The Association for Decentralised Energy

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Bringing Energy Together

Response to the CMA Heat networks market study Statement of scope
19 January 2018

Introduction

The Association for Decentralised Energy welcomes the opportunity to respond to the CMA's Statement of Scope for their upcoming market study on heat networks. The ADE is the UK's leading decentralised energy advocate, focused on creating a more cost effective, efficient and user-orientated energy system. The ADE has more than 100 members active across a range of technologies, and they include both the providers and the users of energy equipment and services. Our members have particular expertise in heat networks, combined heat and power, and demand side energy services, including demand response and storage.

The ADE consider the scope of the market study as currently stated to be appropriate; focusing on the most pertinent themes and issues to ensure the heat networks market delivers for customers while continuing to grow to meet Government's ambition. The Association welcomes that the study acknowledges the Government's anticipated role of heat networks into the future and is mindful of the supply side and investment in the industry. The ADE considers it appropriate to assess and consider how to secure the best outcomes for consumers in a growing heat network market. Sector investability and consumer experience are deeply intertwined. The ADE believes that crucial to future of heat networks is building consumer and investor trust by the creation and enforcement of clear standards, and making heat network projects investable with low cost capital. This will ensure a future heat network market that works to benefit all stakeholders.

Many of the issues and concerns outlined in the statement are recognised within the industry, and work is already being undertaken to address these. Over the last 5 years, the ADE has been leading on significant work to progress the goal of a market that delivers sustainable and efficient heat networks that have positive outcomes for consumers, business and for the environment. This activity includes establishing Heat Trust, the customer protection scheme for heat networks; the Heat Networks Code of Practice (jointly with CIBSE); progressing creation of a technical compliance scheme to ensure build and operational quality is high; and convening an industry Task Force to develop recommendations on how industry and Government can work together to deliver a subsidy-free market and ensure customer protection as the market grows. The work by the ADE covers all the areas proposed by the CMA and the ADE welcomes the opportunity to continue to share our work as the CMA seeks practical remedies for the issues it has identified.

In particular, the Association welcomes the alignment in the aims and considerations of the work of the Task Force with the work being undertaken by the CMA, and look forward to sharing the

findings and recommendations. The report, to be published on 31 January, is the culmination of the significant effort of many stakeholders across the sector and represents the first time that the industry has compiled a set of proposals and principles around which the role of heat networks in a decarbonising economy can be considered. The Association hopes that the CMA will find the report useful and that it can be used to inform ongoing analysis, and as a platform for further discussion with stakeholders.

The ADE considers that consumer trust alongside Government support and investor confidence are critical in creating a sustainable and dynamic market over the long term and crucial to allowing heat networks to deliver on their anticipated role and associated benefits.

Consultation questions

Theme 1: Transparency

1. Are consumers given sufficient information on heat networks before their decision to buy or rent a property that has a heat network?

The quantity and quality of information provided to consumers before they decide to buy or rent a property on a heat network can vary widely. While there are some circumstances in which customers are provided with sufficient information, a reliance often on third parties to pass on the relevant information means that there is inconsistency in this area.

Heat Trust specifies the information that should be available and the ADE believe this, as a minimum, should apply to all heat networks. However, the network operator often does not know when a customer is changing until after the customer has moved in. Estate agents and landlords play a crucial part here, and the CMA should examine their role in ensuring that the information produced by the heat network is made available to the prospective customer in a timely manner.

The ADE agrees that it is important that consumers have access to information before their decision to buy or rent a property.

2. To what extent are consumers able to assess and act upon information regarding heat networks prior to purchasing a property?

As with question 1, the quantity and quality of information provided to consumers before they decide to buy a property on a heat network can vary widely. While there are some circumstances in which customers are provided with sufficient information, a reliance often on third parties to pass on the relevant information means that there is inconsistency in this area.

The ability of the customer to act depends on the quality of information provided. Heat Trust sets these standards and the ADE believes that such standards to be applied to all customers.

We agree that it is appropriate to assess the extent to which, even if prices are transparent, the heating system influences choice of property given the relative size of the cost of heating within the overall property purchase, as this lends important context to the issue. However we agree with the principle that potential buyers and tenants should have access to this information in advance, so they have an understanding of what they are purchasing. With the right information the customer can weigh up the presence of a heat network alongside other considerations when making a decision to move home.

The ability of the consumer to assess (and act upon) the relevant information depends on their understanding of how the heat network operates. Heat network tariffs are not comparable with gas or electricity tariffs as these tariffs do not include other costs such as boiler replacement and maintenance which are usually inclusive in heat charges. The Heat Trust's Heat Cost Calculator was designed to assist consumers in understanding the comparative cost of being on a heat network as compared to having a modern gas boiler. This has been, and could continue to be, a useful comparison tool for customers.

3. To what extent is information on the costs of heat networks made clear to customers in bills?

The type and clarity of information included in bills to customers on heat networks is not standardised and can vary widely. As there are many different models for structuring heat network service provision, the methodology for calculating heat network tariffs varies from scheme to scheme - as can the components of a heat bill and the split between the elements included in the fixed and variable costs. Industry acknowledges that this can be confusing and can undermine trust in the heat network and the heat supplier.

Transparency in the components that comprise a heat network bill can be of particular concern in the landlord/tenant relationship. In gas networks, maintenance costs for the system from the boiler inwards to the home are traditionally borne by the landlord. As maintenance costs for heat networks are usually included in standing charges in the bill (which often goes, in full, to the tenant) there is inconsistency with how these costs are distributed in gas and heat networks. Greater transparency in the breakdown of standing charges on heat network customer bills may assist tenants and landlords to have more comparable arrangements.

The ADE agrees that it is important that customers have clear information on the costs of their heat network reflected in their bills and the Heat Trust sets minimum standards in this area – but industry does not have the power to compel organisations to join. Some information is required to be included by the Heat Network (Metering and Billing) Regulations 2014, but this does not cover all relevant areas.

The Task Force recommend, in their upcoming report, that a standard methodology for the elements that can be included in heat network tariffs should be developed by an independent regulator working with the industry, and should be applied consistently across heat networks. They also noted that it was vital that while transparency and standardisation are important, it would be key to ensure that the establishment of innovative tariffs and service provision were enabled by any policy.

The Task Force considered that further work was needed to define the elements that can reasonably be included in heat network bills, with consideration given to the variability of scheme specific costs and different approaches to billing and how this will be factored into the methodology.

4. Do you have views on our proposed approach to data collection and analysis?

To ensure competition law compliance the ADE does not discuss prices among members. As the ADE does not have access to these data, there is value in the CMA collecting and analysing it so as to better understand how the industry operates. The Heat Network Task Force recommended, in their upcoming report, that further consideration be given to the role of regulation in price transparency and controls for new heat networks covered by the proposed regulatory framework. The report recommends that this occurs as part of detailed design of the Demand Assurance, but noted also that robust evidence should be required to set what

components should be included and excluded from bills beyond the network assets covered by Demand Assurance, and onto the final heat price.

We broadly agree with the proposed approach to data collection, and wish to highlight the importance of gathering a sufficiently broad sample – as noted in question 3, there are many different models for service provision on heat networks and it's vital that the sample group data accurately reflects the diversity of approaches to gain an accurate picture of the industry.

In the longer term, the ADE would like to explore the role of the Association in collating and publishing industry data. Publically publishing even anonymized, aggregated and/or sufficiently historical data could allow consumers to broadly compare available tariffs to better understand the value offered by their own tariff and to have more informed discussions with suppliers about services offered.

5. Do you think that the potential remedies we are considering are appropriate? What are the potential benefits / risks in implementing such remedies and how should they be designed to maximise benefits? Are there other remedies that we should be considering?

In line with the Heat Network Task Force's forthcoming recommendations, the ADE is supportive of a regulatory framework. As noted by the CMA, heat networks are a natural monopoly (like other utilities such as gas, electricity, water), and the work of the industry-led Task Force concluded that, to protect consumers and to encourage equitable investment in the heat network market, regulation is necessary. The ADE would welcome the opportunity to discuss the full report in more detail once published.

Theme 2: Monopoly supply

1. Do heat networks exhibit natural monopoly characteristics (high fixed costs; economies of scale; barriers to further local entry to compete for existing customers)?

Heat networks do exhibit natural monopoly characteristics, as do other energy networks, and this needs to be taken into account when considering their growing role in the energy market.

Many natural monopolies exist – particularly in the utility sector. One point of commonality between many of these is that they are subject to oversight by a regulator.

As noted in the statement of scope and explored in detail in the Heat Network Task Force report, the uncertainty of future heat demand is a key risk for heat network investment. This risk has, in part, been mitigated through exclusive long duration concession contracts. These contract structures are aimed at the legitimate objective of reducing the investment risk. By reducing risk, the cost of capital for the investment can be lower and therefore helps lower the cost of heat provision to the end customer.

The regulatory investment framework proposed by the Task Force in their forthcoming report recommends the introduction of a regulatory Demand Assurance – an investment framework (potentially with a cap and floor) which seeks to move heat demand risk away from investors to enable lower cost capital to come into the market to help drive down heat prices. Such Demand Assurance would be offered in return for a number of obligations such as meeting minimum technical standards obligations on customer service and system reliability serve to reduce customer risk. Combined, the proposed regulatory framework mitigates key risks for all stakeholders from end customers to the investors. Demand Assurance is explored in detail in the report.

2. To what extent are consumers able to switch from their current heat network providers to alternative heat network operators or to alternative heat sources? What are the key factors (contractual and / or technological) impeding consumers from switching?

The CMA is right to identify that the natural monopoly characteristics of heat networks can act as a barrier to switching.

That said, business models exist in which company and contract structure is such that it is possible to separate asset ownership from service provision. In such scenarios, asset ownership is over a long term and shorter contracts exist for services such as network operation and heat supply, customer services, and metering and billing. As a result, the service provider can be held to account for delivery against performance objectives and be at risk of losing the contract for services on that network. In effect, these structures amount to collective switching for customers without undermining the asset investment.

The Heat Network Task Force explored this, and the forthcoming Task Force report explores the potential to expand such models.

As noted in the scope, even where there exists some constraints, there is still the ability to have competitive segments of heat networks.

3. How do commercial and financial incentives at different levels in the value chain affect the decisions of builders, operators and residents?

The CMA is right to identify differing priorities of heat network stakeholders as an important issue that affects both perception and operation of the market. Industry recognises that contracts can place a priority on the relationship with the client and contractor, including cost, without an explicit focus on the end customer interest. However there is increasing evidence that procurers of networks are aware of the importance of considering the final customer at the outset. These practices need to be the common standard.

The Heat Networks Technical Compliance Scheme, planned for initial launch later in 2018, will seek to address this concern by creating a clear chain of liability and responsibility for heat network projects, so that parties are held to account for delivering heat networks that are built to a high standard and meet minimum performance requirements for efficiency, cost and reliability. While the Compliance Scheme cannot set prices or pricing structures, it may include performance metrics that incorporate ensuring customer price is clearly considered and agreed before final project investment.

One area that the Compliance Scheme will be unable to address, but which remains a concern to the industry, is developer contributions which result when ESCOs pass along the cost of funding the capital contribution to end-customers via their standing charges (essentially double-charging them for the asset). The CMA should explore these arrangements to seek to understand the rationale and, if needed, intervene to set rules governing how and when such payments are made (including exploring whether they should be prohibited). This would align the rules around charging for asset conditioning in heat networks with those in the power and gas networks – for example, that the cost of a boiler is included in the price of a new home and not as part of an ongoing charge.

4. Do you have views on our proposed approach to data collection and analysis?

Importantly, the statement of scope recognises the diversity of complexity of suppliers' operating models in the market, and acknowledges the importance of examining a variety of

cost structures and financial flows to better understand that different ways in which the market can operate.

It will be important when analysing information that there is confidence that comparison is 'like for like' – on price, this will mean ensuring a comparison with gas and/or electric heating costs that also incorporates lifetime costs; and on reliability, that it is compared against the heating provision reliability not just the pure fuel reliability (as, for example, gas heating reliability is less then gas reliability on the whole).

5. Do you think that the potential remedies we are considering are appropriate? What are the potential benefits / risks in implementing such remedies and how should they be designed to maximise benefits? Are there other remedies that we should be considering?

When examining long-term contracts it is appropriate to be mindful of the context in which they were created – as noted in question 1, often long term contracts have been issued with the legitimate objective of reducing the demand risk of the initial investment, which has helped to drive down the high cost of capital. This is particularly important in order to grow this market in line with the Government's ambitions. Amendments to existing contracts may destabilise investment and if this remedy were pursued then thought should be given as to how to support those affected in redistributing this risk and managing the transition.

It is important to note that contestability does already exist in the market – for example, for the provision of design, build, operation and maintenance (DBOM) of the schemes, which is subject to competitive procurement and may be separate contracts across stages. Where DBOM for a scheme is contracted to one organisation, the need to service customers and maintain the scheme can have a positive drive to focus on customer outcomes at earlier stages of the project as poor design and build will lead to a costly and inefficient network, impacting the value of an operation and maintenance contract.

Theme 3: Outcomes

1. Are heat network prices reasonable, and is quality of service and reliability adequate, when compared with alternative heat sources and/or operating costs?

The Association and its members, understandably, exercise a high degree of caution and are mindful that competition law prevents industry discussing what a fair price would be.

Comparisons with other heat sources are useful but also need to consider the full costs. For example, heat networks save carbon as do heat pumps but the cost of a heat pump is not in the consumer energy bill and is subsidised under the RHI. Further, consideration should be given to comparing what opportunities for cost-effective decarbonisation are presented by heat networks, in comparison to alternative heat sources.

The results of BEIS's survey on customer cost and expectations indicate that heat network consumers paid, on average, around £100 less for their heating and hot water compared with non-heat network consumers. The survey also found that, overall, heat network consumers were just as satisfied with their heating systems as non-heat network consumers. The results of the BEIS survey suggest that general heat network customer satisfaction is higher than what might be expected from looking solely at media coverage of networks. Across the heating sector satisfied customers understandably tend not to comment on their heating while those with a negative experience rightly complain, which can lead to high profile media stories.

The ADE is aware of poor customer experiences on some heat networks. The ADE has shown that the industry is not complacent about the issues those customers have experienced, as demonstrated by the creation of Heat Trust and work to establish the Heat Networks Technical Compliance Scheme.

Industry, in establishing Heat Trust, has set up what it considers to be the appropriate standards in reliability and service – and the mechanism for monitoring this. The ADE is supportive of the ongoing work of Heat Trust in this space. Over the past year, the Heat Network Task Force has considered industry best practice to ensure good outcomes for consumers and for the growth of the industry, leading to significant recommendations – including mandating particular standards in exchange for the benefits offered by the regulatory Demand Assurance.

2. Do you have views on our proposed approach to data collection and analysis?

The ADE broadly agrees with the proposed approach to data collection, and wishes to highlight the importance of gathering a sufficiently broad sample. As noted above, there are many different models for service provision and charging on heat networks and it's vital that the sample group data accurately reflects the diversity of approaches to gain an accurate picture of the industry.

As noted in the statement of scope, identifying the appropriate conversion calculation for comparison between alternative fuel tariffs is both important and quite complex – this is also discussed above (at theme 2, question 4). The Association would be happy to assist with identifying the appropriate factors to consider in such an analysis.

3. Do you think that the potential remedies to control outcomes directly are appropriate? What are the potential benefits / risks in implementing such remedies and how should they be designed to maximise benefits? Are there other remedies that we should be considering?

The work of the Heat Network Task Force has concluded that a regulated investment framework is the best way to ensure the heat network market can ensure a good outcome for all consumers and ensure that heat networks are investable to achieve the government's ambition in the Clean Growth Strategy. The Task Force report (to be published on 31 Jan) represents a considered approach from a broad range of stakeholders and has many of the issues considered by the CMA at its heart. As a result, the ADE would recommend that the Task Force report and recommendations are a helpful starting point to consider how the focus on ensuring customers are well treated can be achieved while also giving due regard to the need for investment in the sector to grow.

Attracting investors by enhancing the investment framework for heat networks will lead to a reduction in the cost of capital which will, in turn, drive down heat prices and so improve customer value. Additionally, investors desire positive customer outcomes as dissatisfied customers are a risk to project viability. It is thus essential to understand that sector investability and customer experience are deeply intertwined. The ADE believes that crucial to future of heat networks is building consumer and investor trust by the creation and enforcement of clear standards, and making heat network projects investable with low cost capital. A regulated investment framework is the best way to achieve this.

The ADE has been able to undertake only the first stages of analysis and consultation with our members. The Association intends to continue working on identifying ways in which we can contribute to the creation of practical improvements, and look forward to continued engagement with the CMA to identify potential solutions.
The Association particularly welcomes further engagement with the CMA with regard to the recommendations set out in the upcoming Task Force report, and hope that it will provide a useful basis for analysis and further discussion.

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