



New Dutch Heat Act: Public Bodies in the Hot Seat

Our view on the key implications from a financial perspective

February 2024

New Dutch Heat Act: Public Bodies in the Hot Seat

Our view on the key implications from a financial perspective

In short

- **Main aspects in the draft legislation around the new Dutch heat act include a public majority ownership requirement for larger heat networks, and a cost-based tariff regulation**
- **Various elements that are key to evaluating the financial business case of heat companies are yet to be developed further by the legislator**
- **Although the exact (financial) conditions are yet unclear, the contours of the Dutch heat transition are apparent: for the decades to come the Dutch heat sector is expected to experience vast growth towards 2.6m new heat connections, driven by national and international climate targets**
- **The governmental commitment to reach these targets should provide comfort to parties exploring to invest in the sector that the eventual financial conditions will be set in such a way that sector returns will be interesting enough to attract the required capital to do so**

Introduction

Earlier we published an [article](#) on the Dutch heat transition and an [interview](#) on the developments around the evolving new Collective Heat Supply Act (*Wcw*¹), after the Minister for Climate and Energy ('Minister') sent a letter to Parliament listing the main intended changes to the legislative framework for the heat sector. Much-debated topics that all have a big impact on the heat sector include the requirement for public control, the obligated transfer of heat infrastructure, and changes to the tariff regulation. Existing heat companies, their public and private shareholders, and potential new entrants in the heat market have been eagerly awaiting the substantiation of these plans into legislation. As the draft legislation has now been submitted to the Council of State and therefore has been made publicly available, it is time to further elaborate on the key implications of the *Wcw* from a financial perspective. In this article we do so, also briefly touching on a couple of legal components that are related with the financials perspective, without elaborating on these in detail.

Collective Heat Supply Act at a glance

The new Collective Heat Supply Act will replace the current heat act, which has been in place since 2014, and is built on two key principles:

- i. the municipality directs the transition towards making the built environment more sustainable, and
- ii. the heat company is integrally responsible for the entire heat supply chain from production to distribution. The municipality designates a heat company on an exclusive basis to a heat plot, so that the company has the sole right and obligation to connect households within the heat plot to the heat network.

The *Wcw* aims to make heat an affordable, reliable and a sustainable alternative to natural gas, by introducing a new legislative framework that should boost the development of the heat sector. The ministry of Economic Affairs and Climate ('Ministry') has the objective to double the number of heat connections in existing buildings to 1 million by 2030, with the

ambition to grow to 2.6 million new connections in existing buildings in 2050. Key elements in the *Wcw* from a financial perspective include:

- Public ownership of integrated heat companies
- Cost-based heat tariff regulation
- Transitional arrangement and obligated transfer of heat infrastructure
- Valuation of heat infrastructure
- Structuring the public transition of the heat sector
- Financing the public transition of the heat sector

In this article we will discuss these elements, finishing with our view on how the public and private sector can collaborate to reach the ministerial targets, and how the parties involved could move forward.

Public ownership of integrated heat companies

Introduction to regulatory framework

After the introduction of the *Wcw*, municipalities are only permitted to designate heat companies to heat plots if the heat company is majority publicly owned. In the *Wcw*, a heat company is considered majority publicly owned if:

- i. one or more public parties jointly have a direct or indirect majority share (50% + 1 share) in that company, or
- ii. it concerns a heat joint venture between a publicly controlled (50% + 1 share) heat network company and a heat distribution company.

It is interesting to note that this requirement for public ownership represents a stricter requirement than was included in the earlier mentioned letter to Parliament of 2022. In that letter, public ownership of solely the heat infrastructure (i.e. not the integrated heat company) was mandated.

¹ *Wet collectieve warmte*

Our view on implications

The requirement for public control has been the most discussed topic of the Wcw, as research performed for the Ministry shows that c. 84% of current Dutch heat connections are part of commercial heat distributors. These companies now have to rethink their strategy, both operationally and in terms of shareholder structuring. At the same time, we expect many (local) government bodies to (jointly) incorporate new public heat companies, all requiring expertise on the operational, technical, financial, and governance themes, both at the company and –to a lesser extent– shareholder level. The national government offers financial support to municipalities for this purpose through the CDOKE²-scheme. While public control may be a sensitive topic – as the Wcw approaches its final form, both sides could clearly benefit from each other.

According to the legislator, public parties must have decisive control (*doorslaggevende zeggenschap*) regarding the operational activities of the heat company. For instance on the general strategy, the decisions on how to ensure the supply of heat to the system, how to achieve sustainability goals and what rates will be charged to end customers. The Wcw however does offer protection for minority shareholders, i.e. commercial heat companies, for instance by allowing heat companies to make statutory or contractual agreements that protect minority shareholders in the case of investments larger than one third of the asset value on the heat company's balance sheet.

In addition to collaborating through a publicly owned heat company or through a joint venture, commercial heat companies are allowed to operate small collective heat systems such as ATES³ systems, as the Wcw provides an exception for the public majority ownership requirement for heat networks with fewer than 1,500 connections. An exemption from the designating municipality is however required in order for a company other than the designated heat company to operate such small collective heat systems within the heat plot. This measure intends to prevent 'cherry-picking' and thereby affecting the business case of the designated heat company. This means that -even though the requirement for public ownership does not apply to small collective heat systems- commercial companies focusing on these types of solutions will be more restricted than they are under the current heat act. At the same time, commercial parties, with their financial clout and operational expertise, could very well be a welcome partner for municipalities to boost the number of heat connections on the short term.

After the introduction of the Wcw, commercial parties are also allowed to perform activities such as heat production and back-office for the public integrated heat companies. Although the designated heat company is integrally responsible for the entire heat chain, it does not necessarily need to perform all activities itself. This allows for e.g. service level agreements on customer service with commercial heat distributors or heat purchasing agreements with privately owned heat sources.

Cost-based heat tariff regulation

Introduction to regulatory framework

The Wcw introduces a change in tariff regulation from the current gas-linked heat tariffs towards cost-based tariffs. The new regulation aims to provide i) end users with the certainty that they do not 'pay more than needed', and ii) heat companies with certainty that they will be able to earn back their (efficient) (investment) costs including a 'reasonable return' on investments.

The new regulation will be introduced in three phases, governed by the ACM⁴. During the first phase heat tariffs will still be based on a gas-linked tariff, but adjusted for elements that increase the costs for using natural gas that are not related to using heat (e.g. the increasing energy tax on natural gas). Phase 1 will be used by the ACM to prepare for cost-based regulation and the aim is to switch as soon as possible to the next phase.

During the second phase, the maximum tariffs a heat company can charge to household users will be calculated through a yet to be announced formula (or multiple formulas) that takes into account both the actual financial (e.g. incurred costs) and commercial (e.g. number of connections) data of the heat company, and benchmark data from competitors. After a certain period, when the ACM has been able to gather sufficient data, the benchmark can be made more specific, by for example only taking into account a certain category of collective heat system (e.g. ATES, residual heat, geothermal, etc.) or a specific type of heat (e.g. low versus high temperatures). As long as the ACM has limited data available, there is a risk that heat companies will achieve higher or lower returns than the ACM deems reasonable. During phase 2 the ACM will therefore continue to monitor returns of heat companies, allowing for the possibility to signal and correct these deviations in hindsight.

For small collective heat systems such as ATES, phase 2 is the envisaged end state in terms of tariff regulation. Another regulatory change for companies active in this space is that through the Wcw tariff regulation will now also apply to the distribution of cold, in circumstances in which the end user of heat can only purchase heat in combination with cold, for example due to the technical nature of a heat system.

² Tijdelijke regeling capaciteit decentrale overheden voor klimaat- en energiebeleid

³ Aquifer Thermal Energy Storage

⁴ The Netherlands Authority for Consumers and Markets

Phase 3, expected to commence around (only) 2033, is the envisaged end state for the larger systems (i.e. more than 1,500 connections), when the ACM no longer determines the (formula for) maximum tariffs, but the permitted revenue per heat plot or heat company. The permitted revenue will be set at such a level that the heat company is able to earn back its efficient costs plus a 'reasonable return' on a regulatory asset base (RAB). Compared to phase 2, the heat company has more flexibility, for example in determining its tariff structure (as long as total revenue does not exceed the permitted revenue). The Wcw allows the ACM to introduce two variants of regulatory methods:

- i. a 'revenue-guaranteeing' (ensuring a heat company with a fixed revenue level by being able to perform revenue level corrections in later years) and
- ii. a 'non-revenue-guaranteeing' variant of this regulation method.

The ACM also has the possibility to determine efficient costs based on (a combination of) actual costs and benchmarking elements both in terms of revenue and costs, to stimulate operational efficiency. The tariff regulation in phase 3 is similar to what is applicable to the grid operators of the Dutch electricity and gas network.

Our view on implications

The choice for a cost-based regulation on a local level undeniably leads to mutual differences in the tariffs Dutch end users pay for heat. These differences can exist on a national, regional, and even local level, as different heat systems can have different cost structures, which would result in differentiation in tariffs. When determining maximum tariffs and permitted revenue, it will be crucial for the ACM to be able to distinguish between the various heat systems as soon as possible to prevent 'cherry-picking': as long as tariff regulation is based on a benchmark of badly comparable heat systems, heat companies will be incentivized to only develop efficient areas, affecting the speed of the heat transition and increasing the future costs for the development of more inefficient areas later on. The requirement for an exemption from the designating municipality in order for a company other than the designated heat company to operate small collective heat systems within the heat plot mitigates this risk somewhat on the local heat plot level, however on a higher level there is a severe risk that inefficient heat plots will attract limited interest from (partly commercial) heat companies. This could lead to local governments being required to incorporate its own heat company, that subsequently will have to exploit a less attractive business case, at the cost of the taxpayer instead of the consumer.

Also, it would be interesting to see what impact the Wcw will have on shaping the business models of heat companies. The requirement for public control of heat companies pushes commercial companies out of a (potential) role as integrated heat company, but might open possibilities to perform activities in which the commercial companies have strong expertise, such as

heat production and back-office, for example through a purchase agreement or SLA with the designated heat company. Although the designated heat company will be allowed to only earn-back its efficient costs, as long as the exact tariff regulation formulas are unknown, it is yet unclear if purchase agreements or SLAs on 'commercial' terms will be allowed and/or will be beneficial for the combined business case of the designated heat company and -for example- its shareholding commercial heat distributing company. Amongst other elements, this would depend on the weight that the tariff formulas put on the company's own actual costs, and on benchmark costs.

Although the draft legislation sheds light on the way the Minister thinks about tariff regulation, many (potential) heat companies will still feel somewhat in the dark when it comes to often-heard questions such as what the 'reasonable return' will be, and to what extent tariff regulation will depend on a company's own actual costs versus benchmarking elements. As long as this uncertainty remains -and we understand that clarity on the phase 3 regulation is only to be provided years from now as the ACM needs time to gather relevant data- we expect the investment appetite of companies to remain negatively impacted. To prevent a serious delay in the development of the heat sector, the Minister could consider introducing a 'transitional tariff regulation' for new heat networks, providing immediate certainty about tariff regulation to parties who are willing to invest now.

Transitional arrangement and obligated transfer of heat infrastructure

The agreements around existing heat networks will be placed under the Wcw as much as possible to facilitate a smoother transition towards the new regulatory environment. A vital element in the transition is the period the (commercial) heat companies will be allowed to continue their current exploitation of heat networks. These companies will be designated by the municipality for a period of at least 14 years and maximum 30 years. The length of the period is dependent on the remaining term of the current agreements (often concessions) as a basis, while also considering the period in which the 10% most recent connections were realized. At the end of the exploitation term, the designated heat company is obligated to transfer the ownership of the heat network to the company that is designated for the next exploitation term.

Valuation of heat infrastructure

Introduction to regulatory framework

The newly designated heat company has to compensate the former company for the transfer of the heat infrastructure. The compensation methodology has yet to be settled by Executive Decree⁵, but is likely to be based on a net present value methodology, in which case the value of the heat infrastructure would be equal to the net present value of the future cash flows generated by the heat assets: i) the remaining depreciation of the regulated asset base (RAB) plus the future reasonable return on the RAB ($WACC^6 \times RAB$). These future cashflows would then need to be corrected for the technical (e.g. overdue maintenance) and functional (e.g. underutilization or increasing infill development) state of the heat network.

Our view on implications

By the method above, the Minister aims to introduce a valuation framework that provides predictability about the remaining valuation at the end of the exploitation term. We still foresee valuation discussions and negotiations for a large part of the future ownership transfers, as the transferring and the receiving party will likely have different views on the assumptions underlying the corrections on the technical and functional (which seemingly could be interpreted as broad as the commercial outlook of the heat network) state of the heat network.

Next to that, it is important to appreciate the Wcw introduces the method to determine the value of the heat infrastructure, but not of the (shares of the) heat company. Although the net present value of the regulated future cash flows generated by the heat infrastructure is a significant element in the valuation of the company, the value of the shares of the company can be impacted by many other factors, such as other non-regulated activities performed by the company, or legal requirements relating to dividend restrictions and investment decisions. We therefore expect the transfer will resemble a 'classical' sale process.

Structuring the public transition of the heat sector

The requirement of public majority ownership of integrated heat companies means that the public sector faces a substantial capital requirement. Public entities will have to incorporate local heat companies, potentially acquire a majority share in commercial companies, and/or strengthen the financial position of the public heat company through capital contributions. The Ministry intends to appoint a 'national heat company' operating as a catalyst for the public transition of the heat sector, by taking stakes in new and/or existing heat companies, on a national, regional, and local level. It seems that EBN, the state-owned company currently active in the exploitation of the Dutch oil- and gas fields, is best placed to be appointed as national heat company.

By participating, providing capital, and by sharing best practices, the national heat company will be playing a vital role in the

financing of the heat transition and the shift towards public majority ownership. It is to be expected that the national heating company will take a substantial minority share (maximum 40%) in an integrated heat company, requiring regional and/or local public entities to step in as well. This way the local public entity has a say in the local development of the heat network, while their interest are aligned with the national heat company as they both have 'skin in the game'. Next to the national heat company requiring local entities to step in, participation might as well be of interest for municipalities as it would allow them to have a bigger say in aspects such as the fulfillment of public interests, investment decisions, and dividend (restrictions).

Financing the public transition of the heat sector

Introduction to regulatory framework

According to research performed for the Ministry, the total investment sum in heat networks is budgeted at around EUR 35 billion until 2050, excluding the purchase prices to be paid for the obligated transfers of heat infrastructure. With an assumed 70% debt financing, and a public contribution of 50% on the equity financing, a public contribution of ca. EUR 5.25 billion would be required from regional and local public entities. To reduce this, the Minister investigates the possibility of setting up a guarantee fund, that would potentially reduce the required equity contribution to 10% of the total funding requirement, according to the Ministry. In that scenario, local and regional public entities would be looking at a contribution of EUR 1.75 billion until 2050, of which the national heat company could potentially contribute a large part.

Our view on implications

It should be noted that the budgeted total investment sum of EUR 35 billion as mentioned by the research of the Ministry is based on price level 2022. Our analyses show that the total investment sum in heat networks to achieve the target of 2.6m new connections, may add up to as much as EUR 58 billion in nominal terms, accounting for future inflation. This implies that in nominal terms the public contribution is also significantly higher than mentioned in the research by the Ministry.

To reduce the public capital contribution, it would be an option for the national heat company and/or regional and local public entities to take a stake in existing commercial heat companies (on a national or at a local level) to acquire operational cash flows. Although this would increase the initial public capital need, our research shows that the acquired cash flows can be used for the financing of expansion investments in such a way, which lowers the total required amount of public capital on the long run. The faster a public stake is acquired in existing heat networks, the greater this effect is.

⁶ Weighted Average Cost of Capital

Next to public capital contributions, we expect subsidies are still likely to be needed. If cost-based tariffs lead to end user tariffs that are not affordable for everyone, commercial heat companies with a minority stake are not likely to accept business cases with lower tariffs, as the cost-based tariffs are already based on a 'reasonable return'. In such a case, other instruments such as subsidies would have to be taken into consideration.

Concluding remarks and highlights

With the aim to realize 2.6 million new connections in existing buildings in 2050, an ambitious target has been set that requires attention and action from all parties involved. Commercial and public heat companies have been awaiting clarity on the new legislation and are now assessing what roles to play in the sector, and in what form. Municipalities are exploring strategies based on the new regulatory framework and their local heat transition plans, are talking to heat companies, or are investigating the incorporation of a new heat company. The designation of a national heat company as catalyst for local development is being assessed. It is clear that all parties are needed to shape the heat transition. In order to find out what works, and what does not, we advise to progress with investing in heat projects, for example through pilots. Awaiting more details on tariff regulation, we recommend both the public and commercial parties evaluate under what conditions they would be willing to (co-)participate in a heat company, and how they would best finance that.

Looking ahead, our main observations of the Wcw from a financial perspective are:

- Although the exact (financial) conditions are yet unclear, the contours of the Dutch heat transition are apparent: for the decades to come the Dutch heat sector is expected to experience vast growth, driven by national and international climate targets. The governmental commitment to reach these targets should provide comfort to parties exploring to invest in the sector that the eventual financial conditions will be set in such a way that sector returns will be interesting enough to attract the required capital from investors;
- Notwithstanding the exception for the public ownership requirement for heat networks with fewer than 1,500 connections, the Wcw does impact commercial companies (potentially) active in this segment as they can only operate collective heat systems after obtaining an exemption from the designating municipality;
- Still, the risk for cherry-picking is high if the accuracy of the benchmark element in tariff regulation is too low, and/or if the relative importance of the benchmark element is too high. Heat companies will have an incentive to apply (only) for a heat plot designation in cost-effective areas, or to develop only (or firstly) more efficient neighborhoods within a heat plot. This could very well lead to a situation in which nationwide operating heat companies do not apply for a designation of inefficient heat plots, forcing municipalities to incorporate an own local heat company that then implicitly has to operate an unattractive business case, at the cost of the (local) taxpayer;












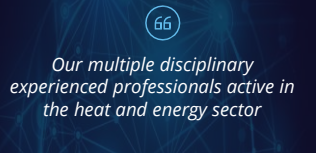
- As long as the details about the end state of heat tariff regulation remain unclear, the appetite for companies to invest in heat is likely negatively impacted. A 'transitional tariff regulation' could prevent delays in the heat transition;
- It would be interesting to see to what degree the tariff regulation will eventually regulate activities such as heat production or the delivery of back-office services, as it is currently yet unclear whether purchase agreements or SLAs on 'commercial terms' will be allowed and/or would be beneficial for heat companies;
- Despite the attempt of the Ministry to provide a valuation method to determine the value of the heat infrastructure, the valuation remains largely unclear, with ample room for discussion and negotiation. Also, it is important to appreciate that the Wcw does not introduce a formula for the valuation of the (shares of the) heat company, which can be impacted by many other factors than just the value of the infrastructure;
- The cash flow bathtub effect of the heat sector remains unsolved, with high upfront investments, of which the financing needs to be bridged initially;
- Investing in the acquisition of (the operational cash flows from) existing heat companies reduces the total required amount of public capital on the long run, as long as the acquisition price is based on a market conform valuation; and
- The current Wcw seems to leave municipalities with three options, being i) taking a stake in a (currently still) commercial heat company, ii) enabling a currently active public market player to shape the heat transition at a local level, or iii) incorporating an own local heat company.

Anticipated planning

- Bill to the Dutch Parliament (after consultation by Council of State)
- Intended inception of Wcw on 1 January 2025


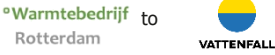

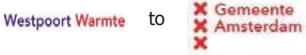











Deloitte heat specialists

Netherlands

 <p>Michiel Jurgens (author) Senior Manager Corporate Finance</p> <p>+31 8 8288 5818 mjurgens@deloitte.nl</p>	 <p>Matthijs Wouterse Director Valuation & Modelling</p> <p>+31 8 8288 7968 mwouterse@deloitte.nl</p>	 <p>Neil Lomax Partner Corporate Finance</p> <p>+31 8 8288 6165 nlomax@deloitte.nl</p>	 <p>Joost Goesten Partner Transaction Services</p> <p>+31 8 8288 3311 jgoesten@deloitte.nl</p>
 <p>Tim Bird Director M&A Legal</p> <p>+31 8 8288 7648 tibird@deloitte.nl</p>	 <p>Don van Neuren Partner Value Creation Services</p> <p>+31 8 8288 6166 dvanneuren@deloitte.nl</p>	 <p>Gwan Auw Yang Partner Transaction Services</p> <p>+31 8 8288 1822 gauwyang@deloitte.nl</p>	 <p>Jos Boerland Director Tax</p> <p>+31 8 8288 4630 jboerland@deloitte.nl</p>
 <p>Jeroen van Leeuwen Director Corporate Finance</p> <p>+31 8 8288 1413 jvanleeuwen@deloitte.nl</p>	 <p>Renée van der Zwan Director Real Estate</p> <p>+31 8 8288 0143 rvanderzwan@deloitte.nl</p>	 <p>Michiel Engelaar Director Sustainable Finance</p> <p>+31 8 8288 8394 mengelaar@deloitte.nl</p>	 <p>Our multiple disciplinary experienced professionals active in the heat and energy sector</p>

Selected credentials of Deloitte in the Dutch heating domain

Netherlands

<p>Financial advisor to</p>  <p>in the sale of</p> 	<p>Financial advisor to</p>  <p>in the sale of</p> 	<p>Financial advisor to</p>  <p>Analysis of joint heat network in the Twente area</p>	<p>Financial advisor to</p>  <p>Valuation analyses</p>
<p>Financial advisor to</p>  <p>Multiple financial analyses regarding heat assets</p>	<p>Financial advisor to</p>  <p>Analysis of a public participation model in local heat networks</p>	<p>Financial advisor to</p>  <p>Advisory to the consortium with regard to the largest hydrogen project in Europe</p>	<p>Financial advisor to</p>  <p>in the sale of Mijnwater to</p> 
<p>Financial advisor to</p>  <p>Regarding its activities in the heat sector</p>	<p>Financial advisor to</p>  <p>Valuation analysis on the shares of Stadsverwarming Purmerend</p>	<p>Financial advisor to</p>  <p>Analysing how to socially and fairly distribute heat to the citizens of the Rotterdam area</p>	<p>Financial advise regarding</p>  <p>refinancing process and acquisition process</p>

Deloitte.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited (“DTTL”), its global network of member firms, and their related entities (collectively, the “Deloitte organization”). DTTL (also referred to as “Deloitte Global”) and each of its member firms and related entities are legally separate and independent entities, which cannot obligate or bind each other in respect of third parties. DTTL and each DTTL member firm and related entity is liable only for its own acts and omissions, and not those of each other. DTTL does not provide services to clients. Please see www.deloitte.com/about to learn more.

Deloitte provides industry-leading audit and assurance, tax and legal, consulting, financial advisory, and risk advisory services to nearly 90% of the Fortune Global 500® and thousands of private companies. Our professionals deliver measurable and lasting results that help reinforce public trust in capital markets, enable clients to transform and thrive, and lead the way toward a stronger economy, a more equitable society and a sustainable world. Building on its 175-plus year history, Deloitte spans more than 150 countries and territories. Learn how Deloitte’s more than 345,000 people worldwide make an impact that matters at www.deloitte.com.

This communication contains general information only, and none of DTTL, its global network of member firms or their related entities is, by means of this communication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte organization shall be responsible for any loss whatsoever sustained by any person who relies on this communication.

© 2024. For information, contact Deloitte Netherlands.