



Making a positive difference
for energy consumers

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Dear Sir/Madam

Consultation on Heat & Energy Efficiency Strategies, and Regulation of District Heating

Thank you for the opportunity to respond to your *Consultation on Heat & Energy Efficiency Strategies, and Regulation of District Heating*, published on 24 January 2017.

The decarbonisation of heat is one of the greatest challenges facing energy policy over the next few decades. We note that the Scottish Government designated energy efficiency to be a national infrastructure priority in June 2015 and welcome the focus on energy efficiency and district heating in this consultation as two of the ways through which to decarbonise heat.

In our November 2016 Future Insights paper on *The Decarbonisation of Heat*¹ we set out considerations for some of the options for decarbonising heat that are currently being discussed by policy makers including: improved energy efficiency; adaptation of natural gas networks through blending in lower carbon gas; electrification of heating through heat pumps; development of heat networks; and hydrogen networks.

In this response we do not comment on the overall merit of these individual options, rather we draw on our experience as regulator of the gas and electricity markets to set out what we see as being some of the key considerations to inform policy development around heat network and energy efficiency strategies. We do not comment on the legislative framework within which these policies may develop.

We believe that our regulatory experience from the gas and electricity markets can help to inform the development of an appropriate regulatory framework for heat networks that delivers good outcomes for current and future consumers. We are therefore keen to continue to work with the Scottish Government on the appropriate regulatory solutions for heat.

In the sections below, we set out some high-level considerations in response to your consultation.

¹ https://www.ofgem.gov.uk/system/files/docs/2016/11/ofgem_future_insights_programme_-_the_decarbonisation_of_heat.pdf

Section A - Local Heat & Energy Efficiency Strategies

Decisions on how to heat our homes and businesses involve a range of stakeholders at individual, local and national levels. For example, the decision to install a renewable heating technology such as a heat pump may be taken at a household level, whereas the choice of fuel we transport through our gas networks is a regional or national decision.

An understanding of the likely direction of travel for heat policy is therefore crucial to ensuring optimal outcomes for decarbonisation and minimising energy costs for consumers. We agree that with the right tools and expertise, local authorities could play a role in identifying appropriate solutions and coordinating connections for heat networks.

In considering whether local authorities could also have a role in setting targets for energy efficiency and decarbonisation it will be important to ensure that robust information is available on which to base decisions.

For example, we do not yet know enough about the future costs and consumer impacts of certain heating options such as hydrogen and its full supply chain including Carbon Capture and Storage. For this reason, we support a policy of trialling different options to uncover additional information, alongside progressing with actions that are reliable in a wide range of potential futures, such as improving energy efficiency.

Section B – District Heating Regulation

Any regulatory framework for heat networks needs to deliver good outcomes for consumers without being overly burdensome for the industry. As the market for heat networks develops, any regulation should not inhibit innovation or lock development in to one specific model. Clear principles for expected conduct by suppliers and standards of service may be helpful in this regard. Ofgem is moving to principles-based regulation of the retail energy markets, removing prescriptive tariff rules from the gas and electricity supply licences.

We agree with the need to address issues of consumer protection, governance and investment risk. Below we set out what we see as three of the key issues that any regulation would need to address:

Price:

The monopolistic nature of heat networks may lead to poor outcomes with regards to pricing. Customers may be locked in to long-term contracts with no ability to switch supplier and often insufficient information to understand the basis on which they are being charged. There is also scope for consumers being charged too much given there are no formalised regulations on charging, although the sector is subject to competition law.

Regulation of prices can be used to prevent the abuse of a monopoly position. Perhaps the closest parallel in the current electricity and gas regulatory framework is with independent gas transporters (IGTs) and independent distribution network operators (IDNOs). These are licensed entities and subject to price caps, which typically involve requirements that they do not charge more than the local incumbent network. For heat networks, one option might be that customers connected to heat networks are charged no more than if they were using natural gas for heating.

Customer Service:

Energy is an essential service and customers on heat networks should quite rightly expect similar levels of protection and customer service as we see for other utilities. Strong principles for customer service standards have been developed by the Heat Trust and form a good starting point for further development.

Formal regulation could have a wider reach and stronger tools to ensure compliance. Principles based regulation would likely make it easier to read across arrangements from electricity and gas, which may help meet customer expectations. A regulatory backstop might also be considered to address systematic failures, with special administration for insolvency.

Investment Risk:

The difficulties in securing investment in heat networks and a baseload of customers are well documented. District heating projects currently have a higher risk profile than those across gas, electricity and water.

We understand that the purpose of granting concessions to licence holders would be to reduce risk and the cost of capital in a similar way that we see for other utilities. However, at this stage we feel that further exploration of potential regulatory models is needed to arrive at a better common understanding of the appropriate allocation of risk. It is not immediately clear that both licences and concessions would be needed as part of any regulatory framework.

Thank you again for the opportunity to respond to this consultation. We are happy to discuss any of the areas outlined in this response in greater detail. Should you wish to do so, please contact energy.futures@ofgem.gov.uk.

Yours sincerely

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