

Guidance

Heat networks fair pricing and cost allocation draft guidance

Publication date:	29/09/2025
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This is draft guidance for the fair pricing framework and cost allocation. It is relevant for heat network suppliers and operators serving domestic and non-domestic consumers.

This guidance is subject to consultation and stakeholder feedback and will be updated and published accordingly. Heat network suppliers and operators are responsible for keeping up to date with the latest version of requirements, including guidance.

Guidance – Heat networks fair pricing and cost allocation draft guidance

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Contents

Heat networks fair pricing and cost allocation draft guidance	1
Introduction.....	4
Fair Pricing Principles	6
Background	6
Scope.....	6
Applying the principles of the fair pricing framework.....	7
Cost-reflective pricing.....	8
Cost efficiency.....	10
Fair and reasonable returns	13
Affordability	14
Regulatory control	16
Price transparency	17
Outcomes.....	17
Fairness test.....	19
Market segmentation.....	20
2. Cost Allocation	24
Background	24
How to interpret this guidance	24
Relevant Principles.....	25
General cost pass-throughs	27
Tariff Structure.....	29
Depreciation	31
Bad Debt.....	34
Corporate Risk	36
Fuel Procurement	38
Fair and Reasonable Returns	40
Penalties and Redress.....	41
Legacy Arrangements.....	43
Connection charges.....	44
Appendix 1 – Fairness Test	45

Introduction

- 1.1 Our fair pricing policy proposals, together with the wider heat networks regulatory proposals, seek to balance good consumer outcomes with market growth through investment.
- 1.2 As outlined in our previous consultations, our focus will be on addressing pricing issues where these arise while keeping any burdens on heat networks to a proportionate level.
- 1.3 The following draft guidance aims to support heat networks in maintaining compliance as fair pricing regulation comes into effect starting January 2026. It contains our first published draft guidance on the topics of fair pricing and cost allocation.
- 1.4 The [2018 CMA market study](#) did not find evidence of systemic high prices across heat networks nor identified at the time an urgent requirement for intervention to reduce prices. However, the study did recommend that the sector regulator should monitor prices for cases of excessive pricing and require compliance with 'principles-based' guidance on pricing.
- 1.5 This document makes references to the following previous consultations and government responses:
- 1.6 The '[2020 consultation](#)' refers to the Heat networks: building a market framework consultation published in 2020, which informed the provisions in the Energy Act 2023. The subsequent government response is referred to as the '[2021 government response](#).'
- 1.7 The '[2023 consultation](#)' refers to the Heat networks regulation: consumer protections consultation published in August 2023, which informed the Heat Networks Market Framework Regulations SI (2025 HNMFRGBR SI). The subsequent government response is referred to as the '[2024 government response](#).'
- 1.8 The '[2024 ICP consultation](#)' refers to the Heat networks regulation: implementing consumer protections consultation published in November 2024. The subsequent government response is referred to as the '[2025 ICP government response](#).'
- 1.9 The '[2024 ARO consultation](#)' refers to the Heat networks regulation: authorisation and regulatory oversight consultation published in November

2024. The subsequent decision document is referred to as the '[2025 ARO decision](#)'.

- 1.10 The '[2025 consultation](#)' refers to the Heat Networks regulation: fair pricing protections consultation published in April 2025.
- 1.11 Our intention is for this guidance to be iterative in order to accommodate phased pricing protections and other policy developments. We acknowledge the need for flexibility to keep developing policy, with the balance between prescriptive rules and guidance open to change over time if required and we will consult on these changes when required.
- 1.12 Stakeholder responses in previous consultations outlined above suggested avoiding prescriptive rules until adequate data has been gathered from regulated heat networks to inform the guidance, highlighting the need for flexibility and a holistic approach to guidance.
- 1.13 The following pricing guidance aims to set minimum expectations, principles, and examples of best practice. These are to be used by heat networks as a guide to our principle based approach rather than (unless otherwise indicated) as a set of prescriptive rules. Areas of guidance set out additional detail on how each relevant principle applies to an area of pricing or cost allocation, and expected standards resulting from these principles.
- 1.14 Where authorised persons have deviated from guidance we expect these heat networks to be able to justify their approach and how it aligns with the pricing principles set out within this guidance and previous consultation.

Fair Pricing Principles

Section summary

In this section we outline draft guidance for interpreting the fair pricing authorisation condition. The draft guidance sets out minimum expectations and best practice in relation to the fair pricing principles that guide the application of the fair pricing obligation. It also makes provisions about how we will determine whether charges are fair and not disproportionate through the application of a 'fairness test'.

Background

- 1.15 In the [2024 ICP consultation](#) we consulted on a proposed high-level framework for pricing protections. In the [2025 consultation](#) we consulted on a more detailed framework, including its high-level structure, a proposed set of objectives, principles and outcomes, and a fairness test to support its implementation. [Our response to that consultation can be found here](#). This draft guidance has been developed taking forward the proposals set out in those consultations and incorporates feedback received from stakeholders.

Scope

- 1.16 The fair pricing framework applies to both suppliers and operators of heat networks.
- 1.17 Both suppliers and operators are responsible for ensuring that any contracted service providers that engage with consumers on their behalf also comply with the fair pricing framework.

What are the broad principles authorised persons must follow?

- 1.18 The fair pricing framework develops the general obligation on heat networks to provide fair and not disproportionate prices which will be included in the Authorisation Conditions (ACs). The latest draft of the Fair Pricing AC (AC number 04) can be found in Annex 5 (Draft Authorisation Conditions) of [our response to the 2025 consultation](#). The high-level structure of the fair pricing

Heat networks fair pricing and cost allocation draft guidance

framework was set out in the [2025 consultation](#) (chapter 2 fair pricing framework).

- 1.19 The framework has an overarching objective and consumer and industry outcomes, as well as six principles to be followed. It also includes a 'fairness test' element to support its implementation. Authorised persons (and their representatives) must have regard to the principles in a manner consistent with the overarching objective and achieving the consumer outcomes. Table 1 below shows the consumer objective and set of principles and outcomes.

Table 1: Fair pricing framework objective, principles and outcomes

Objective	Principles	Outcomes
Consumers pay fair and not disproportionate prices	<ul style="list-style-type: none"> • cost-reflective pricing • cost efficiency • fair and reasonable returns • affordability • regulatory control • price transparency 	<ul style="list-style-type: none"> • consumer outcomes • industry outcomes

Applying the principles of the fair pricing framework

- 1.20 Authorised persons should ensure that the prices it imposes are fair and are not disproportionate.

Cost-reflective pricing

This principle establishes our expectation that prices should be reflective of the underlying cost of providing heat and consumption levels of consumers. Additionally, consumers should pay for the additional costs they impose on the system, as well as a contribution to the fixed costs of the system, ensuring long-term efficient use and sustainability of the system.

- 1.21 The authorised person is expected to adhere to this principle when designing their pricing strategies and be able to explain how their prices meet this principle if requested. Guidance on cost reflective pricing covers the following areas:

Data accuracy and meter readings

- 1.22 Authorised persons must use the most accurate data available to them when calculating charges. This includes the use of accurate meter readings (when these exist) to calculate charges.
- 1.23 When meter readings are not available, suppliers should use reasonable proxies for unmetered usage. Further guidance is provided under cost allocation, paragraph 2.25.
- 1.24 Please note that this guidance does not impose an obligation to install meters. Currently, metering is regulated under the Heat Network (Metering and Billing) Regulations. New metering requirements will be set out in the Heat Network Technical Assurance Scheme (HNTAS).

Cost-reflective tariff structure

- 1.25 Tariff structure should align with the cost-reflective pricing principle set out here. Tariff design and structure is discussed in more detail in the cost allocation guidance section page 25.
- 1.26 In relation to the 'price promise' or 'cost avoidance' pricing methodology, where prices are set with reference to a counterfactual, this guidance does not preclude the use of these pricing models, provided it delivers fair and not disproportionate prices for consumers. The fairness test will explore the extent to which prices are fair and not disproportionate according to the principles

Heat networks fair pricing and cost allocation draft guidance

outlined, regardless of the pricing methodology applied. For more detail please see our response within 'Response to consultation on heat networks regulation: fair pricing protections' page 10.

Cost efficiency

This principle establishes our expectation that underlying costs should be efficient while providing an appropriate quality of service, and that authorised persons should take steps to create cost efficiencies where feasible. Additionally, authorised persons should make choices based on long-term efficiencies.

- 1.27 Heat networks can create cost efficiencies through, for example:
- implementing technical efficiencies
 - competitive fuel procurement
 - outsourcing contracts where beneficial
 - other operational efficiencies
- 1.28 Heat networks should consider long-term efficiencies. In seeking to cut short-term costs, they should not neglect larger-scale investments, such as capital and asset investments, to achieve efficiency improvements. They should also ensure there is sufficient financing to cover such improvements where appropriate.
- 1.29 Guidance on cost efficiency covers the following areas:

Network efficiency

- 1.30 We expect authorised persons to operate heat networks efficiently to minimise costs. However, this guidance does not introduce obligations in relation to technical efficiency. For detailed technical standards and best practices, please refer to the forthcoming Heat Network Technical Assurance Scheme (HNTAS), which is being jointly developed by the DESNZ and the Scottish government. We acknowledge that different heat networks will have different levels of technical efficiency which could drive legitimate differences in pricing, and we would take this into account when considering whether prices are fair and not disproportionate.

Maintenance, service and customer service costs

- 1.31 We expect authorised persons to carry out maintenance and service activities to prevent costly breakdowns and avoidable reductions in efficiency levels, such as routine inspections, efficiency monitoring, cleaning and servicing of equipment.

Heat networks will also typically incur costs related to customer service, such as billing and metering, customer support and other administrative costs. These costs may depend on factors such as age and technology of the heat network, total number of customers and proportion of vulnerable consumers, and we would take this into account when considering whether prices are fair and not disproportionate.

- 1.32 In terms of best practice, we expect authorised persons to carry out these activities in a cost-efficient manner and be transparent in cost reporting. If these services are outsourced, we expect authorised persons to ensure value for money by, for example, testing the market and comparing prices and service quality from different providers. Authorised persons should be able to justify their decision to outsource and choice of service provider.

Fuel procurement and hedging

- 1.33 Regarding fuel procurement and hedging, we acknowledge that a trade-off can exist between the level of risk (for example, price risk, volume risk and shape risk) that sits with the network in a procurement contract, and the price paid. For example, a network seeking longer-term price certainty may choose to pay a premium in return for fixing the fuel price for longer.
- 1.34 In terms of best practice, we expect authorised persons to have a clear strategy in their approach to risk, and to aim to put in place contracts that strike an appropriate balance between price and risk. We recognise that the appropriate procurement strategy may vary depending on the characteristics of the network, for example:
- heat network operators or suppliers which are larger entities, for example operating multiple networks or with significant other activities, may have the financial resilience to take on a larger degree of risk
 - domestic consumers may value price stability more than commercial consumers, who may accept a higher degree of volatility (or vice versa: some commercial consumers may have a strong preference for predictability or stability)
 - smaller networks may have less bargaining power
 - some networks may make use of third-party intermediaries (TPIs). See below for expectations on procurement best practices.
- 1.35 We recognise that a wide range of different procurement and hedging strategies are being used, which may be appropriate given different circumstances and

characteristics of heat networks. However, these strategies must be employed with the aim of securing fair prices for consumers.

- 1.36 In terms of procurement best practice, we expect authorised persons to:
- clearly document the procurement strategy and justification for the procurement strategy being appropriate for the network's customers, including the consideration of different options for contract terms and period of renewal
 - seek multiple quotes from suppliers or TPIs
 - regularly monitor the level of fees charged by a TPI (and how this compares to fees charged by other TPIs)
 - improve transparency in the procurement approach by requesting individual cost lines from TPIs if these are not provided (particularly for larger networks)

Restricted cost passthrough

- 1.37 Guidance in relation to restricted cost passthrough is discussed under cost allocation rules (see paragraphs 2.94-2.99).

Capital cost recovery

- 1.38 Guidance in relation to capital cost recovery is discussed under cost allocation rules (see paragraphs 2.32-2.34).

Corporate risk

- 1.39 The efficiency of underlying costs includes efficient recovery of capital expenses which is reflective of the corporate risk. Guidance in relation to corporate risk is discussed under cost allocation rules (see paragraphs 2.58-2.69).

Fair and reasonable returns

This principle establishes our expectation that authorised persons should not leverage their monopoly status to earn returns in excess of what could be expected in compensation for the risks associated with the investment (unless this is merited, in the short term, by exceptional performance).

- 1.40 This guidance does not set specific levels of return that would be considered appropriate, as this will differ based on wide range of complex factors including performance, risk profile, ownership model, and will also vary over time. However, we will monitor profitability across the sector and may investigate cases where profit levels are higher than what we would expect. We will also have regard to how authorised persons' profit levels compare to an estimate of the cost of debt and equity in the market or the "weighted average cost of capital". We might also have regard to authorised persons' changes in capital structures, to monitor that profit levels are not leading to excessive debt levels.

Affordability

This principle establishes our expectation that authorised persons should strive to maximise consumer benefit in their pricing decisions, while also making a fair and reasonable rate of return and recovering their costs. In particular, they should have regard to affordability for consumers. These considerations should be applied throughout the entire pricing process, from the design of the pricing strategy to the charging methodology.

- 1.41 The application of this principle does not require authorised persons to charge consumers differently based on their economic circumstances.
- 1.42 We understand that some affordability challenges (for example high wholesale energy prices, and legacy inefficiencies) will be partly beyond the control of authorised persons. As such, we do not expect authorised persons to resolve all affordability issues. However, in areas where heat networks do have greater control, affordability should be a key consideration.
- 1.43 This principle should not disincentivise authorised persons from making cost-effective choices based on long-term efficiencies such as technical efficiency and decarbonisation improvements.
- 1.44 Guidance on affordability covers the following areas:

Cross-subsidisation

- 1.45 We expect authorised persons to ensure that if there is cross-subsidisation among consume, this does not lead to individuals or groups of consumers facing disproportionate prices as a result. Authorised persons should be prepared to provide a clear and reasoned justification for the approach adopted.

Shock bills

- 1.46 In some exceptional circumstances, unusual or unexpected high bills might be unavoidable. However, we expect authorised persons to plan ahead and strive to minimise their likelihood and impact.
- 1.47 We expect authorised persons to be proactive in managing the impact on consumers of shock bills if they occur. For example, by:
 - communicating the expected costs to consumers in a clear and timely manner to help them anticipate and plan their bills

Heat networks fair pricing and cost allocation draft guidance

- offering flexible payment plans, such as instalment options, to help consumers manage the unexpected high bill
- 1.48 Our wider consumer protection proposals include the proposals on billing and back-billing rules that would require suppliers to provide regular and accurate billing, and for most authorised persons, prevent them from issuing back-bills for heat used more than 12 months prior to the date of the bill. These would also help mitigate the likelihood and impact of 'shock bills'. This proposal has some dependencies on the unbundling of the individual heat charge from wider charges, such as service charges or rent. For more information on these proposals please see the [2024 ICP consultation](#).
- 1.49 With regard to debt repayment, we confirmed our position in our aforementioned joint consultation with DESNZ that suppliers must proactively offer repayment plans appropriate to consumers' ability to pay, and they must consider alternative payment options such as pre-payment meters or third-party deductions from social security benefits (where appropriate). Furthermore, consumer protection guidance requests where a consumer is identified as rationing heat usage or self-disconnecting, the network should consider reassessing or reducing the consumer's debt repayment plan and refer them to third party debt advisors.

Regulatory control

This principle establishes our expectation that authorised persons should have oversight and control over regulatory outcomes even when management is outsourced. The organisation will be held directly accountable for the actions or omissions of the outsourced party.

- 1.50 In terms of best practice, we expect authorised persons to have a clear strategy in their approach to ensure regulatory control. This principle is separate to, and should be considered in conjunction with, any existing financial resilience provisions regarding control. We recognise that this strategy may vary depending on the characteristics of the network, and the contracted service. We expect authorised persons to achieve this, for example, through:
- clear contractual obligations with outsourced parties that align with regulatory requirements
 - supply chain visibility, including access to key data such as cost structures, and tariff setting methodologies
 - strategic alignment through shared objectives that reflect the regulatory outcomes
 - robust tendering criteria ensuring the ability of contractors to understand and comply with regulatory requirements

Price transparency

This principle establishes our expectation that authorised persons should communicate their prices to customers in a way that is accessible and easy to understand.

- 1.51 Detailed guidance on transparency in relation to communicating prices to customers are being developed as part of the 'billing and transparency' proposals and are included in the [consumer protection guidance consultation](#). For our proposals to publish some pricing information please see chapter 5 (central price transparency) of the response document.

Outcomes

- 1.52 The pricing framework seeks to achieve the following outcomes:

Consumers outcomes:

- the framework helps prevent disproportionate pricing: consumers pay prices for their heat that are not disproportionate
- the framework incentivises efficiency: consumers pay prices which reflect the costs of an efficiently run heat network
- consumers receive an appropriate quality of service
- the framework enhances transparency and consumer confidence in the sector: consumers can understand the charges and are confident they are fair
- the framework is forward looking and seeks to protect future consumers: consumers will keep paying fair prices in future through appropriate investment in the networks and industry development
- consumers should not be unduly disadvantaged compared to other consumers on alternative heat sources

Industry outcome:

- the framework does not discourage growth of the heat network sector

Fairness test

- 1.53 The fairness test helps us to apply and implement the fair pricing authorisation condition and principles effectively and consistently. Its features include:
- principle-based: 'fair' and 'disproportionate' prices are not predefined (for example by setting out acceptable return levels). When determining whether prices meet the fairness test (i.e. whether prices are fair and not disproportionate), we will use the principles set out in this guidance (for example cost-reflective pricing, cost efficiency, affordability) and the concept of reasonableness.
 - reasonableness: alongside the principles, this framework must be interpreted in line with the standard that could reasonably be expected of a prudent regulated entity that follows our general authorisation conditions and is well-run .
 - case-by-case basis: assessments would take relevant circumstances into consideration.
 - objectivity: to ensure assessments are as objective as possible we:
 1. will develop and use statistical and economic models, such as price benchmarking and profitability assessments. For more detail on these proposals see [chapter 3 of the response document](#).
 2. may set specific steps informed by defined criteria and guided by best practice in economic regulation.
- 1.54 [Appendix 1](#): Fairness test sets out some questions that we may consider when operationalising the fairness test, including what and how tools could be applied.

Market segmentation

Background

- 1.55 Market segmentation shows how rules and requirements are adapted for different types of heat networks in the market, to ensure that the application of the regulation is relevant and proportionate.
- 1.56 In both the April 2025 and August 2023 consultation there was support amongst respondents for a segmented approach to regulating the market. We have continued to consider how the regulatory approach can be designed to be fit-for-purpose and proportionate for different types of heat networks.
- 1.57 In the April 2025 consultation, we examined how segmentation could apply in a number of different ways to account for the diversity of the market, exploring a long list of network characteristics and a possible segmentation approach (see table 2 of the [2025 consultation](#)). For this guidance consultation we are focusing on the segmentation approach for this first iteration of the guidance.
- 1.58 [Table 2](#) below sets out the heat network characteristics that are relevant for segmentation in relation to the pricing requirements in the fair pricing guidance.

Table 2

Characteristic	Description	Segmentation approach
Metered versus non-metered	Whether customers are metered or unmetered.	<p>Relevant principle: 'cost reflective'</p> <p>Only metered networks are requested to use 'accurate meter readings' to calculate charges.</p> <p>Only non-metered networks are requested to use reasonable proxies for unmetered usage.</p> <p>All other principles apply normally.</p>
Pricing methodology: 'cost recovery'	<p>In this context, 'cost recovery' refers to an approach where prices are set only to recover the underlying costs of operating a heat network, excluding any profit or return on capital invested. This includes situations where, due to forecasting tools or estimation methods, an authorised person may temporarily over-recover costs, as long as adjustments are made in the subsequent pricing period to ensure that only costs are recovered. It also covers cases where costs are recovered in advance to build sinking funds, provided these funds are intended for legitimate future network expenses.</p>	<p>Relevant principle: 'fair and reasonable returns'</p> <p>This principle is not relevant for authorised persons applying a strictly 'cost recovery' model, as defined here.</p> <p>All other principles apply normally.</p>

Heat networks fair pricing and cost allocation draft guidance

Pricing methodology: 'price promise'	Under a 'price promise' (also known as 'cost avoidance') approach prices are set with reference to a counterfactual.	<p>Relevant principle: 'cost-reflectivity'</p> <p>This guidance does not preclude the use of 'price promise' pricing model, provided it delivers fair and not disproportionate prices for consumers.</p> <p>The fairness test will explore the extent to which prices are 'fair and not disproportionate' according to the principles outlined. For example the comparator benchmarking will test if prices are comparable to other networks with technically similar characteristics, and this comparison can be made regardless of the pricing methodology applied.</p>
Charges are bundled into rent or service charges	Where heat charges are bundled into rent or service charges, and subject to housing legislation rules such as that service charges costs must be 'reasonable' (Section 19 of the Landlord and Tenant Act 1985)	<p>Relevant principle: all</p> <p>We acknowledge the interaction between existing housing legislation (the Landlord and Tenant Act) and the implementation of various parts of the pricing framework. As highlighted in the 2024 consultation, we are engaging with MHCLG and DESNZ to further explore this interaction. At this current stage, we expect heat networks charges that are bundled to be reasonable (as required by the Landlord and Tenant Act) and follow our fair pricing principles and cost allocation guidance as best as possible. This factor will be considered in any future compliance/enforcement action that may be taken.</p>

Heat networks fair pricing and cost allocation draft guidance

Domestic versus non-domestic	Serves either domestic or industrial and commercial properties.	Relevant principle: 'affordability' Affordability considerations are relevant in relation to both domestic and non-domestic consumers, but are particularly relevant when dealing with domestic consumers.
Shared Ground Loops	Whether the network operates a Shared Ground Loop (where consumers are connected to a common heat source but also have individual heat pumps).	Relevant principle: all Whilst networks operating Shared Ground Loops may have different charging structures to other heat networks, for example charging a fixed fee for access, the general principles set out in this guidance still apply to them.
Level of vulnerability	Proportion of consumers who are vulnerable.	Relevant principle: all Although not strictly a matter of market segmentation, the potential impact on vulnerable consumers might be an aspect to consider in prioritising regulatory actions.

- 1.59 Other heat network characteristics may be relevant for other aspects of the fair pricing framework. For example: for benchmarking we will take into account different characteristics such as size of the network, efficiency levels etc that are likely to drive costs. For more information on our pricing benchmarking approach please see the [2025 consultation](#) (chapter 3) and [the response document](#). For market segmentation in relation to cost allocation please see [chapter 2](#) in this document.
- 1.60 Additionally, we may take into account characteristics such as the proportion of vulnerable consumers in prioritising regulatory action.

2. Cost Allocation

Cost allocation refers to how heat suppliers allocate costs to the various charges they levy on consumers, and how prices are structured more generally. Currently, suppliers use diverse pricing structures — including different combinations of connection charges, standing charges, unit rates, and other fixed charges – and allocate different costs to these charges. These differences may complicate price benchmarking.

Based on the responses from stakeholders in our previous consultation, we will be providing high level guidance for cost allocation.

In addition to the guidance, we will be imposing only one prescriptive rule initially: Guaranteed Standards of Performance (GSOP) payments, compensations, fines, penalties and other redress provided to consumers must not be passed through to customers

Background

- 2.1 This guidance aims to provide some best practices around broad cost allocation practices that occur in the market. The proposed best practices are linked to principles that are outlined in the previous chapter of fair pricing principles.
- 2.2 In general, we expect heat networks that fall within scope to abide by the proposed best practices wherever possible, and only deviate in situations where they are unable to abide by them due to legacy arrangements such as contractual agreements made prior to regulation which cannot be broken or renegotiated by authorised persons, other requirements in legislation, or when they can establish that deviating from proposed examples can provide better consumer outcomes.

How to interpret this guidance

- 2.3 We have not provided an exhaustive list of guidance on all possible costs that can be incurred in the market. Due to the nascent state of the market and limited data we have, proposing a prescriptive and exhaustive list would neither be feasible nor desirable at this stage of regulation. However, as we have mentioned in the previous consultations, we intend on keeping our approach to cost allocation under review as we start collecting monitoring data.

- 2.4 Given that the list in this guidance is not exhaustive, we expect heat networks to apply the fair pricing principles when deciding what and how to pass on the costs to consumers even for cases that are not covered in this guidance. This guidance provides an example on how the fair pricing principles can be applied to cost allocation when making such decisions.
- 2.5 The guidance has been organised by fair pricing principles that should be considered when dealing with the relevant area. Where no segment is indicated, it should be assumed that the guidance applies to all network types. Where segmentation has a bearing on the guidance this has been included as a subheading within the relevant principle.

Relevant Principles

- 2.6 Below we have outlined the principles that are most relevant to cost allocation:
- 2.7 Cost reflectivity – This principle establishes our expectation that prices should be reflective of the underlying cost of providing heat and consumption levels of consumers. Moreover, consumers should pay for the additional costs they impose on the system, as well as a contribution to the fixed costs of the system, ensuring long-term efficient use and sustainability of the system.
- 2.8 Cost efficiency – This principle establishes our expectation that underlying costs should be efficient while providing an appropriate quality of service, and that authorised persons should take steps to create cost efficiencies where feasible. Additionally, authorised persons should make choices based on long-term efficiencies.
- 2.9 Affordability – This principle establishes our expectation that authorised persons should strive to maximise consumer benefit in their pricing decisions, while also making a fair and reasonable rate of return and recovering their costs. In particular, they should have regard to affordability for consumers. These considerations should be applied throughout the entire pricing process, from the design of the pricing strategy to the charging methodology.
- 2.10 Transparency – This principle establishes our expectation that authorised persons should communicate their prices to customers in a way that is accessible and easy to understand.

Heat networks fair pricing and cost allocation draft guidance

- 2.11 Fair and Reasonable Returns – This principle establishes our expectation that authorised persons may price in a way which includes some level of profit, but that this should not be achieved in excess of what could be expected in compensation for investment.
- 2.12 The above list is not exhaustive, however does outline the main relevant pricing principles when considering cost allocation practices.

General cost pass-throughs

- 2.13 This part of the guidance provides the general approach all authorised persons should take when deciding how to deal with costs that may need apportioning across multiple heat network entities or multiple business units.

Scope

- 2.14 This part of the guidance is applicable to heat networks that may incur some costs at a portfolio level, either across different heat networks or across different business units (for example, across heat network function and billing for rent function).

Cost Reflectivity Principle

- 2.15 Authorised persons should consider apportioning costs that may be incurred at portfolio level by some proxy of activity level across the different heat networks within the portfolio to ensure compliance with cost reflectivity principle. This can be based on customer numbers or energy generation across the different heat networks within the portfolio. The proxy should have significant correlation with the activities that incur the costs.
- 2.16 Authorised persons should consider apportioning costs incurred across different business units, such as a single person managing the billing of heat networks and rent, by some proxy of time spent on the aforementioned activities.
- 2.17 In situations where an immediate change in the method of apportioning costs that are incurred at the portfolio level is expected to cause significant issues in terms of price increases or affordability, we expect authorised entities to ensure balance between cost reflectivity and affordability.

Cost Efficiency Principle

- 2.18 Costs that are passed through must be reflective of the costs incurred of running the heat network efficiently.
- 2.19 Final consumers must not be disadvantaged by having to pay charges that are incurred by the heat network due to inefficient management of the heat network.
- 2.20 Heat networks must find efficiency savings where possible, both short and long term, and both in terms of their management of the heat network and the technical efficiencies of the network.

Tariff Structure

- 2.21 This part of the guidance covers how tariffs are to be allocated and structured for metered and unmetered dwellings. For metered dwellings, this section provides guidance on how best to allocate costs between standing charges and unit rates.
- 2.22 Standing charges are the charges from suppliers that do not vary with the energy consumption. Unit rates are the prices charged for each unit of energy that is consumed.

Scope

- 2.23 This part of the guidance will outline how the fair pricing principles are to be interpreted in terms of allocating costs to standing charges vs unit rate, and allocating costs across unmetered dwellings. It will not outline how each and every cost component should be treated, rather provide guidance and examples on what principles and factors need to be taken into account when making the decision for the cost allocation.

Cost Reflectivity Principle

- 2.24 Under this principle, heat network entities that are metered should consider allocating costs that do not vary by consumption to the standing charges, and allocating costs that vary by consumption to unit rate. This is so that the final charges/tariffs are reflective of the underlying consumption and system usage.
- 2.25 For heat networks that are unmetered, under the cost reflectivity principles authorised persons should consider using a proxy for consumption such as the area of the dwelling or the number of bedrooms in the dwelling to allocate their unit rate. Authorised persons should consider allocating standing charges at the same cost per dwelling.
- 2.26 For shared ground loops that usually only have a flat fee that does not vary with consumption, the underlying cost components charged to consumers should adhere to this principle in that the fee should accurately reflect the costs incurred.

Affordability Principle

- 2.27 With regards to heat networks' ability to earn their profits through standing charges or unit rates, there are trade-offs between this principle and the cost reflectivity principle.

- 2.28 Since heat networks are required to collect information on the proportion of consumers in vulnerable circumstances of various types, authorised persons should use this information to determine whether it is more appropriate for them to recover their profit margin from standing charges, unit rates, or a mixture of both, with optimal consumer outcome being the priority in the trade off.
- 2.29 This does not mean that entities are not allowed to recover their costs or not allowed to earn profits. Rather, the method of cost recovery and the method of earning profits should have regard for the consumers they serve.

Transparency Principle

- 2.30 Authorised persons should consider structuring their tariffs in such a way that consumers can easily and accurately understand their charges and the relationship between their consumption and their charges. This includes both for metered and unmetered dwellings.
- 2.31 For unmetered dwellings, where the cost allocation method is based on a proxy of consumption, authorised persons should consider choosing a proxy that can be easily and accurately understood by their consumers.

Depreciation

- 2.32 Over time, purchased assets or significant work done on a previously owned asset that represent a capital expenditure must be depreciated. As these assets lose value over time due to usage and wear and tear, ageing and obsolescence, authorised persons should consider depreciating to account for this lost value in order to reflect the true costs of running the heat network system.
- 2.33 Authorised persons should consider the cost reflectivity principle to reflect the true costs of running the heat network system in their charges/tariffs, impacting both the allocation method between unit rate and standing charges, choice of the depreciation method, and the time horizon over which the usefulness of the assets must be depreciated over.

Scope

- 2.34 This depreciation guidance covers all heat network entities. However, we have segmented the guidance where appropriate to address specific features of certain network types where this relates to a best practice approach to depreciation.
- 2.35 This depreciation guidance will not provide any specific methodology on the accounting methods of depreciation. All depreciation methods under the UK GAAP (Generally Accepted Accounting Principles) or IFRS (International Financial Reporting Standards) that are covered in their methodology for plant and equipment are accepted. However, we will provide certain best practice guidance on how to choose the appropriate method amongst the available choices and the appropriate time horizon.
- 2.36 This guidance has been organised by the relevant fair pricing principles mentioned in the previous chapter, with each section covering how heat networks should consider their depreciation approach in relation to a relevant principle. In cases where no segments have been indicated, it should be assumed that the guidance applies to all heat network entities. When segmentation has an impact on the application of the fair pricing principle, this has been included as a subheading within the relevant principle.
- 2.37 Depreciation guidance under cost reflectivity has been segmented into metered and unmetered networks. This is due to the fact that unmetered networks have a single charge for the consumers, whilst metered networks have both a standing charge and a unit rate through which they can recover their costs.

Cost Reflectivity Principle

- 2.38 Under this principle, entities should consider depreciating in a manner that reflects the wear and tear of the assets. This entails both the appropriate time horizon over which to depreciate the asset, and the charging methodology from final consumers for the metered networks.
- 2.39 For **both metered and unmetered networks**, authorised persons should consider the time horizon over which to depreciate the asset and pass on the costs to final consumers in a manner reflective of the useful asset lifetime. This approach is in line with the cost reflectivity principle as costs passed on are reflective of the underlying use of the asset.
- 2.40 For **metered networks**, the choice of how to pass on the costs through either the standing charges or unit rate depends on the type of asset that is being depreciated. If the majority of the depreciation of the asset can be directly correlated with the energy usage of the consumers, authorised persons should consider charging through the unit rate. If the majority of the asset depreciation over time is driven by factors other than the energy usage of the consumers, then authorised persons should consider charging through the standing charges. This approach is in line with the cost reflectivity principle, as the passing on of the costs are reflective of the underlying driver that varies/does not vary by usage.
- 2.41 In addition to the choice of time horizon, the choice of depreciation method should also be considered taking into account the principle of cost reflectivity. In general, the depreciation methods that are commonly used are the straight line method, declining balance method, units of production method and sum of the years' digits method.
- 2.42 Our guidance proposes to use the straight line method, as it is the most straightforward method and the most transparent method of depreciation. The declining balance method and sum-of-the-years' digits method depreciate heavily in the beginning of the asset's life which is not aligned with the cost reflectivity principle. The units of production method requires estimation of the energy production throughout the lifetime of the asset that would make it difficult to evaluate its cost reflectiveness.
- 2.43 However, authorised persons are expected to choose the most appropriate depreciation methods that are most suited to their needs. An example would be an authorised person that choose to use a shorter time horizon than the full

Heat networks fair pricing and cost allocation draft guidance

lifetime of the asset as they may move to a different technology sooner than the full lifetime of the asset.

Bad Debt

- 2.44 Effective bad debt management is a necessary component of heat network operation. High levels of bad debt within a network may increase costs across the network if this debt is recovered from final consumers through higher prices.
- 2.45 Within the [2024 ICP consultation](#) we discussed some of the debt recovery challenges facing heat networks when attempting to balance effective debt management with protecting vulnerable consumers. For instance, heat network consumer bases are significantly smaller than the consumer base of a gas and electricity supplier. Because of this, the impact of bad debt in a heat network on cost recovery can be much greater than among gas and electricity suppliers as these costs must be recovered from fewer customers.

Scope

- 2.46 This part of the guidance specifically covers **bad debt**. Corporate debt such as working capital requirements, cost of corporate debt, etc are covered under **corporate risk** section.
- 2.47 The following guidance applies to all heat networks. However, we have segmented the guidance where appropriate to address specific features of certain network types where this relates to a best practice approach to debt.
- 2.48 This guidance will not provide a specific methodology for apportioning bad debt costs, nor a prescriptive set of rules determining what could be deemed to be an appropriate level of bad debt cost to pass through to consumers.
- 2.49 Heat networks should have regard to the following principles when considering debt; Affordability, Cost Efficiency, and Cost Reflectivity.
- 2.50 Debt guidance under Cost Reflectivity has been segmented into metered and unmetered networks. We consider these networks will require some difference in approach to debt due to the inability of unmetered networks to receive accurate data on individual consumer consumption.

Affordability Principle

- 2.51 Under the Affordability principle, we would not expect heat networks to charge consumers differently based on their economic circumstances. However, this principle does expect operators to maximise consumer benefit within their pricing decisions in addition to recovering their costs and making a fair and reasonable return where applicable. In this way, authorised persons must have

regard for affordability when dealing with customers who have themselves accrued energy debt.

- 2.52 This principle also applies to the treatment of bad debt cost recovery across the wider consumer base. Whilst certain elements of bad debt will be dependent on the personal circumstances of the consumer base and therefore outside the control of a heat network entity, to the extent that certain components of bad debt are within the control of a heat network entity we would expect these to be shaped by this principle of Affordability (and cost efficiency as described below).

Cost Efficiency Principle

- 2.53 Authorised persons are expected to make underlying costs efficient through, for example, operational efficiencies, whilst maintaining an appropriate quality of service. We expect heat networks to incur cost related to customer service and administrative functions, some of which may be related to bad debt management. These costs may also be influenced by factors such as the age and technology of the heat network, the proportion of vulnerable consumers and total number of consumers on the network which will be taken into account when considering the proportionality of pricing.
- 2.54 In the [2025 consultation](#) we outlined in best practice an expectation for authorised persons to carry out their activities in a cost efficient manner, be transparent in cost reporting, and (where services are outsourced) ensure value for money. Likewise in relation to bad debt we would expect authorised persons to employ efficient and effective debt management practices. These activities are directly related to efficient cost pass-through and mitigating shock-bills.

Cost Reflectivity Principle

- 2.55 Under the Cost Reflectivity Principle we expect authorised persons to price in a way that reflects the underlying cost of providing heat and the consumption levels of consumers. For bad debt, we would expect authorised persons to apportion associated costs (such as bad debt, debt-related administrative costs, and working capital requirements) across their consumer base in a cost reflective manner.
- 2.56 For **metered networks**, authorised persons should consider reflecting bad debt costs which are fixed in a standing charge.
- 2.57 For **unmetered networks**, authorised persons should consider apportioning debt costs to across dwellings equally.

Corporate Risk

- 2.58 Efficient capital cost and expenditure recovery will be required to maintain efficient underlying costs. The recovery of these costs is reflective of corporate risk.
- 2.59 The [2024 ICP consultation](#) proposed that customers should be protected from taking on a disproportionate level of corporate risk. A key concern should capital cost recovery not properly reflect corporate risk is that there may be a mismatch between consumers who are paying for and consumers who benefit from improvements to the network.

Scope

- 2.60 The following guidance applies to all heat network entities, though additional considerations may be required for district and unmetered networks.
- 2.61 The guidance will not prescribe a method to appropriately reflect corporate risk in the recovery of capital costs, nor will it provide a quantitative or singular definition for “disproportionate” levels of corporate risk.
- 2.62 The following guidance has been categorised by relevant Pricing Principle. For corporate risk we consider the key applicable principles to be Cost Efficiency and Cost Reflectivity.

Cost Efficiency Principle

- 2.63 Authorised persons are expected to maintain efficient underlying costs, including efficient recovery of capital expenses.
- 2.64 Disproportionate reflection of corporate risk in capital cost recovery represents an inefficiency in underlying costs for consumers.
- 2.65 As explored in the [2025 consultation](#), disproportionate corporate risk includes practices such as;
- improper recovery of significant initial capital costs during the development phase
 - improper recovery of capital expenditure recovered from sinking funds
- 2.66 Recovery of upfront capital costs under **district heat networks** may lead early users to bear a disproportionate share of these costs, effectively subsidising the network for later users. In order to ensure upfront capital costs are recovered efficiently, authorised persons should consider, in the case of district heat

networks, accounting for changes in customer numbers over time as more buildings connect to the network.

Cost Reflectivity Principle

- 2.67 Prices should reflect the underlying costs of supplying heat, with consumers expected to contribute to the fixed costs of the system.
- 2.68 **Metered networks** (under typical conditions) should consider recovering capital costs through a standing charge to reflect the fixed nature of this cost.
- 2.69 **Unmetered networks** should consider recovering capital costs equally across their consumer base and not using (under typical conditions) any approximation of consumer consumption to recover this cost.

Fuel Procurement

- 2.70 Authorised persons will generally be required to procure fuel to power the network. Energy procurement often uses a process known as hedging to manage price volatility. Hedging involves using contracts to secure a set price for a particular fuel (such as natural gas or electricity). There are many different hedging strategies used to balance risk.
- 2.71 The level of risk associated with fuel procurement and hedging will likely differ between heat networks. There are trade-offs between price certainty and price paid, with the balance between these two points depending on the type of network engaging in this procurement.

Scope

- 2.72 The following guidance applies to all heat network entities. This guidance will not prescribe a specific hedging or fuel procurement strategy which heat networks should adhere to, but it will provide examples of best practice.
- 2.73 Guidance on fuel procurement is categorised by the relevant Pricing Principles. For fuel procurement we consider the key applicable principles to be Cost Efficiency and Affordability.

Cost Efficiency Principle

- 2.74 Under the Cost Efficiency Principle authorised persons are expected to create cost efficiencies through competitive fuel procurement. However, competitive fuel procurement in practice will look different for different networks.
- 2.75 Larger heat networks, such as district networks, may have greater financial resilience to manage risk which may deliver more competitive fuel prices.
- 2.76 Likewise, larger heat networks may have additional bargaining power which could secure competitive fuel prices with a greater deal of price stability through favourable contract negotiations.
- 2.77 The approach taken by a district or larger heat network to achieve competitive fuel prices will depend on the make-up of the individual network and the resulting desire for stability or agility in pricing.
- 2.78 We note that smaller heat networks such as communal heat networks may have less bargaining power than larger networks in negotiating favourable contracts.

- 2.79 Similarly, smaller networks will likely not have the same level of financial resilience as a larger district network which may limit their ability to achieve competitive fuel prices.
- 2.80 Therefore, communal heat networks should consider procuring fuel competitively within their means, taking on no greater risk than their level of financial resilience allows and prioritising stability where this is cost effective and to the benefit to their consumers.

Affordability Principle

- 2.81 We expect authorised persons to maximise consumer benefit in their pricing decisions (whilst also recovering required costs).
- 2.82 Decisions about fuel procurement and hedging strategies should have regard for consumer benefit and affordability.
- 2.83 As discussed under the Cost Efficiency principle, authorised persons are expected to engage in competitive fuel procurement which should benefit consumers through reduced costs in this area. However, authorised persons should also consider securing a fair price for customers as a key component of their chosen procurement strategy. Whilst multiple hedging strategies may be appropriate for the given features of a network, the authorised person(s) should consider the needs and preferences of their consumer base when choosing a particular strategy. For example, a network which is largely made up of domestic consumers may value stability in pricing over greater flexibility for more predictable bills. This preference should be considered by the authorised persons when deciding upon their fuel procurement strategy.
- 2.84 In particular, we suggest best practice in this area would involve clear documentation and justification of the procurement strategy used being appropriate for the network's consumers.
- 2.85 In the [2025 consultation](#) we also highlighted how the appropriate fuel strategy will differ depending on the consumer base. For example, domestic consumers may value price stability more than commercial consumers.
- 2.86 Authorised persons should consider engaging in competitive fuel procurement, taking on risk as appropriate for their level of financial resilience or securing prices to provide stability where it benefits consumers.

Fair and Reasonable Returns

- 2.87 As outlined in our Pricing Principles, prices charged by heat networks can include a level of profit to provide a fair return on investment. However, it is important that the monopoly status of heat networks are not used to achieve excessive profits compared to what could be expected given the level of risk associated with investment.
- 2.88 In the [2024 ICP consultation](#) with DESNZ we positioned protecting consumers from disproportionate pricing and monopoly powers as a key aim of the regulatory proposals. If heat networks are able to consistently return profits exceeding a competitive level this may signal consumers are being overcharged through a network leveraging its natural monopoly status.

Scope

- 2.89 The following guidance is not applicable to heat networks which operate on a strict cost recovery only model. Under this model, returns are not provided to shareholders or investors which is the key concern of this guidance. This guidance applies to all other heat networks.
- 2.90 This guidance will not provide specific instruction on appropriate levels of return as this will differ depending on a range of factors.

Fair and Reasonable Returns Principle

- 2.91 Profit returned from a heat network should be reflective of investment risk and performance.
- 2.92 Authorised persons should not use their natural monopoly status to attain returns in excess of what could be expected based on investment risk and performance.
- 2.93 Authorised persons should expect their profitability to be monitored with other heat networks and for investigations to occur where profits are higher than expected. **Heat networks operating on a strict cost recovery model** are still required to submit financial data although some assessments may not apply.

Penalties and Redress¹

- 2.94 This section of the guidance provides the prescriptive rule around the passing of the fines, penalties and redress through the heat network charges to the final consumers
- 2.95 The heat networks enforcement guidelines and penalties policy are currently under consultation. Further information on penalties, fines and redress will be provided in the final version of the guidance once the policies on heat network enforcement and penalties policies are finalised. To note, this section will be updated only to provide further information on penalties, fines and redress to reflect what the enforcement guidelines say and does not involve any change in pricing policy.

Scope

- 2.96 The scope for this prescriptive rule includes all of heat networks.

Prescriptive Rule

- 2.97 This principle is set out in the Cost Allocation Authorisation Condition, requiring that fines and redress must not be passed on to the final consumers through heat network charges.
- 2.98 Heat networks are expected to be run efficiently with the aim of providing fair pricing and good consumer outcomes, including meeting specified service standards or service levels. This includes the expectation to adequately plan and implement maintenance and service strategies that are able to provide adequate standards of performance and fair pricing. Appropriate planning and implementation of such maintenance and service strategies are expected to result in good consumer outcomes, and in cases where investigation, enforcement and compliance activities result in fines, penalties and redress, such costs are reflective of the heat networks not achieving the standards that are expected of them and therefore should not be borne by the final consumers.
- 2.99 Similar to the approach taken in gas and electricity market, in deciding whether it would be appropriate to impose a financial penalty and/or make a consumer redress order, Ofgem will take account of the relevant facts and circumstances of the contravention or failure under consideration. This includes but is not

¹ [Heat networks regulation: enforcement guidelines and penalty policy - Ofgem - Citizen Space](#)

Heat networks fair pricing and cost allocation draft guidance

limited to, the nature of the operating heat network and the circumstances under which the heat network is operating.

Legacy Arrangements

- 2.100 This section of the guidance will provide broad outlines for the approach that needs to be taken by heat networks that have legacy arrangements that would require them to deviate from the proposed approach for cost allocation.

Scope

- 2.101 All heat networks that have legacy arrangements as set out at the start of this guidance (page 21) are within scope.

Guidance for legacy arrangements

- 2.102 When it is necessary for heat networks to deviate from the proposed approach due to legacy arrangements, this will be taken into account in cases of price investigation.
- 2.103 Authorised persons should consider evaluating to the best extent possible whether there is a need to deviate from the proposed guidance in order to comply with a temporary legacy arrangement or requirements, with the goal of moving towards the proposed cost allocation guidance approach over time as soon as practically possible.
- 2.104 When establishing the need to deviate from the proposed guidance to fulfil certain legal requirements, authorised persons will have to give regard to the impact on consumers and the fair pricing principles.

Connection charges

- 2.105 The **cost reflectivity** principle requires entities to reflect the true costs of running the heat network system in their charges/tariffs, impacting both the allocation method between unit rate and standing charges, and what is the cost that should be recovered from consumers for connection charges.

Scope

- 2.106 This connection charges guidance covers all heat networks that are incurring connection charges.

Cost Reflectivity Principle

- 2.107 Authorised persons should consider ensuring that the connection charges to new consumers are no less than the incremental cost of connecting to new customers.
- 2.108 Because connection charges do not vary with consumption, we propose that connection charges be allocated to the standing charges.
- 2.109 Any deviation from the above guidance should be accompanied with valid reasoning that give regards to other principles in the fair pricing guidance that prioritises good consumer outcomes.

Appendix 1 – Fairness Test

A1.1 To operationalise the fairness test and assess what and how tools are applied, we expect to consider questions such as:

A1.2 To identify disproportionate pricing:

- how do the prices compare to alternatives (external benchmarking)?
- how do the prices compare to historical prices? (past-price benchmarking)?
- how do the prices compare to prices charged by similar networks (comparator benchmarking, for example, regression model)?
- what are the cost drivers?
- how do profits (in percentage or GBP) or rate of return compare to similar networks?
- have high prices been persistent?

A1.3 To assess concerns:

- who are affected by disproportionate pricing?
- what are the sizes of groups affected by disproportionate pricing?
- how much are these groups affected by disproportionate pricing?

A1.4 To prioritise actions:

- has there been intentional breaching, signs of negligence, or a recurring pattern of poor behaviour?
- what is the tariff design and rationale?
- what is the structure of cost and capital recovery?
- is cross-subsidisation between groups present?
- is the tariff prohibitive to heat network uptake?
- are prices and billing transparent?