

## Heat networks regulation: fair pricing protections

### Response to consultation provided by the City of Edinburgh Council

#### **Fair pricing framework**

- 1) Have we identified the right set of fair pricing consumer objective, principles and outcomes and are these properly defined? If you disagree with this proposal, please specify what changes you would like to see and provide a justification.

**Objective:** we are unclear of the distinction between a price that is “fair” and a price that is “not disproportionate”. We would suggest that an objective of “Consumers pay fair prices” is simpler, more succinct, and easier to comprehend.

**Principles:** we would suggest that “Price stability” (or some other wording reflecting an environment in which prices for consumers do not rapidly/regularly/dramatically change) might be added as a principle.

Under “Cost-reflective pricing”, we would suggest it may be useful to add a note to the effect that changes in price should track downward movements in cost at the same rate as upward movements in cost. We have had feedback from consumers that it is perceived that prices increase swiftly in response to supply costs but the inverse is not necessarily the case.

Under “Cost efficiency”, for “Maintenance, service and customer service costs”, we would suggest that it may be useful to provide a general steer towards keeping overheads low, i.e. so that overheads do not account for a disproportionate share of costs relative to operating costs (which directly benefit the consumer). For “Restricted cost passthrough”, we would strongly favour a provision relating to certain types of debt, e.g. to avoid borrowing costs associated with (for example) a leveraged takeover being passed on to customers. We note that the guidance is unclear on how “operate efficiently” is to be managed; the definition focuses on excluding “technical efficiency” from the definition.

Under “Fair and reasonable returns”, while noting the points around profits/levels of return varying, we would suggest it may be useful to provide a notional upper limit, and perhaps to give some direction around profit distribution (perhaps tying into the references around sinking funds elsewhere in the proposals).

Under “Price transparency”, we would suggest the definition should be broadened somewhat, as it is not purely a matter of communicating prices, but also of being open and transparent about how the prices have been arrived at and their makeup.

**Outcomes:** we would suggest it might be useful to consider outcomes for the heat network (considered as a piece of societal infrastructure) separately from outcomes for the consumer/industry. I.e. in principle the consumer could benefit (via, e.g. attractive pricing) and the industry could benefit (via, e.g. via profits) but the network could be deteriorating due to underinvestment.

Under “Consumers outcomes”, we would suggest it may be useful to add an outcome relating to shielding the consumer from certain “corporate” matters, e.g. overly high overheads, fines, certain forms of debt, etc.

- 2) Do you agree with our proposals to develop the fair pricing guidance in relation to the principles (please note that questions on cost allocation proposals, including guidance, are asked separately under Chapter 3: Cost allocation). In particular:

- a) have we identified the right areas to be covered by the guidance implementing the fair pricing principles (see paragraph 2.53 for a summary of the areas we are proposing to develop in guidance under each principle)? If you disagree with this proposal or think other areas should also be included, please specify what changes you would like to see and provide a justification.

We would note our suggestions in response to Q1.

- b) Do you agree with the specific proposals to develop each of these areas in guidance? If you disagree, please specify what changes you would like to see and provide a justification.

We would note our suggestions in response to Q1.

- 3) Do you agree with the proposed 'fairness test'? In particular:

- a) Do you agree with the high-level features of the fairness test (principle based, reasonableness, case-by-case basis, and objectivity)?

In respect of the "principle-based" feature, we feel it would be helpful to give some element of quantitative steer around returns, even if this is less prescriptive than other pricing controls.

- b) Do you agree with our proposals to implement the fairness test discussed in Appendix 1: Fairness test?

Under A1.2, we would suggest it might be useful to include consideration of how prices are being arrived at, e.g. do overheads account for a disproportionately high share of the price.

- 4) Does the revised authorisation condition, 'fair pricing', reflect the policy intent?

No comment.

## Market segmentation

- 5) In relation to market segmentation (please note that we are asking in relation to the considerations discussed in paragraphs 2.58-2.61, segmentation considerations in relation to price benchmarking are considered under Chapter 4: Price comparison and benchmarking methods):

- a) Have we identified the right characteristics for market segmentation, and are these correctly defined?

We would suggest it may also be useful to distinguish heat networks where the supplier and consumers are part of the same organisation, e.g. a heat network serving a university campus. Heat networks of this nature would appear to require significantly less oversight from a consumer protection perspective. We would suggest adding this as an additional Characteristic.

We suggest that networks built pre-regulation should be required to set out a plan to bring network up to the level of compliance expected elsewhere – it would be important that current customers connected to a poorly run network would be supported to experience gradual improvement of services post-regulation.

We suggest type of network should not be a consideration as there are currently many customers connected to communal heat networks which are not being managed well.

We suggest location within or outwith a heat network zone should not have material weighting on market segmentation.

We are unsure whether shared ground loops should be considered under regulation.

- b) Do you agree with the segmentation approach discussed for each of these characteristics?

No comment.

### Data requirements

- 6) Of the information listed in Table 3 below, what do heat networks already regularly collect and can be easily reported?

No comment.

- 7) Of the information listed in Table 3 below, which items would be more challenging for heat networks to report?

No comment.

- 8) Of the cost drivers listed in Table 7 (in Appendix 3), which items would be more challenging for heat networks to report?

It is judged that "Other efficiency measures" and "Level of vulnerability" could be more challenging to monitor.

- 9) Should certain types of heat networks have more limited data reporting requirements? If so, which heat networks should these reduced requirements apply to, and what data should they be exempt from reporting?

No comment.

### Cost allocation

- 10) Do you agree with our proposed prescriptive rule that GSOP payments, compensations, fines, penalties and other redress provided to consumers should not be passed through to customers?

We strongly agree with this proposal.

- 11) Do you agree with the draft best practice guidance provided? Is there anything that should be added? Should any of the best practice guidance be strengthened to prescriptive rules?

As set out in our response to Q1, we would strongly support a provision to the effect that the costs of certain types of debt should not be passed on to customers. For example, borrowing costs associated with a leveraged takeover being passed on to customers.

- 12) Do you think that the best practice approach to cost allocation should differ for different types of heat networks, or different types of suppliers? If so, for which types and how?

No comment.

- 13) Does the authorisation condition, 'cost allocation', reflect the policy intent?

As set out in our response to Q1 and Q11, we would strongly support extending the condition to the effect that the costs of certain types of debt should not be passed on to customers. For example, borrowing costs associated with a leveraged takeover being passed on to customers.

- 14) What other feedback do you have on the proposed approach to cost allocation?

As noted in Q1, we would suggest it may be useful to add a note to the effect that changes in price should track downward movements in cost at the same rate as upward movements in cost. We have had feedback from consumers that it is perceived that prices increase swiftly in response to supply costs but the inverse is not necessarily the case.

### Price comparison and benchmarking methods

- 15) Do you agree with our proposed approach for defining heat network prices in a comparable way? Are there any other ways to define price that we should consider?

No comment.

- 16) Do you agree with our proposal to use gas boilers and heat pumps as external reference benchmarks?

We think it would be reasonable to use gas boilers as an external reference for gas-fired heat networks, and heat pumps as an external reference for low/zero carbon heat networks (albeit if the proposal is that networks will be benchmarked against both gas boilers and heat pumps that would appear reasonable).

- 17) Do you agree with the proposed method for calculating a heat pump benchmark, including the key input parameters outlined? Are there any additional factors that should be considered to ensure a robust heat pump benchmark?

We would suggest that the benchmark should take into account the costs of replacing the heat pump at the end of its working life.

- 18) Do you agree with the proposed approach to comparator benchmarking, and our list of potential cost drivers set out below and in Appendix 3: Cost driver? Are there any relevant cost drivers that we haven't considered?

We would suggest that a relevant cost driver would be the proportion of "vulnerable" customers, as where this is higher the network's cost/revenues are likely to be adversely impacted.

We would suggest it would be useful to distinguish between networks that are growing (i.e. adding new customers, laying additional pipework) and those that are static.

- 19) What is your view on the ease with which data could be reported on the four 'High Importance' cost drivers set out in paragraph 4.33? What information do heat network operators and suppliers already collect, and what would be challenging to provide?

We would envisage that this would generally be straightforward, albeit while noting that the answers may fluctuate over the year, so mandating responses for a specific date may cause some complexity.

- 20) What is your view on the ease with which data could be reported on the remaining 'Medium Importance' cost drivers set out in paragraph 4.33? What information do heat network operators and suppliers already collect, and what would be challenging to provide?

We would envisage that this would generally be straightforward, albeit while noting that the answers may fluctuate over the year, so mandating responses for a specific date may cause some complexity.

- 21) What is your view on our proposal to publish a high-level methodology for each benchmark (once data is collected and methods have been tested), to provide an accessible overview of the approach?

No comment.

- 22) Do you have any other feedback on the proposed approach to price comparison and benchmarking?

As set out at Q1 and Q3B, we would suggest that not just the total price should be compared, but also the makeup of the price, so it can be seen if certain networks have (for example) disproportionately high costs associated with overheads.

### **Profitability analysis**

- 23) Do you agree with the proposal for ongoing monitoring of profitability through data collection on EBIT margins for all heat networks?

No comment.

- 24) How challenging would it be for heat network operators and suppliers to provide the data outlined for calculating EBIT margins? What barriers, if any, might affect the accuracy and completeness of the data?

No comment.

- 25) As data collection improves, do you agree that more in-depth profitability assessments, for example using Return on Capital Employed (ROCE), should be conducted for networks identified as outliers through benchmarking?

No comment.

- 26) Do you have any other feedback on the proposed approach to profitability assessment?

We would note that this approach may be more limited where the company structure is complex, e.g. where there is an operating company and a holding company. It would be necessary to ensure that (for example) reported profits were deflated due to transfer pricing.

### **Central price transparency**

- 27) What are your views on the three options? Please comment on each option in terms of the price information to be centrally published, how the price information is presented and what prices are compared to.

Option 1 – we are uncertain as to whether creating comparable cohorts of heat networks is realistic given the vast number of variables determining prices. However, we recognise this may become more realistic as the number of networks increases.

Option 2 – we are uncertain as to whether averages would be meaningful given the vast number of variables determining prices.

Option 3 – we feel this option is the most reasonable in terms of providing meaningful information, albeit it is unclear what consumers would be envisaged as doing with the information.

- 28) Do you think the options have the right balance between providing a good level of transparency, burden on consumers to interpret the information, risks of misinterpretation by consumers, disclosure of commercially sensitive information, and risk of price convergence?

We are unconvinced that displaying this data would necessarily be helpful given the recognition that the large number of variables means like for like comparisons between heat networks are generally not meaningful.

Overall, we feel it is highly important that consumers are able to access transparent data on network characteristics and centrally available price information. We feel the mechanism via which this data is to be shared perhaps needs additional development.

- 29) Do you support focusing on one option or a combination of options in paragraph 6.69?

We are unconvinced that any of the options will be especially helpful for consumers but would favour option 3 alone if one was to be pursued.

- 30) Do you support the phasing in of the options described in paragraph 6.70?

No comment.

- 31) Do you support the adoption of different options for different heat network groups described in paragraph 6.71?

No comment.

- 32) Do you agree that central price transparency measures are unlikely to put additional administrative burden on heat networks in addition to data reporting for benchmarking? Do you have concerns on the administrative burden from any options?

We would disagree. Our view is that supplying this data in a manner that would support comprehensive benchmarking would add a burden to operators.

- 33) Do you think it is appropriate to link central price transparency with benchmarking?

No comment.

## Price investigations

34) Do you agree with the approach to price investigations set out so far? Please provide reasons and views to support your response?

No comment.

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