



Department
of Energy &
Climate Change

HYDRO BENEFIT REPLACEMENT SCHEME & COMMON TARIFF OBLIGATION

Three-year review of statutory schemes:
Government Response



4 July 2016

HYDRO BENEFIT REPLACEMENT SCHEME & COMMON TARIFF OBLIGATION

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The Government Response can be found on DECC's website: <https://www.gov.uk/decc>

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1. Introduction

Purpose of this document

- 1.1. This document sets out the UK Government's response to the consultation on the three yearly review of the Hydro Benefit Replacement Scheme and the Common Tariff Obligation. The consultation sought views from a broad range of relevant stakeholders including consumer representatives, local authorities and industry on whether the schemes continue to meet their policy objectives and are operationally effective. Views were also invited on the best way to deliver a revised funding arrangement for the Shetland cross-subsidy from around the end of the decade onwards.

Overview of the schemes

- 1.2. The Hydro Benefit Replacement Scheme¹ protects domestic and non-domestic consumers from the high costs of distributing electricity in the North of Scotland. In 2015/16, it provided an assistance amount of £57m to consumers in the North of Scotland, and in 2016/17 this increases to £58m. This is worth around £41 per household. The Common Tariff Obligation² ensures electricity suppliers in the North of Scotland are not able to charge comparable domestic consumers different prices solely on the basis of their location within the area. This is designed to protect consumers in remote rural areas or islands from the relatively high costs of supplying electricity in these areas.
- 1.3. The Common Tariff Obligation also helps to underpin a cross-subsidy arrangement for most electricity consumers on Shetland, who would otherwise face significantly higher electricity prices than comparable consumers on the mainland. The resulting costs – which amounted to £28.5m in 2014/15³ – are currently spread across all consumers in the North of Scotland, but these are expected to increase from around the end of the decade⁴ onwards. This is because Lerwick Power Station is nearing the end of its operational life, and there is a need to identify and deliver new arrangements to meet customers' electricity needs on Shetland. In light of this potential cost increase, the Government confirmed in March 2015⁵ that:
 - the full costs of the cross-subsidy for Shetland would be spread over Great Britain from the date at which the new energy solution for Shetland is implemented;
 - the best mechanism to deliver this funding change would be considered through the consultation on the three yearly review of the Hydro Benefit Replacement Scheme.

¹ The Hydro Benefit Replacement Scheme became law under the Energy Act 2004 (Assistance for Areas with High Distribution Costs) Order 2005.

² The Common Tariff Obligation became law under the Electricity Act 1989 (Uniform Prices in the North of Scotland) Order 2005.

³ Source: Ofgem

⁴ Subject to the development of the competitive process to implement a new energy solution for Shetland <https://www.ssepd.co.uk/ShetlandEnergy/>

⁵ *Government Response to consultation on non-domestic electricity consumers on Shetland* (DECC, March 2015).

Feedback to the consultation

- 1.4. The consultation ran from 22 December 2015 to 17 February 2016 with the consultation document published on the Government website and announced through a Government press release. A link to the consultation document was sent to over 100 stakeholders, including consumer groups, suppliers and other industry parties.
- 1.5. We received 17 responses, primarily from consumer representatives and local authorities with a direct interest in electricity costs for the North of Scotland. In addition, there were six responses from industry parties. There was general support for the Government's proposals to:
 - continue the Hydro Benefit Replacement Scheme and Common Tariff Obligation, albeit several respondents argued for a move to national electricity distribution pricing as an alternative approach;
 - deliver a revised funding arrangement for the Shetland cross-subsidy through the Hydro Benefit Replacement Scheme.
- 1.6. A majority of respondents favoured an increase in the assistance amount provided through the Hydro Benefit Replacement Scheme, on the basis that electricity distribution charges remain higher in the North of Scotland even with the assistance provided.

Structure of the Government Response

- 1.7. Section two of this document sets out the detailed feedback received on the consultation questions relating to the rationale for the Hydro Benefit Replacement Scheme and the Common Tariff Obligation, and the Government's position on the key issues highlighted through the consultation process. Similarly, section three covers operation of both schemes and section four considers delivery of the Shetland cross-subsidy. Section five summarises the Government's conclusions and next steps.

Conclusion and next steps

- 1.8. The Government remains committed to protecting consumers in the North of Scotland and will continue the support provided through the Hydro Benefit Replacement Scheme and the Common Tariff Obligation. There is a legal requirement to undertake a further review in three years' time.
- 1.9. The Government also remains committed to the introduction of GB-wide funding for a Shetland cross-subsidy at the same time that Shetland's new energy solution is implemented. This will be delivered through the Hydro Benefit Replacement Scheme, and we would expect to be able to confirm full details for this by the time of the next review.
- 1.10. As regards the possibility of introducing a single national electricity distribution tariff, the Government does not support a move away from the important principle of cost reflective charging, but we will continue to consider any evidence that is presented on this matter.

2. Rationale for Hydro Benefit Replacement Scheme & Common Tariff Obligation

Consultation questions and feedback

Consultation Question

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| 1. | Do you agree that the policy objectives of the Hydro Benefit Replacement Scheme and Common Tariff Obligation – which are focused on ensuring that consumers in the North of Scotland do not bear an unreasonable burden of electricity distribution costs – remain valid? |
| 2. | Do you agree that the assistance amount provided by the Hydro Benefit Replacement Scheme is appropriate, when overall electricity network charges are considered, or should it be either decreased or increased? Please give reasons and provide evidence to support your answer. |

Summary of responses

- 2.1. There was wide-scale support for the objectives of both the Hydro Benefit Replacement Scheme and the Common Tariff Obligation.

Hydro Benefit Replacement Scheme

- 2.2. It was noted that the support provided through the Hydro Benefit Replacement Scheme plays an important role in helping to alleviate the high costs of electricity distribution for consumers in North of Scotland. Without this support, costs would inevitably be significantly higher in the North of Scotland than any other region, with resulting impacts on affordability and levels of fuel poverty.
- 2.3. There were eight respondents who favoured an increase in the assistance amount provided through the Hydro Benefit Replacement Scheme, on the basis that electricity distribution charges remain higher in the North of Scotland even with the assistance provided. Respondents considered that distribution charges were an important factor in fuel poverty levels for the North of Scotland, particularly for off-gas households dependent on “Total Heating Total Control” or Economy 10 tariffs, although there were also calls for further moves to tackle fuel poverty. In addition, several respondents noted that any comparison of regional distribution charges needs to take account of above average electricity demand in the North of Scotland, rather than using flat rate

consumption volumes. However, one respondent supported the view that there is no need to increase the level of assistance given the impacts on consumers elsewhere, whilst another considered that the factors on which the original assistance amount was set have not changed.

- 2.4. Five respondents argued that the level of electricity transmission charges for the North of Scotland should not be taken into account when considering the level of support, as the Hydro Benefit Replacement Scheme was introduced in the specific context of electricity distribution costs and there was a separate rationale for transmission charges based on locational signals.
- 2.5. Six respondents questioned the general principle that distribution costs should vary across the country. As an alternative, it was suggested that a single electricity distribution charge across GB should be introduced, or at least that the number of distribution network operators could be reduced (for example, meaning a single operator for Scotland which would allow a larger population to share the higher distribution costs will inevitably continue in the North of Scotland).
- 2.6. On the mechanics of calculating the assistance amount, one respondent suggested that the formula used for indexing the amount should mirror the formula set out within Distribution Network Operator regulatory licences.

Common Tariff Obligation

- 2.7. Two respondents pointed out that the statutory definition of vulnerable consumers includes those households living in remote and rural areas. Hence, there is a specific rationale for the Common Tariff Obligation given the additional costs remote and rural consumers in the highlands and islands might face if it is removed, with a particular impact on those communities residing off the mains gas grid. In contrast, another respondent suggested that this measure was probably not necessary because suppliers normally charge common prices within areas for reasons of simplicity and administration, although it was recognised that it did provide additional assurance.
- 2.8. On the scope of the Common Tariff Obligation, two respondents highlighted the fact that it does not apply to non-domestic consumers. It was felt that this should be reconsidered, as its application to all types of consumer could encourage new business and commercial and industrial enterprise equally across the region.

Government response

Hydro Benefit Replacement Scheme

- 2.9. The particular challenges of electricity supply in the North of Scotland mean that electricity distribution costs will inevitably be much higher for this region than elsewhere. We welcome respondents' recognition that the assistance provided through the Hydro Benefit Replacement Scheme significantly reduces the differential in electricity distribution charges between the North of Scotland and the next highest regions, and the Government remains committed to continuing this level of support, with an annual adjustment to take account of inflation. The Government notes that, with the assistance provided through the Hydro Benefit Replacement Scheme, average distribution costs are not markedly higher than those for the next highest charging regions.
- 2.10. As noted in the Government consultation document, the Hydro Benefit Replacement Scheme does not (and never could) provide an efficient or effective way of providing targeted support to specific groups of vulnerable consumers within a region. Fuel

poverty is generally a devolved matter, with separate indicators, targets and strategies adopted by each nation. Whilst fuel poverty is a devolved issue, the Energy Company Obligation (ECO) delivers vital support to millions of low income and vulnerable homes across GB each year with heating and insulation measures, as well as direct reductions in their energy bills. There were 183,292 energy efficiency measures installed in 157,710 households under ECO in Scotland up to the end of September 2015.

- 2.11. The Scotland Act 2016 transferred powers to the Scottish Government over the design and delivery of energy supplier obligation schemes relating to energy efficiency and fuel poverty. The Act gives Scottish Ministers powers to determine how the national programmes obligating energy companies to install energy saving measures in domestic households (currently ECO) and rebate fuel poor homes (currently the Warm Home Discount) are designed and implemented in Scotland. Scottish Ministers will be able to use these powers to design and target those schemes as they see fit for the benefit of Scottish consumers.
- 2.12. The Government notes the calls from some for a move to a single national network charge, but continues to believe that the priority must be minimising overall network costs for consumers across GB. As with other types of network charge, electricity distribution charges vary regionally to reflect the costs of running the network in a specific area and the number of consumers those costs are spread across. Such a significant move away from the important principle of cost-reflective charging could be very unhelpful, as it risks weakening the pressure on each network company to keep overall costs down for its local stakeholders, potentially leading to an overall increase in costs. However, we will continue to consider any evidence that is presented on this matter.
- 2.13. In conjunction with Ofgem, DECC has considered the approaches to indexation of funding for the Hydro Benefit Replacement Scheme and the Distribution Network Operator regulatory licences. Both approaches use an adjustment based on the Retail Price Index (RPI), but with different timescales over which RPI is calculated. DECC does not believe that this difference makes a material difference to the sums involved, and has agreed with Ofgem that no change to either approach is necessary at this time.

Common Tariff Obligation

- 2.14. The costs of supplying electricity to remote and rural areas of the North of Scotland will inevitably remain higher than to urban areas, and Government continues to believe that the policy intent of the Common Tariff Obligation to protect domestic customers in these areas remains valid. Whilst it is not possible to be certain that removal of the measure would cause suppliers to increase charges in remote and rural areas, its retention is prudent in order to provide assurance.
- 2.15. The non-domestic electricity market in mainland GB is different to the domestic market, partly because suppliers are not under an obligation to offer terms and conditions to non-domestic customers, unlike the domestic sector. This means that non-domestic customers in rural areas of the North of Scotland could be disadvantaged by being included within the Common Tariff Obligation, as suppliers could be dis-incentivised to operate in higher cost areas. Government believes that non-domestic customers' interests are best served by being able to choose suppliers, and negotiate contract terms, in a competitive market. There would also be practical difficulties with extending the scope to cover non-domestic consumers, for example how a comparable supply of electricity might be determined given the wide range in non-domestic consumption levels. We are aware that the Competition and Markets Authority during its investigation

into the energy market has found consumer detriment in the micro business segment of the market. The Department intends to keep under review any implications of this for the Common Tariff Obligation.

3. Operation of Hydro Benefit Replacement Scheme & Common Tariff Obligation

Consultation questions and feedback

Consultation Question

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| 3. | Do you agree that the Hydro Benefit Replacement Scheme and Common Tariff Obligation remain operationally effective? |
| 4. | Do you have any evidence to show that the savings resulting from the Hydro Benefit Replacement Scheme are not being passed on fully by suppliers to end-consumers? If so, would the introduction of a licence obligation on suppliers to pass on the savings be an effective way of addressing this? |

Summary of responses

- 3.1. Subject to the points raised in response to consultation questions 1-2, respondents considered that the operation of both schemes was generally effective. However, several detailed points on operational aspects were raised - see below.

Hydro Benefit Replacement Scheme

- 3.2. Five respondents referred to the work which Scottish Hydro Electric Power Distribution (SHEPD) is currently undertaking with the energy regulator, Ofgem, and the regulator for managing Scotland's seas, Marine Scotland, on the future of Scotland's submarine electricity cables⁶. This process involves a Cost Benefit Analysis to understand if SHEPD needs to change its engineering practices to meet the requirements of Scotland's National Marine Plan, in terms of how submarine electricity cables are installed on the seabed. Respondents considered that, if this involves increased costs for the North of Scotland, these should be taken into account in determining the level of support provided by the Hydro Benefit Replacement Scheme.
- 3.3. One respondent expressed concern that the existing distribution charging model (known as the Common Distribution Charging Model), which is used to set the tariffs for suppliers, applies the assistance amount by way of a reduction in the total chargeable revenue. It was argued that the effect of this is to dampen peak time consumption prices which may in turn drive the need for additional network reinforcement. Two

⁶ See: <http://news.ssepd.co.uk/submarinecables/>

respondents proposed that support should be funded through general taxation instead of a bill levy, as this would represent a less regressive approach.

- 3.4. No clear evidence was presented to suggest that the savings resulting from the Hydro Benefit Replacement Scheme are not being passed on fully by suppliers to end-consumers. Several respondents, however, considered that the area was opaque, and called for increased transparency. There were mixed views on whether a licence obligation should be placed on suppliers to ensure that the assistance amount is passed through to consumers. Whilst some respondents considered that a licence obligation would bring welcome certainty that savings are being passed through to consumers, others cited potential concerns with such an approach. These concerns focused on the practicality of how a pass through obligation on one element of the cost base could work when prices are set competitively rather than on a cost plus basis, as well as unintended consequences such as the risk of limiting innovation amongst suppliers. It was also suggested that competition amongst suppliers should ensure that savings are passed through.

Common Tariff Obligation

- 3.5. On the operation of the Common Tariff Obligation, one respondent noted the importance of being clear that the measure is not intended to prevent communities living in close proximity to renewable generation from receiving a tariff discount. It was suggested that this approach does not conflict with the intended purpose of the measure, and ensures that communities in the North of Scotland are offered the same opportunity as those in the exact same situation in other regions.

Government response

Hydro Benefit Replacement Scheme

- 3.6. SHEPD is currently undertaking a significant piece of work to help identify the best value methods to be deployed in the future for laying and protecting subsea cables around the coast of Scotland. These activities are regulated by Marine Scotland through the marine licensing regime. SHEPD is regulated by Ofgem, which is responsible for protecting the interests of consumers and ensuring they have access to an affordable, secure and sustainable energy system. The Government believes that, in general, cost reflective charging continues to represent the right approach, and hence does not intend to pursue an adjustment in the level of support to reflect the requirements of Scotland's National Marine Plan, but notes in any case that potential impacts are not expected to arise before the next review of the Hydro Benefit Replacement Scheme in 2018/19.
- 3.7. The Government accepts that applying the assistance amount at a flat-rate across time periods, rather than at a lower rate for peak time periods, could potentially increase peak usage and drive additional network reinforcement. However, we do not propose to alter the current approach as it could result in markedly higher peak prices for consumers in the North of Scotland than any other region. A change would also cause additional administrative costs to be incurred. On the funding source of the scheme, we consider that the lowest administrative costs can be expected through using a cross-subsidy mechanism.
- 3.8. In the absence of evidence to show that savings resulting from the Hydro Benefit Replacement Scheme are not being passed on by suppliers to end-consumers, the Government does not believe there is a sufficient case for introducing a licence

obligation. We also accept that there are practical difficulties with such a measure, as outlined by respondents.

Common Tariff Obligation

- 3.9. When introduced in April 2005, the purpose of the measure was very clearly expressed as protecting comparable domestic consumers in remote rural areas from being charged higher prices solely on the basis of their geographic location within the area. There was no suggestion that the Common Tariff Obligation should prevent households in the North of Scotland who live in close proximity to renewable generation from being offered a local generation tariff. The Government agrees with the respondent that communities in the North of Scotland should be offered the same opportunity as those in the same situation in other regions.

4. Delivery of the Shetland cross-subsidy

Consultation questions and feedback

Consultation Question

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| 5. | Do you agree that the Hydro Benefit Replacement Scheme provides the best way of delivering revised funding arrangements for the Shetland cross-subsidy? If not, what alternative mechanism(s) could be used? |
| 6. | Do you agree that the specific arrangements proposed in this consultation document for delivery of the revised funding arrangements for the Shetland cross-subsidy through the Hydro Benefit Replacement Scheme are effective? If not, what changes or additions should be made? |

Summary of responses

- 4.1. Most respondents agreed with the Government proposal to use the Hydro Benefit Replacement Scheme to deliver the revised funding arrangement for the Shetland cross-subsidy, as this was seen to be the simplest and most cost-effective mechanism. However, two respondents considered that no final decision should be taken until greater certainty exists on the additional costs that would result from funding the Shetland upgrade, whilst a third respondent questioned the rationale for the Shetland cross-subsidy in the event that a subsea cable link was built between Shetland and the GB mainland. One respondent supported the earliest practical implementation in order to relieve the extra costs which are currently funded by consumers in the North of Scotland.
- 4.2. On the detail of the arrangements, five respondents noted the importance of transparency in establishing and operating these arrangements, in order to help ensure value for money. In particular, it was suggested that annual forecasting and reporting arrangements similar to those of the existing Hydro Benefit Replacement Scheme should be established.

Government response

- 4.3. The Government welcomes respondents' support for these proposals, and remains committed to their introduction through the Hydro Benefit Replacement Scheme at the same time that Shetland's new energy solution is implemented. SHEPD is currently taking forward a competitive tender process for the new energy solution, which will result in it putting forward a recommendation to Ofgem for approval. The outcome of

this process will determine the level and timing of the cross-subsidy. If there is a significant change in circumstances in the future which brings into question the need for the Shetland cross-subsidy (such as a new energy solution which removed any cost differential), we would consult on any revised proposals for the cross-subsidy. We will also provide clarity on the costs of the cross-subsidy once these become available.

- 4.4. The Government agrees with respondents that the arrangements for the Shetland cross-subsidy must be established and operated in a transparent way. Initial discussions have already taken place with National Grid and SHEPD, who would administer key aspects of the cross-subsidy, to ensure that appropriate annual forecasting and reporting arrangements would be established to help achieve this.

5. Conclusion and next steps

5.1. The Government remains committed to protecting consumers in the North of Scotland from the high costs of electricity distribution in the region, and will continue the support provided through the Hydro Benefit Replacement Scheme and the Common Tariff Obligation. No further actions are required to ensure that the schemes can continue in the medium-term. There is a legal requirement to undertake a further review in three years' time.

5.2. The Government also remains committed to the introduction of GB-wide funding for a Shetland cross-subsidy at the same time that Shetland's new energy solution is implemented. This will be done through the Hydro Benefit Replacement Scheme, although it will only be possible to confirm full details once the outcome of SHEPD's competitive tender for the new energy solution is clear.

5.3. As regards the possibility of introducing a single national electricity distribution tariff, the Government does not support a move away from the important principle of cost reflective charging given the risk this would create of increasing overall network costs for consumers across GB. The Government will continue to consider any evidence that is presented on this matter.

Annex: List of respondents

Changeworks

Citizens Advice

Citizens Advice Scotland

Comhairle nan Eilean Siar, Local Authority for the Outer Hebrides

Co-operative Energy

COSLA (Convention of Scottish Local Authorities)

Highland Affordable Warmth Partners Group

Highlands and Islands Enterprise

Highlands and Islands Housing Association Affordable Warmth Group

Lerwick Port Authority

National Grid

Scottish Power

Shetland Fuel Poverty Action Group

SmartestEnergy

SSE

The Highland Council

In addition, one response was received from a member of the public

