

Heat Networks Regulation: Fair Pricing Protections

Summary

SFHA supports the introduction of a fair pricing framework and the overall objective that heat network consumers should pay fair and not 'disproportionate' prices. Social housing tenants who are supplied through a heat network, managed either by their housing provider or a third party, should be treated fairly and we therefore agree that heat network suppliers and operators, including Registered Social Landlords (RSLs), should be held to account on this obligation.

As noted in the consultation, the diversity of existing heat network schemes makes it difficult to apply prescriptive rules and the use of a principles-based approach is welcome in offering flexibility. We welcome further guidance on how adherence with these principles will be assessed, particularly on the 'affordability' principle which would benefit from a clearer definition. While the consultation acknowledges that heat networks cannot tackle all affordability issues, there needs to be a stronger alignment with UK and Scottish Government fuel poverty policies, including safeguards against volatility in the wider energy market as experienced in recent years.

The success of this approach will also be dependent on how the various methodologies proposed for price comparisons are applied in practice. For example, our members have raised concerns about the absence of planned maintenance as well as metering and billing in the identified cost drivers. Electric heaters are also excluded from the external benchmarks despite their current and anticipated use in social homes in Scotland. We appreciate that these may have to develop over time and encourage Ofgem to continue to review the validity of these methods as more empirical data becomes available.

The framework should also make clear distinctions between modern, commercial district heating schemes, which offer considerable economies of scale, and the smaller, not-for-profit heat networks typically operated by RSLs. The proposals around market segmentation for comparison purposes are therefore welcome. However, we seek further clarity on how the cost allocation rules for Guaranteed Standards of Performance (GSOP) payments will be applied in not-for-profit schemes and whether a tailored improvement plan could be offered as an alternative.

It is also recognised that certain types of heat networks may require more limited reporting and we believe there is justification for minimising the reporting required by our members given they are not-for-profit, social purpose business and already subject to regulation and financial monitoring. More generally, we would call for a more streamlined reporting process whereby Ofgem acts as the central repository for data which could then be accessed by other relevant bodies to avoid duplication of effort.

We would welcome further engagement with the social housing sector as the framework and accompanying guidance is developed further.

Consultation questions

Q1. 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.

We support the overall objective that heat network consumers should pay fair and not 'disproportionate' prices. We agree that heat network suppliers and operators, including Registered Social Landlords (RSLs), should be held to account on treating their customers fairly but recognise that the diversity of existing schemes makes it difficult to apply prescriptive rules. The use of a principles-based approach is therefore appropriate in meeting this objective while offering flexibility to heat operators and suppliers. However, this is dependent on how the overall framework will be applied in practice.

Q2. 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.

The identified principles appear sensible although this is dependent on how they will be assessed and the extent of guidance to be provided to help regulated entities in adhering to these principles.

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.

Yes. It will be important to develop clear guidance on each of these areas to understand expectations.



On 'cost efficiency' in particular, we agree that different levels of technical efficiency could drive legitimate differences in pricing which much be considered. The guidance should provide further clarity on this.

The 'affordability' principle also requires further consideration. The consultation mentions having 'regard to affordability' but it is unclear what this means in practice. We note that the guidance proposes to provide further information on cross-subsidisation and shock bills which we welcome. However, from a social landlord's perspective, the aim is to provide access to affordable warmth which in turn mitigates against fuel poverty.

Fuel poverty is not currently mentioned in the consultation document however fuel poverty thresholds, and the extent to which energy prices (in this case the heat network), influence the household's fuel poverty status, are important considerations for our members. The Scottish Fuel Poverty Panel is also a statutory consultee on heat network regulations given the opportunities and challenges which heat networks present for those in, or at risk of, fuel poverty.

While we recognise that that high household fuel prices are only one of the four fuel poverty drivers identified by the Fuel Poverty (Targets, Definition and Strategy) (Scotland) Act 2019, the 'affordability' principle should make a stronger link with fuel poverty objectives. This could include further information on how heat network consumers will be supported through wider UK and Scottish Government policies (e.g. Warm Home Discount) and protected from external cost drivers, including volatility in the wider energy market as experienced in recent years. This could include further detail on circumstance which may trigger a review of the current approach, including the decision not to introduce a price cap, and where other measures, such as an equivalent to the Energy Bills Discount Scheme, may need to be introduced.

Q3. 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)?**

Yes.

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

Yes. We agree with the general proposals but would like to see this make explicit reference to heat networks operated by RSLs to ensure the unique role of these organisations as not-for-profit, social purpose businesses is taken into account in the fairness test questions.

On A1.2, we note that the identification of disproportionate pricing will make benchmark comparisons and we would again call for this to make clear distinctions between the heat networks typically operated by our members (generally small and fairly old schemes) and larger, modern district heating schemes which may offer greater economies of scale and price advantages. This would likely be addressed through the use of comparator benchmarking if appropriate archetypes can be identified and applied.

On A1.3, the question of 'who' would be affected by disproportionate pricing gives no detail on the level of information sought. Is this aiming to establish the demographic profile or whether vulnerable households are being affected, or simply the number of customers impacted? Further clarity on how this question will be used to determine level of concern would be welcome.

Q4. Does the revised authorisation condition, 'fair pricing', reflect the policy intent?

Yes

Q5. 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 are in broad agreement with the list of characteristics identified and for our members we particularly support the inclusion of profit vs not-for-profit, size, metered vs non-metered, housing tenure, and district vs communal heat networks.

We have concerns about the inclusion of the 'level of vulnerability' as a network characteristic and how comparisons on this basis would work in practice given the existing difficulties in defining 'vulnerability'. Would this be linked to the Priority Service Register criteria in place for other utilities? If so, the nature of the networks run by our members mean that the customer base is likely to include high numbers of customers who meet these criteria.

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

On network size, we agree that this is likely to impact cost and price and would support controlling for this in benchmarking methodologies and making data submission requirements less onerous for these schemes. Further definition of a 'small' network in this context would be helpful.

On metered vs non-metered networks, we support the development of best practice on cost allocation. Given the prevalence of non-metered networks in care homes and other sheltered and supported housing schemes managed by social landlords, we would welcome further discussion with our members on the development of this guidance.

On profit vs not-for-profit, we agree this is an important distinction although a clearer definition of not-for-profit would be helpful. We agree on the data submission requirements being less onerous for not-for-profit schemes and it is also sensible to exclude the profitability assessments for this group. We note the intention to still collect key financial metrics and would call for this to be reconsidered in line with our response to Q9.

On function (or regulatory role), we note that responsibility for compliance with price regulation sits with either the heat network owner or a long-term concession holder (e.g. ESCo). We would welcome further guidance on overall responsibilities, particularly on data reporting, given the diversity of different ownership models and need to align data/reporting requirements.

On housing tenure, we agree on the need to examine the potential interactions between price regulation and housing legislation and can facilitate further discussions with our members on this issue.

On networks built pre-regulation versus post-regulation, we agree that some existing networks, including those managed by social landlords, may not yet have processes in place to collect and report certain types of data. We would therefore support allowing a sufficient transition period for existing heat networks to develop these systems in addition to the overall data submission requirements being proportionate based on the other network characteristics (e.g. size, profit vs not-for-profit).

On the type of network, we agree on the need to distinguish between district and communal heat networks and expect this would overlap with the size comparisons depending on the segmentation approach.

Q6. Of the information listed in Table 3 below, what do heat networks already regularly collect and can be easily reported?

In terms of existing reporting requirements, information on location, capacity and supply figures are already reporting to the UK Government as part of the Heat Network (Metering and Billing) Regulations. With Ofgem now becoming the regulator for the sector, we would question the need for these parallel reporting systems and call for a more streamlined process whereby Ofgem acts as the central repository for data which could then be accessed by other relevant bodies.

Social landlords in Scotland also report to the Scottish Housing Regulator on their financial performance including provision of an Annual Assurance Statement, audited financial statements and five-year financial projections. They also submit an Annual Return on the Charter which covers various aspects of performance including customer satisfaction and compliance with the Scottish Housing Quality Standard. While these don't offer direct comparisons with the items in Table 3, they do offer assurances of the overall financial health and robust governance processes of RSLs.

Q7. Of the information listed in Table 3 below, which items would be more challenging for heat networks to report?

Feedback for our members suggests that the challenge here is not necessarily the individual data points but the cumulative impacts of reporting on all of these items. This will be particularly challenging for RSLs who are involved in multiple schemes which will need to be reported on an individual basis. This will not only require co-ordination across different departments but in cases where third parties are involved (e.g. where metering and billing is outsourced), co-ordination across different organisations, resulting in a resource intensive data gathering and reporting process.

On the specific items noted in Table 3, on the financial data, our members have highlighted particular challenges in reporting on the operational expenditure associated with maintenance, including maintenance of the consumer facing units and plant, and factoring in the amortisation of the equipment.

Q8. Of the cost drivers listed in Table 7 (in Appendix 3), which items would be more challenging for heat networks to report?

We note that many of the data points listed would remain consistent (e.g. fuel/technology type, location) so the challenge for these would be in the initial data collection exercise. We would there call for sufficient timescales and support from Ofgem to aid this initial data reporting. The more challenging items would be those which need to be regathered for each reporting cycle and again the concern from our members is the cumulative impacts of reporting on all of these datapoints.

See Q18 for further comments on the specific cost drivers.

Q9. 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?

Yes. We would like to see reduced reporting requirements for not-for-profit heat networks which are managed by social landlords.

While we agree that heat network operators should be held to account on treating their customers fairly, our members are already regulated by the Scottish Housing Regulator (SHR) and must comply with its regulatory framework, including Standards of Governance and Financial Management. RSLs also must comply with the Scottish Government's Social Housing Charter, with the SHR measuring compliance through the Annual Return on the Charter. The SHR monitors compliance and will engage with any landlord directly regarding any issues. It can also use its statutory powers to require action from a landlord where it is failing to provide services or manage its affairs to an appropriate standard.

So while the data collection proposed in this consultation is primarily for facilitating cost comparisons, where information is being gathered for assurance purposes, we believe that sufficient protections already exist where the heat network entity is covered by the social housing regulatory framework. On this basis, there could be a case for excluding the social landlords from the financial data collection although we note that Tabe 2 suggests this information would still be beneficial for transparency and benchmarking.

The current proposals also suggest that both charges and prices would be collected on a quarterly basis. As acknowledged in the consultation, this would be a considerable administrative burden and not aligned with the annual reporting cycles for the social housing sector. We would therefore support this quarterly reporting being reduced to annual reporting for not-for-profit heat networks which are managed by social landlords.

Q10. 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 support this principle when applied to for profit heat networks. However, the current consultation does not specify how this is expected to work for not-for-profit heat networks. The 2023 consultation made explicit reference to this and acknowledged that customers served by a not-for-profit heat network would essentially be paying for their own compensation through future price rises. This approach would therefore be unworkable for our members and

could result in some social landlords shifting to alternative ownership models or being reluctant to be involved in future heat network project.

In our response to the 2023 consultation, we supported the proposal that not-for-profit heat network providers should be required to submit a tailored improvement plan where they are failing to meet Overall Performance Standards, without the automatic compensation scheme. We would like to see this alternative route made clear in the Fair Pricing Framework and for there to be further engagement with the social housing sector to develop guidance to support this obligation.

Q11. 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?

Yes. As per Q10 we would like to see further guidance on the approach to GSOP obligations for not-for-profit providers.

Q12. 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?

Yes. See Q10.

Q13. Does the authorisation condition, 'cost allocation', reflect the policy intent?

Yes

Q14. What other feedback do you have on the proposed approach to cost allocation?

N/A

Q15. 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?

Yes

Q16. Do you agree with our proposal to use gas boilers and heat pumps as external reference benchmarks?

For external benchmarks, we believe electric heaters could also be a valid counterfactual. While the consultation mentions that this has been considered but is not currently being progressed, we would like this to be reviewed. It is

already the case that 7% homes in Scotland make use of electric storage heating and with the forthcoming Heat in Buildings Bill and Social Housing Net Zero Standard requiring a shift to clean heating by 2045, the gas comparator will become less relevant over the coming decades. Furthermore, where individual heat pumps are unsuitable for a property, the most likely options for meeting net zero requirements will be high retention heat storage heaters.

Q17. 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?

This is useful as a starting point but given the reliance on estimates and assumptions, this should be reviewed and compared to external sources as suggested. We are particularly aware that ongoing maintenance and servicing costs for heat pumps can vary considerably depending on location with some of our rural members reporting costs much higher than industry-standard estimates.

Q18. 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 have concerns about the use of 'network pipe length' which may, on its own, not be a good indicator of costs although we note that this has been identified through modelling and will be subject to review following the increased availability of real-world data. Feedback from our members suggests that temperature loss per metre of network pipe may be a more useful indicator given this would also take the quality and specification of the pipework into account.

Inclusion of the 'number of consumers', while helpful in assessing scale also doesn't capture the proportion of consumers in the area who could be but aren't connected to the network. This therefore doesn't capture the cost efficiency implications of an underutilised scheme, which can particularly impact our member's schemes where a higher proportion of customers self-disconnect than the rest of the population, further reducing RSLs ability to achieve the most efficient and therefore cost effective, systems.

More broadly, we are concerned that neither planned maintenance costs or metering and billing costs (including service fees where this function is outsourced) are included in the list. Feedback from our members suggests that these are critical cost drivers and that maintenance costs in particular can vary geographically given the lack of availability of suitable contractors in some areas of Scotland.

Q19. 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?

See Q8.

Q20. 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?

See Q8.

Q21. 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?

Agree

Q22. Do you have any other feedback on the proposed approach to price comparison and benchmarking?

N/A

Q23. Do you agree with the proposal for ongoing monitoring of profitability through data collection on EBIT margins for all heat networks?

See Q9

Q24. 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?

Q25. 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?

N/A

Q26. Do you have any other feedback on the proposed approach to profitability assessment?

N/A

Q27. 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 (segmented approach) – This is potentially the most appropriate in offering transparency but depends on the validity of the comparisons being made to ensure these are ‘like for like’.

Option 2 (pooled market average) – We have concerns on the validity of the comparisons given averages would not reflect the diversity of the sector. For example, this would likely result in more favourable results for newer developments compared to older schemes and could therefore disadvantage many of the heat networks our members are involved in.

Option 3 (RAG rating) – We have concerns about this approach as while it is more simplistic, it could still be subject to misinterpretation. As noted in the consultation, there is a risk of a ‘red’ rating being interpreted as a ‘fail’ and could create alarm and more confusion for consumers.

Q28. 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?

While comparisons can be helpful, there are risks of overcomplicating and providing consumers with an overwhelming amount of information. Our members already report difficulties in comparing and explaining different pricing and tariff structures to customers. There are risks that confusion and misinterpretation could lead to increased complaints around costs and billing, even where these aren’t justified.

More broadly, it is important to recognise that unlike the gas and electricity market, heat network customers don’t have a choice in their supplier. So, while these options may offer increased price transparency, it doesn’t allow customers to switch to a more affordable alternative.

Q29. Do you support focusing on one option or a combination of options in paragraph 6.69?

Option 1 preferred.

Q30. Do you support the phasing in of the options described in paragraph 6.70?

Yes. It seems sensible to evolve this process as more data becomes available.

Q31. Do you support the adoption of different options for different heat network groups described in paragraph 6.71?

Yes. It could be helpful to treat not-for-profit heat networks differently if there are to be fewer reporting requirements. We understand that there would be a trade off in the validity of central price comparisons if this is based on more limited data inputs, but this should be explored further.

Q32. 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 agree that the proposed options won't require further information than that already proposed through the price comparison proposals, but as discussed elsewhere in the response, this is still a considerable increase in data collection and reporting compared to current practice.

Q33. Do you think it is appropriate to link central price transparency with benchmarking?

N/A

Q34. Do you agree with the approach to price investigations set out so far? Please provide reasons and views to support your response.

Broadly, yes, given this will be done on a case by case rather than a prescriptive basis. However, the proposed guidance for Authorised Entities will be of critical importance and we would welcome further engagement with the social housing sector as this is developed.

It would be particularly useful to understand how the different benchmarking methods discussed in Chapter 4 will be used in the case of a price investigation. We note that while it is proposed that all three methods may be used, there needs to be some consistency to avoid a heat network basing its pricing on one method but then being assessed against another.