inefficiencies in the transition to a low carbon economy. They considered that imposing the costs on electricity customers and not on heat networks customers would distort the cost reflectivity of the charges on electricity customers. The response commented that if Ofgem is minded to adopt its cost recovery proposal, that it should be time bound.

Question 2a:

Do you agree with our proposed changes to the licence fee cost recovery principles?

2.7. Five of the eight respondents agreed with the changes proposed to our licence fee cost recovery principles and considered that they would deliver the proposed change. The remaining three respondents did not comment on this.

Question 2b:

Do you have any comments to make about our proposed changes to the licence fee cost recovery principles?

2.8 Of the eight respondents, six had no comment in response to question 2b.

2.9 Of the remaining two respondents one noted that separately Ofgem should consider risks around continuity of supply from heat networks in the event of business failure.

2.10 Another respondent noted that our consultation did not say whether there would be a breakdown of costs in respect of Ofgem's invoice to the sector that would make clear what magnitude of costs were related to the regulation of heat networks.

Ofgem decision

2.11 We will make the changes to the Licence Fee Cost Recovery Principles that we set out in the consultation document and publish them as soon as possible. Further to that publication, Ofgem costs in respect of set up for heat network regulation and for regulation during the initial period, will be recovered through the licence fee cost recovery mechanism. The first invoice will be issued in June 2024 in respect of heat networks regulation set up costs to be incurred in the 2024/2025 financial year.

2.12 Several respondents asked Ofgem to keep this approach under review or make it time limited. Additionally, there were calls for transparency on the approach over time.

2.13 Ofgem and government's work in the area of heat networks regulation cost recovery is still under development. However, previous consultations have made it clear that the policy intent is that at least a portion of the costs will be collected from heat network operators and suppliers of heat in the future. What has not yet been determined is;

- what that proportion will be
- what factors will be used to determine the amount paid in respect of each heat network
- how or whether we recover costs from very small heat networks
- over what period we will transition from gas and electricity funding to a blend of gas and electricity and heat network funding

We will consult further on the approach when our policy thinking has progressed.

Some respondents also wanted transparency on the magnitude of costs relating to heat network regulation that are being met through the licence fee cost recovery mechanism and confirmation that those costs are efficiently incurred. Ofgem does not routinely set out the cost of parts of its business on a function-by-function basis in its annual report and accounts or in its forward work programme. However, we acknowledge that the recovery of heat networks regulation costs is a new cost for Ofgem to charge to licensees and consequently we see merit in being transparent in respect of those costs. Therefore, we intend to separate out costs for heat networks regulation in the letter that accompanies the Tranche 1 invoice to licensees that are liable for Ofgem's costs. Ofgem proposes to do this for the first few years of heat networks regulation.

As previously stated, we will consult further on the approach to cost recovery in respect of heat networks regulation and the proportion to be met by the licence fee recovery mechanism in future years.

In terms of reporting on whether those costs are incurred efficiently – we are subject to scrutiny through periodic audit by the National Audit Office and these audits can include a 'value for money' component. Additionally, we will develop internal Key Performance Indicators (KPI's) to ensure that individual elements of regulatory activity are undertaken to challenging yet achievable timelines that work for the industry. We report against our KPI performance in the Annex to the Annual Reports and accounts and will consider whether to include KPI's for heat networks regulation in future reports.

General feedback

2.14 We believe that consultation is at the heart of good policy development. We are keen to receive your comments about this document. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall quality of this document?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Are its conclusions balanced?
5. Did it make reasoned recommendations?
6. Any further comments

Please send any general feedback comments to heatnetworksregulation@ofgem.gov.uk

