



Department
of Energy &
Climate Change

Hydro Benefit Replacement Scheme and Common Tariff Obligation

Three year review of statutory schemes: call for comments

March 2013

Executive Summary

Purpose of these statutory schemes

1. The Hydro Benefit Replacement Scheme and Common Tariff Obligation protect consumers in areas with very high distribution costs (the North of Scotland) from the relatively high electricity charges that would otherwise arise and ensure those consumers are not adversely affected as a result of where they live within the North of Scotland.
2. Section 184 of the Energy Act 2004 gives the Secretary of State for Energy and Climate Change the power to require authorised transmitters to make a payment to the relevant distributor serving a single specified area, where distribution costs are significantly higher than in any other area of Great Britain. This is done through the Hydro Benefit Replacement Scheme. The payment must be passed from the distributor to authorised suppliers within the area which effectively lowers the distribution use of system charges those suppliers pay. The scheme is funded by charges on licensed suppliers across Great Britain.
3. The scheme is intended to benefit customers in the North of Scotland, where there are the highest distribution costs in Britain by a significant margin.
4. The Common Tariff Obligation prohibits suppliers from charging comparable consumers different prices on the basis of their location in the North of Scotland. Suppliers can offer different terms to customers, provided they ensure that these differences are not determined on the basis of the customers' geographical location within the North of Scotland.
5. The two schemes are complementary in addressing price disparities that may arise due to a customer's location: the Hydro Benefit Replacement Scheme ensures that prices in the area designated as North of Scotland are not significantly higher than elsewhere in GB, whilst the Common Tariff Obligation ensures that consumers within the same area, in particular those in remote parts, do not bear an unreasonable burden of the costs of electricity distribution.

Why the schemes are being reviewed

6. The Energy Act 2004 requires the Hydro Benefit Replacement Scheme to be reviewed every three years, with the last review being completed in 2009. A Ministerial commitment was made to review the working of the Common Tariff Obligation in parallel with the Hydro Benefit Replacement Scheme review.

The Government's position

7. The Government has considered the operation of the two schemes in conjunction with National Grid which is responsible for operating the scheme through conditions included in its licence imposed by Ofgem. The schemes were also considered under the

Government's recent Red Tape Challenge process to assess whether they were still justified and if so what scope there may be to improve their implementation.

8. In operational terms, both the Hydro Benefit Replacement Scheme and Common Tariff Obligation are running smoothly. The Government considers that the original policy objectives remain relevant and both schemes continue to meet those objectives. The Red Tape Challenge process has led the Government to look at the scope for excluding the smallest licensed suppliers from an obligation to fund the scheme. Our initial view is that there is no economically rational basis for setting a particular threshold below which some licensed suppliers would be excluded (particularly as the smallest unlicensed suppliers are already excluded).
9. On this basis the Government is therefore not at this stage minded to make any changes to the Orders governing both the Hydro Benefit Replacement Scheme and Common Tariff Obligation. However, before making a final decision, the Government would welcome comments from stakeholders on this approach by 12 April 2013. In particular, views are sought on whether there could be a rationale for setting a threshold below which licensed suppliers would be excluded from funding the Hydro Benefit Replacement Scheme.
10. There is no sunset clause included in either scheme, so both continue to operate whilst this review is carried out. Government will also be obliged to carry out a further review in 2015.

Policy Background

What is the Hydro Benefit Replacement Scheme?

11. The Energy Act 2004 (Assistance for Areas with High Distribution Costs) Order 2005 requires authorised transmitters (National Grid as transmission system operator for Great Britain) to make a payment to the relevant distributor (Scottish and Southern Energy Power Distribution) serving a single specified area (North of Scotland), where distribution costs are significantly higher than elsewhere in Great Britain. This is done through the Hydro Benefit Replacement Scheme. An “assistance amount” is recovered through charges on the 25 licensed electricity supply companies across Great Britain and passed on to the relevant distribution company to reduce distribution costs in that area.
12. The aim of the scheme is to protect consumers in areas with high distribution costs from the relatively high electricity costs that would otherwise arise. The scheme is intended to benefit customers in the North of Scotland, where there are the highest distribution costs in Britain by a significant margin.

History of the Hydro Benefit Replacement Scheme

13. Hydro Benefit came about in the 1940s and was formalised on the privatisation of the Scottish electricity industry in the 1990s through specific licence conditions. The licence conditions required Scottish and Southern Electricity’s (SSE) generation business to pay an amount of money to SSE’s network businesses and that this money would be used to offset distribution and/or transmission charges for consumers in the Highlands and Islands. The amount to offset transmission charging was set to zero but the amount set to offset distribution charges was set at £40m per annum. Hydro Benefit was unique in that Northern Scotland was the only area where cross subsidy of this sort was explicitly allowed.
14. The original rationale for Hydro Benefit was that the costs of providing power to remote Highlands and Island consumers was high, mainly due to the harsh and remote terrain which added significantly to maintenance costs. SSE was vested with a large number of small hydro stations and dams in the north west of Scotland linked to lochs. Many of these were built in the first half of the 20th Century at high public cost. The fuel (rain fall and snow melt) was effectively free and plant maintenance was generally low. Therefore Hydro Benefit was set up to make sure that some benefit of this cheap form of electricity was passed to remote consumers.
15. The original scheme was abolished in January 2004, following legal advice to Ofgem that it was incompatible with EU law. A new scheme was created to replace it, whereby the high costs of electricity distribution to consumers in the North of Scotland was spread across Great Britain. The new scheme commenced on 1 April 2005 under the power in section

184 of the Energy Act 2004¹. The subsidy is funded by charges on licensed suppliers across Great Britain.

How does the Hydro Benefit Replacement Scheme work?

16. Section 184 of the Energy Act 2004 gives the Secretary of State for Energy and Climate Change the power to require authorised transmitters to make a payment to the relevant distributor serving a single specified area, where distribution costs are significantly higher than in any other area of Great Britain. The payment must be passed from the distributor to authorised suppliers within the area. The scheme must be funded by charges on licensed suppliers across Great Britain.
17. The Order stipulates:
 - (i) That the area covered is the North of Scotland Specified Area, previously defined in connection with the Electricity Act 1989.
 - (ii) That the level of the payment will be the same as the level of payment when the previous scheme was withdrawn, and that it will be adjusted annually in line with any efficiency saving imposed during the distribution network's price control review.
18. The Hydro Benefit Replacement Scheme is administered by National Grid as transmission system operator. National Grid have a licence condition that obliges them to collect the "assistance amount" from licensed suppliers across Great Britain and pass it on to the relevant distributor for the North of Scotland to reduce distribution costs in that geographic area.
19. The "assistance amount" is recovered from licensed suppliers based on the total amount of electricity they supply to their customers. Consequently the "Big Six" suppliers contribute around 90% of the total costs of the scheme with the next three in size picking up a further 9%. This means that the smallest 16 licensed suppliers only contribute a 1% share of the total costs of the scheme (and unlicensed suppliers do not contribute at all).

What does the Hydro Benefit Replacement Scheme cost?

20. In 2011-12 the assistance amount totals £50.2m which includes a payment to National Grid to cover the costs of administering the scheme. This assistance gives an average bill reduction of £31 a year to the 690,000 domestic consumers in the North of Scotland, with the remainder giving bill savings to the 70,000 non-domestic consumers. This represents 2.5% of the total 27 million domestic consumers in Great Britain.

¹ The Energy Act 2004 (Assistance for Areas with High Distribution Costs) Order 2005 (No. 528)

What is the Common Tariff Obligation?

21. The Common Tariff Obligation gives certainty to the Government policy ensuring that comparable domestic customers in the peripheral areas of the North of Scotland are not charged different prices purely on the basis of where they live. This policy is intended to avoid the socially undesirable consequences that may otherwise occur.
22. The Common Tariff Obligation ² prohibits suppliers from charging comparable consumers different prices on the basis of their location in the North of Scotland. It only covers domestic customers and not the Industrial and Commercial sector. Suppliers can offer different terms to customers, provided they ensure that these differences are not determined on the basis of the customers' geographical location within the North of Scotland.

History of the Common Tariff Obligation

23. The Common Tariff Obligation was originally set out in section 3(2)(a) of the Electricity Act 1989. A duty was imposed on the Secretary of State and the Regulator to ensure that electricity suppliers maintained a common tariff within a given area of Scotland. In 1990 the Secretary of State laid an Order under the Electricity Act 1989 which specified the area the Common Tariff Obligation would be applied to as 'North Scotland'.
24. The Utilities Act 2000 (c.27) repealed section 3(2)(a) of the Electricity Act 1989 and inserted Section 7B. This enabled the Secretary of State to lay an Order requiring transmission, distribution and supply licensees to charge prices, or offer contractual terms (suppliers) that do not distinguish between users in different parts of North Scotland. However, no Order was made under this section for nearly five years.
25. The market nonetheless continued to operate on the assumption that the Order under section 3(2)(a) of the Electricity Act 1989 continued in effect (probably because Standard License Condition 42 referred to the Common Tariff Obligation as if the Order were in effect). The omission was however rectified when an Order was made on 1 April 2005 to ensure that customers in North Scotland continued to be charged prices that do not differentiate according to geographical location.

How does the Common Tariff Obligation work?

26. The Common Tariff Obligation Order simply provides that holders of supply, distribution or transmission licences shall ensure that the prices/charges payable for the purpose of supplying any domestic premises in the North of Scotland "do not take into account the geographical location within that area".
27. The Common Tariff Obligation is a self-sufficient scheme requiring no separate funding from Government, taxpayers or other market participants. It is monitored and enforced by

² The Electricity Act 1989 (Uniform Prices in the North of Scotland) Order 2005 (N. 490)

Ofgem through its licensing system. Ofgem has powers to impose fines on businesses which do not comply with their licence obligations and ultimately to revoke licences.

Three Year Review

Why are the schemes being reviewed?

28. Section 184 of the Energy Act 2004 includes a statutory requirement to review the Hydro Benefit Replacement Scheme every three years. A Ministerial commitment was made to review the Common Tariff Obligation at the same time.

Red Tape Challenge

29. The Red Tape Challenge process also led the Government to look at the scope for excluding the smallest licensed suppliers from an obligation to fund the Hydro Benefit Replacement Scheme. No rationale for setting a particular threshold could be justified to exclude some licensed suppliers (particularly as the smallest unlicensed suppliers are already excluded).
30. It is recovered from licensed suppliers based on the total amount of electricity they supply to their customers. Consequently the Big Six suppliers contribute around 90% of the total costs of the scheme with the next three in size picking up a further 9%. This means that the smallest 16 licensed suppliers only contribute a 1% share of the total costs of the scheme.
31. National Grid calculates the charges and invoices supply companies alongside wider use of system charges so the administrative burden on suppliers is relatively low.

The Government's Position

Rationale

32. When the Hydro Benefit Replacement Scheme came into force in 2005 with the switch to the British Electricity Transmission Trading Arrangements (BETTA), the cost of distributing electricity in the North of Scotland was assessed as being about 50% higher than elsewhere in Great Britain. This was mainly due to the cost of maintaining the distribution network over long distances and in sparsely populated terrain. The last statutory review of the schemes elicited no evidence to suggest that this had changed and subsequent analysis has reinforced this position.

Red Tape Challenge

33. In line with the recommendations under the Red Tape Challenge process, DECC has considered whether there is scope for improving the way the Hydro Benefit Replacement Scheme and Common Tariff Obligation are implemented.
34. In the case of the Hydro Benefit Replacement Scheme, DECC specifically considered whether a case could be made to reduce the number of licensed suppliers obliged to pay towards the "assistance amount".
35. Having considered this, DECC's initial view is that there is no economically rational basis for setting a threshold to limit the obligation to one particular group of licensed suppliers. The impact on the smallest licensed suppliers appears minimal, whilst licence exempt suppliers are already excluded. DECC would however welcome stakeholder views on this position and is open to considering any arguments in favour of setting a threshold.
36. The Common Tariff Obligation places no burden on business and has no costs associated with it. DECC therefore does not see any way to improve its implementation.

Conclusion

37. The Government is minded to not make any substantive changes to the Orders governing both the Hydro Benefit Replacement Scheme and Common Tariff Obligation, but welcomes comments from stakeholders. There is no sunset clause included in either scheme, so both continue to operate whilst the review is carried out.
38. DECC also considers that this approach has the advantage of not burdening stakeholders with a detailed consultation exercise, although the Government will consider any evidence received on its merits, as part of the review process.
39. In addition, Government will be obliged to carry out a further review in another three years.

Call for Comments

Rationale

40. DECC invites views on any aspects of this statement, but in particular whether stakeholders agree with the view that both the Hydro Benefit Replacement Scheme and Common Tariff Obligation continue to meet their original policy objectives and are operationally effective.
41. DECC would also welcome any comments or suggestions that would help to identify any inconsistencies in the governing legislation – for example the 2005 consultation on the Hydro Benefit Replacement Scheme Order identified changes in the names of local councils that were used to define the North of Scotland area.
42. Finally DECC would welcome any views on whether there is a rationale for setting to threshold to exclude some of the smaller licensed suppliers from contributing to the costs of the Hydro Benefit Replacement Scheme.
43. The deadline for responses is 12 April 2013. When responding, please state whether you are responding as an individual or representing the views of an organisation. If responding as a representative body, please make clear who the body represents and, where applicable, how the views of members were assembled. Responses should be submitted, preferably by email, to:

Future Electricity Networks Team
DECC
Area D, 4th Floor
3 Whitehall Place
London SW1H 0ET
Tel: 0300 068 5827
e-mail: hbrscto.review@decc.gsi.gov.uk

What happens next?

44. Following the deadline, the Government will consider responses and publish a formal response within three months.

Confidentiality and data protection

45. Information provided in response to this call for comments, including personal information, may be subject to publication or disclosure in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004). If you want information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence.

46. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.
47. The Department will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.
48. If you have any comments or complaints about the call for comments process, please email consultation.coordinator@decc.gsi.gov.uk.

