

Insights

ACHIEVING NET ZERO – REGULATION OF DISTRICT AND COMMUNAL HEATING AND COOLING AND IMPACT ON THE REAL ESTATE SECTOR

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SUMMARY

This is our first insight on new regulation that will affect the district/communal heating and cooling sector. It focuses on consumer protection and the impact on building owners/landlords and management companies.

Our second insight to be released shortly will focus on the regulations that will affect new property developments and in particular those in “Heat Network Zones”.

The district/communal heating/cooling sector is to be fully regulated in the UK as from late 2023/early 2024.

Consumer protection is at the forefront of the changes.

Heat/cooling suppliers (entities contractually obliged to provide heat/cooling) and heat/cooling network operators will need to be “authorised” to carry out those activities.

Heat/cooling networks, for the purpose of regulation, will comprise direct heat/cooling networks and communal heat networks.

From early/mid 2024 OFGEM will oversee and enforce requirements opposite heat/cooling suppliers and heat/cooling network operators in respect of:

- authorisations to carry out those activities;
- reliability of the supply of heating, hot water and cooling;
- the reasonableness of charges for those supplies;
- reduction of emissions of targeted greenhouse gases generated by heat/cooling networks; and

- plain communication to customers about services and charges.

This will impose a significant regulatory burden on a sector that hitherto has been able to operate in a broadly unregulated environment.

Many building owners, landlords and management companies will – perhaps unwittingly and unwillingly - fall into the category of a regulated heat/cooling supplier or heat/cooling network operator.

If so they will need to keep abreast of the evolving regulatory landscape, review their current arrangements to check regulatory compliance and if required create an action plan to ensure compliance.

THE CURRENT STATE OF PLAY

Contractually any entity can operate a heat/cooling network and supply heat/cooling to end customers.

For large networks and developments experienced ESCOs are typically appointed by developers/landowners to operate networks and supply heat/cooling to end customers under outsourced arrangements e.g. concession agreements.

For smaller developments, building owners/landlords/management companies may operate networks and/or supply heat and cooling to end customers through:

- **Leases** – much like any other utility where a landlord on-sells to a tenant electricity/gas supplied to the landlord by a regulated electricity/gas supplier; or
- **Direct heat supply agreements** – akin to an occupier having a direct electricity or gas supply agreement with an electricity/gas supplier.

Note that where building owners/landlords currently employ a third party to carry out metering and billing services those are generally carried out on the basis that the building owner/landlord remains as the contractual heat supplier. Usually the terms and conditions of metering/billing organisations make this clear.

THE IMPACT OF REGULATION

The new regime is set out in Part 7 and Schedule 16 of the Energy Bill, currently at Committee stage in the House of Commons.

It is intended that the consumer protection regime will apply to Great Britain.

The provisions are relatively skeletal with detail to be fleshed out in draft statutory instruments over the course of this year/next year, but a good steer as to likely content is contained in prior Government consultations. We have also been speaking to our contacts in the industry who are in ongoing consultation with the Department of Energy Security and Net Zero (“DENZ”).

Regulation will apply to the function - operation and supply – not the means of delivery e.g. lease or direct supply agreement. So for example where a heat/cooling charge is bundled into an all-inclusive residential rent there is still technically a contractual supply and regulation will apply.

If a development, for example, contains domestic premises and commercial premises each premises will be assessed individually as to whether regulation does or does not apply to the particular premises.

Residential and micro business customers will benefit from the consumer protection requirements. It is currently unclear if small/medium commercial business will be protected. Larger commercial customers are considered to have sufficient bargaining power to protect themselves. There is no definition of a micro business in the Bill. It will appear in the statutory instruments but OFGEM is likely to use the definition currently used by the Heat Trust, such that a micro business is one which:

- has annual electricity consumption of not more than 100000 kWh per annum; or
- has annual gas consumption of not more than 293000 kWh per annum; or
- has 10 full time equivalent employees or annual turnover of £2m.

Where operations and supply have been outsourced to ESCOs there may be little impact. The ESCOs will be the regulated network operator and/or heat/cooling supplier. Their agreements with end customers will need to reflect new regulatory protections to the extent not already provided for. Although how any additional costs arising from regulatory requirements may be apportioned as between ESCo, customer and the building owner/landlord will depend on the contractual risk allocation between those parties already in place.

Where building owners/landlords/management companies continue to operate networks and/or supply customers they will be exposed to the new regulatory regime. DENZ has indicated that the level of regulatory burden and cost impact is to be realistic and proportionate for the size/complexity of the network. This is good news for smaller networks but nonetheless, as a minimum, the authorisation, charging and standards regulations will apply to all networks.

TWO LIMBS

The new regime encompasses two primary limbs:

- **Regulator facing** – “authorisation” and reporting, with enforcement powers granted to OFGEM.

- **Customer facing** – supply standards, transparency and pricing.

AUTHORISATION

A general authorisation regime will be brought in that will enable OFGEM to enforce consumer protection rules. All entities supplying heat/cooling or operating heat/cooling networks will need to notify OFGEM of their intention to carry out these functions in order to be authorised to do so. OFGEM will have powers to set specific notification requirements for authorisation and to perform risk-based checks. Government has stopped short of a full licensing regime (as applies for electricity/gas operator and suppliers)

Initially any entities currently carrying out operation and supply activity will be “grandfathered in” but over the course of 2024 will need to apply for authorisation.

REPORTING

Authorised entities will be required to report periodically to OFGEM. The regulations may, in particular, require OFGEM to collect information relating to standards of performance achieved by authorised entities.

ENFORCEMENT

Cases of non-compliance with the regulations will be resolved by OFGEM. Where appropriate, this may involve supporting regulated entities to take steps to comply. Enforcement actions by OFGEM will only be taken in appropriate circumstances, such as where there is non-compliance causing significant consumer detriment or where the regulated entity has not taken steps to comply.

Where enforcement action is necessary OFGEM will have recourse to powers equivalent to those it has for gas and electricity. These include provisional and final orders, financial penalties, consumer redress orders, revocation of an authorisation and powers to address schemes operating on an unauthorised basis. Regulated entities will have rights to appeal enforcement decisions.

OFGEM's role will be limited to systemic issues. The independent Energy Ombudsman service will handle escalated individual consumer complaints (many supply agreements already provide for that Energy Ombudsman role. Leases generally do not).

STANDARDS, TRANSPARENCY AND PRICING

The operator and supplier authorisations will require minimum performance standards to be adhered to. These will probably be based on the current Heat Trust KPIs in relation to supply interruption and fault rectification.

Customers are to be provided with a minimum level of information and guidance on heat/cooling networks at the pre-contractual stages of property transactions. This obligation will sit outside of

Ofgem's remit but will be required by legislation. Customers will also receive a minimum level of easily accessible information during their residency, including heat/cooling supply agreements (or equivalent).

Regulation of pricing/charges is likely to be the toughest challenge for suppliers. Key for Government is to introduce a regime that provides for heat/cooling customers protections equivalent to those available in the competitive gas/electricity supply markets.

Ofgem will have powers to:

- introduce rules and/or guidance on fair and consistent pricing;
- take enforcement action against disproportionately high pricing;
- set price comparison and benchmarking methodologies.

Direct profit regulation and individual direct scheme capping will not be imposed now but Ofgem will hold powers to introduce pricing regulation in future should there be evidence of widespread consumer detriment, or as a mechanism to incentivise innovation to reduce costs and encourage growth in a more mature market.

It is likely that as from 2024 Ofgem will:

- set out which category of costs can be included in a variable tariff and which in the standing charge so that pricing can be assessed across the market on a consistent basis
- seek to deal with the wide pricing variation seen across networks (e.g. variable tariffs can vary from 5p/kwh to 45p/kwh) to provide a degree of consistency. Somewhere at an upper level pricing range Ofgem may impose a market-wide charges cap or possibly deal with this indirectly by mandating a level of network efficiency which in turn should feed beneficially into supply charging. We understand there will be a further consultation on charges and pricing.

HOW TO TACKLE THE CHANGES

AUDIT

Building owners/landlords should assess the current operation of their networks and supply arrangements. In particular their charges and network efficiency/operations.

The critical components that make up the charges should be analysed including:

- can the purchasing of input fuel be carried out more efficiently?; and
- can the network operate more effectively whether through upgrade or improved O&M/life-cycling? Grant funds under the Heat Network Efficiency Scheme may be available for

upgrades.

Such an analysis should look at the operation and supply arrangements holistically – operational inefficiency feeds directly into high pricing.

Consideration should be given to appointing energy consultants to assist with this task if there is a lack of in-house expertise or if different contractors are employed on the operation and supply sides.

Carrying out that exercise will place clients in a good position to take appropriate action (if needed) once pricing/charging regulation becomes clearer.

KEEPING ABREAST OF THE REGULATORY EVOLUTION

In addition to the fleshing out of the known regulatory requirements over the remainder of 2023 there are important areas of conceptual/structural uncertainty to be resolved – for example:

- the application or otherwise of regulation to small/medium businesses;
- **Nursing homes** – are they considered domestic (regulated) or commercial (possibly unregulated)?
- **Bulk heat/cooling supplies** - many building owners/landlords supplying domestic customers take and pay for a bulk supply of heat from a heat supplier and then on supply. Is the bulk supply domestic or commercial? If the latter the building owner/landlord may face regulated charges opposite the customer but be charged by its bulk supplier on an unregulated basis. Ideally the bulk supply should be aligned conceptually with the end supply so that the building owner/landlord is not exposed to taking an unregulated supply but having to provide a regulated supply.

We will be monitoring further output from DENZ and OFGEM and advising clients.

CONTRACTING

Depending on the outcome of audits and/or the level of regulatory burden, building owners and landlords may seek to exit the heat supply business and move to an ESCo model. Whether practical may depend on the size of the opportunity for potential ESCo's (although some may be willing to do a "portfolio" deal) and the ability to change current contractual arrangements opposite customers e.g. amending leases to move to direct supply agreements with an ESCO.

For those staying in the heat supply business consideration will need to be given as to how best to:

- re-structure current contractual arrangements to bolt on the regulatory regime. This should be easier for those building owners/landlords who currently supply through direct supply

agreements outside of a lease. Those can probably be varied more easily than a lease;

- structure operation and supply for future acquisitions/developments and in particular dealing with the issues of network efficiency, creating synergies between operation and supply in the context of customer charging and creating contractual arrangements that best fit with the regulatory requirements. For example:
- running supply through direct supply agreements not leases; and/or

creating a ring-fenced heat/cooling operations and/or supply entity discrete from the building owner/landlord that can take forward the heat/cooling activity across a portfolio.

RELATED PRACTICE AREAS

- Real Estate
- Energy & Natural Resources
- Power
- Regulation, Compliance & Advisory

MEET THE TEAM



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