



Department for
Business, Energy
& Industrial Strategy

HYDRO BENEFIT REPLACEMENT SCHEME AND COMMON TARIFF OBLIGATION

Three-yearly review of statutory schemes:
response to consultation



OGL

© Crown copyright 2020

This publication is licensed under the terms of the Open Government Licence v3.0 except where otherwise stated. To view this licence, visit nationalarchives.gov.uk/doc/open-government-licence/version/3 or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or email: psi@nationalarchives.gsi.gov.uk.

Where we have identified any third-party copyright information you will need to obtain permission from the copyright holders concerned.

Any enquiries regarding this publication should be sent to us at: enquiries@beis.gov.uk

Contents

Executive Summary	4
1. Introduction	5
Summary of Government's proposals	5
Summary of responses to the consultation	6
Conclusion and next steps	6
2. Hydro Benefit Replacement Scheme and Common Tariff Obligation	8
Summary of responses	8
Policy objectives and level of support	8
Operation of the Hydro Benefit Replacement Scheme	8
Operation of the Common Tariff Obligation	9
Broader points	9
Government response	9
Policy objectives and level of support	9
Operation of the Hydro Benefit Replacement Scheme	10
Operation of the Common Tariff Obligation	11
Broader points	11
3. Delivering the Shetland cross-subsidy	12
Summary of responses	12
Use of the Hydro Benefit Replacement Scheme	12
Design of the funding arrangement	12
Predictability, transparency and efficiency of operation	13
Government response	13
Use of the Hydro Benefit Replacement Scheme	13
Design of the funding arrangement	14
Predictability, transparency and efficiency of operation	14
Annex A: List of respondents	15

Executive Summary

The Government is committed to helping protect consumers in the North of Scotland from the inevitably high costs of distributing electricity in the region. The Government ran a consultation from 12th July 2019 to 6th September 2019 which set out proposals to:

- Retain two statutory schemes, the Hydro Benefit Replacement Scheme and the Common Tariff Obligation, which support electricity consumers in the North of Scotland.
- Increase the assistance amount provided through the Hydro Benefit Replacement Scheme so that the costs of an existing Shetland cross-subsidy are spread across all licensed electricity suppliers in Great Britain (GB), instead of being funded by North of Scotland suppliers (and ultimately North of Scotland consumers) currently.

In total, 26 consultation responses were received from a range of interested parties including the energy industry, local authorities, consumer representatives and individuals.

Following the consultation, the Government is confirming that:

- The Hydro Benefit Replacement Scheme and the Common Tariff Obligation will be retained.
- Secondary legislation will be taken forward to deliver GB-wide funding for the Shetland cross-subsidy through the Hydro Benefit Replacement Scheme. This will have the effect of reducing costs for all electricity consumers in the North of Scotland by a total of £27m annually from April 2021.

There is a statutory requirement to review the Hydro Benefit Replacement Scheme every three years, with the next review scheduled for 2022. There is a Ministerial commitment to review the Common Tariff Obligation in parallel with three-yearly reviews of the Hydro Benefit Replacement Scheme.

1. Introduction

It costs more to distribute electricity in the North of Scotland than elsewhere because of the unique geographic challenges faced by the region. To help protect domestic and non-domestic consumers from these high costs, the Government's Hydro Benefit Replacement Scheme¹ provided an assistance amount of £61m to reduce the distribution costs ultimately borne by consumers in the North of Scotland in 2018/19, and for 2019/20 this increases to £63m. This is worth around £40 per household in the region.

In addition, the Government's Common Tariff Obligation² is designed to protect consumers in remote rural areas and islands of the North of Scotland from the extra costs of supplying electricity to those areas, compared to urban areas. It does this by ensuring that 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.

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 mainland³. The resulting costs are ultimately paid by consumers in the North of Scotland, and these costs are rising due to the implementation of an energy solution for Shetland⁴. In order to support consumers in the North of Scotland, the Government previously confirmed⁵ that the full costs of the cross-subsidy for Shetland would be spread over GB following the implementation of a new energy solution for Shetland. The Government also proposed⁶ that this cross-subsidy arrangement would be delivered through the Hydro Benefit Replacement Scheme. This will have the effect of reducing electricity distribution costs for all consumers in the North of Scotland.

Summary of Government's proposals

The Government's consultation proposed retention of the Hydro Benefit Replacement Scheme and the Common Tariff Obligation, on the basis that the policy objectives of both measures remain valid and are operationally effective.

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

² The Common Tariff Obligation is set out in the Electricity Act 1989 (Uniform Prices in the North of Scotland) Order 2005.

³ The cross-subsidy is for all domestic consumers on Shetland, as well as all existing non-domestic consumers at 1 April 2015 and, from the same date, all new non-domestic consumers with a maximum demand connection of 2 megawatts.

⁴ Lerwick Power Station is vital to Shetland's electricity distribution arrangements, but is reaching the end of its operational life. This means that a new energy solution is needed to maintain Shetland's security of supply. Any new energy solution can be expected to increase Shetland electricity costs, resulting in an additional burden to North of Scotland consumers if the existing cost-recovery arrangement continues. Ofgem has recently concluded that the most cost-effective approach in the near-term will be to implement an interim solution which involves extending the operation of Lerwick Power Station through targeted investment until at least 2024/25. Whilst the costs of this interim energy solution are expected to be less than for the eventual full new energy solution, the interim solution will increase distribution costs for consumers in the North of Scotland.

⁵ <https://www.gov.uk/government/consultations/support-for-non-domestic-electricity-consumers-on-shetland>

⁶ <https://www.gov.uk/government/consultations/hydro-benefit-replacement-scheme-and-common-tariff-obligation-three-year-review-of-statutory-schemes-consultation>

To deliver the Government's commitment to cross-GB funding of the Shetland cross-subsidy through an increase in the assistance amount provided by the Hydro Benefit Replacement Scheme, the consultation set out proposals on the detailed operation of this arrangement. Key design considerations were ensuring predictability and transparency for all interested parties. The Government proposed that the new funding arrangement should take effect from April 2020, which was considered to be the very earliest practical date at which the necessary measures could be implemented.

As noted in the Government's consultation, the introduction of cross-GB funding for the Shetland cross-subsidy would reduce distribution charges for the North of Scotland by £27m annually, which would be worth an estimated £17 per household in the region in addition to the existing assistance amount. This represents around a 2% reduction in energy bills for consumers in the North of Scotland. For a typical GB household, the change would mean a small increase in electricity costs of less than 50p each year, or less than a 0.1% bill impact. No impact would be expected on the costs of administering the scheme.

Summary of responses to the consultation

In total, 26 consultation responses were received from a range of interested parties including the energy industry, local authorities, consumer representatives and individuals. Most respondents had a direct interest in electricity costs for the North of Scotland.

All respondents supported some form of action to protect electricity distribution consumers in the North of Scotland, and the majority agreed that the Hydro Benefit Replacement Scheme and Common Tariff Obligation should continue. Others considered that a more fundamental change was needed, such as moving to a single rate of distribution charge across GB.

All those respondents who expressed a view agreed with the Government's proposal to revise funding arrangements for the Shetland cross-subsidy so that it is delivered through the Hydro Benefit Replacement Scheme. Some suggestions were made to improve both the way in which the revised funding arrangement is implemented and the operation of the two existing support measures. The earliest practical implementation date which would enable suppliers to pass on the full value of the benefit to end-consumers was considered by some respondents to be April 2021.

A list of respondents is attached at [Annex A](#).

Conclusion and next steps

This government response is divided into two chapters covering, respectively, the retention of the current measures, and delivery of the Shetland cross-subsidy. Each chapter contains an overview of the responses received in relation to the questions posed in the consultation (the 'summary of responses' sections) and explains the decisions that the government has taken and the legislative change it intends to make.

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.

The Government also remains committed to the introduction of GB-wide funding for a Shetland cross-subsidy, and expects suppliers to pass on the full value of benefit to end-consumers. We intend to lay the necessary secondary legislation before Parliament in early 2020 to implement the changes from April 2021.

Several areas were raised by respondents which the Government will explore in time for the next review of the Hydro Benefit Replacement Scheme and Common Tariff Obligation in 2022. These areas are noted in Chapters 2 and 3 below. In addition, and as noted in our consultation document, Government would also intend to consult as part of the next review on a move from the Retail Price Index (RPI) to CPIH (the Consumer Prices Index including owner occupiers' housing costs) as the basis for annual adjustment to the assistance amount, in the event that Ofgem moves from RPI to CPIH as part of its next electricity distribution price control in 2023.

2. Hydro Benefit Replacement Scheme and Common Tariff Obligation

Consultation questions

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 are not unreasonably disadvantaged by the price differential in electricity distribution costs – remain valid?
2. Do you agree that the Hydro Benefit Replacement Scheme and Common Tariff Obligation remain operationally effective and should be retained?

Summary of responses

All respondents offered comments relating to these questions.

Policy objectives and level of support

There was consensus that consumers in the North of Scotland should be protected from the high costs of electricity distribution in that region, with the majority of respondents strongly supporting the policy objectives of the existing measures. 12 respondents considered that the current level of assistance was insufficient, on the basis that it should more closely reflect the specific characteristics of the region such as high levels of renewable generation, high levels of fuel poverty and the lower proportion of the population without access to mains gas. In addition, three respondents advocated a single electricity distribution charge across GB as a more equitable approach which would ensure consumers in the North of Scotland did not pay higher distribution costs than elsewhere.

Operation of the Hydro Benefit Replacement Scheme

On the detailed operation of the Hydro Benefit Replacement Scheme, 8 respondents supported retention of the existing arrangements, variously noting that these were relatively simple, transparent, efficient and well-understood by interested parties. Operational changes were suggested by a minority of respondents:

- One respondent highlighted what they considered to be an ‘embedded benefit’⁷ distortion within the current arrangements, which they believe prevents delivery of the full benefit of the scheme to end consumers. It was suggested that the Government

⁷ Embedded benefits relate primarily to network charging arrangements, and their exact nature varies depending on the specific context. Broadly, they arise where generators connected to the lower voltage distribution network can access revenues or cost reductions which are not available to generators connected to the high voltage transmission network. As an example, a distribution connected generator can reduce a supplier’s demand from the transmission network, thereby reducing the supplier’s liability for transmission charges, and be paid by the supplier for doing so. A concern with this arrangement is that, if it is assumed that the supplier’s action does not reduce the total level of transmission costs that need to be recovered, other suppliers (and ultimately end-consumers) will have to pick up the shortfall.

considers measures to remove this embedded benefit. Its relevance to the proposals for revised funding of the Shetland cross-subsidy was also noted.

- Two respondents questioned whether there was sufficient competitive pressure in the North of Scotland electricity supply market to ensure the assistance amount is passed through to the end consumer. In support of this view, it was noted that consumer switching rates within the region were lower than elsewhere and that Government had not identified any positive evidence to demonstrate the assistance had been applied. It was proposed that licensed domestic and non-domestic electricity suppliers should be required through a new licence condition to evidence in a clear and transparent way that the assistance had been applied. Similarly, it was noted that greater transparency in billing would be useful in helping to identify the application of the transmission and distribution charges component in every bill.
- To help mitigate the risk of a funding shortfall arising because of any future electricity supplier failure, one respondent proposed that the assistance amount should be collected from licensed electricity suppliers on a monthly rather than quarterly basis.
- Two respondents considered that the Hydro Benefit Replacement Scheme was regressive, as its funding approach takes no account of a consumer's ability to pay. Instead, funding through general taxation was seen as a more socially just approach.
- The fact that off-grid consumers in the North of Scotland, such as small island communities, do not benefit from the protection of these schemes was noted as a possible concern by two respondents.

Operation of the Common Tariff Obligation

On the operation of the Common Tariff Obligation, one respondent proposed that the protections it provides to domestic consumers in the North of Scotland should be extended to also cover non-domestic consumers. It was felt that this would remove a barrier to cost competitiveness for businesses in remote rural and island communities in the North of Scotland. In contrast, another respondent suggested that the Common Tariff Obligation was probably unnecessary, because energy companies tend to charge common prices within electricity distribution areas for reasons of simplicity.

Broader points

Some broader points were raised including on the operation of the Warm Home Discount Scheme and whether policy costs should continue to be levied primarily on electricity customers.

Government response

Policy objectives and level of support

The Government agrees with respondents that consumers in the North of Scotland should be protected from the significantly higher electricity distribution costs arising in the region, and welcomes the strong support given by most respondents to the schemes' policy objectives. The Government continues to believe that these objectives remain valid.

On the level of assistance provided through the Hydro Benefit Replacement Scheme, the Government's introduction of GB-wide funding for the Shetland cross-subsidy will reduce distribution charges ultimately paid by consumers in the North of Scotland. Further details on this are set out in Chapter 3 of this government response document. It is also important to note that the scheme is designed to reduce most of the differential between electricity distribution charges in the North of Scotland and elsewhere. It is not intended to remove the differential entirely which, as explained in the next paragraph, would undermine the important principle of cost reflective network charging. Neither is the scheme intended to address issues which are not directly related to electricity distribution, such as fuel poverty, off-grid consumers or the implications for network charges of renewable generation. Instead, other measures cover these areas, including the Energy Company Obligation (which provides energy saving measures for homes), Warm Home Discount Scheme (which provides assistance to households with energy costs) and arrangements delivered through the electricity transmission charging regime⁸.

The Government notes that some respondents proposed an alternative approach of introducing a single electricity distribution charge across GB. As described in our consultation document, 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. This cost reflective approach helps to minimise overall network costs across GB by ensuring that each network company has to account to its local stakeholders for the costs it has incurred. Any significant move away from this important principle of cost-reflective charging 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. It remains the Government's priority to minimise overall network costs for all consumers across GB, and hence the Government does not intend to move away from the current approach.

Operation of the Hydro Benefit Replacement Scheme

The Government notes that an embedded benefit distortion may exist within the current operating arrangements of the Hydro Benefit Replacement Scheme, and this could potentially mean higher consumer costs overall. The Government is exploring this further with relevant parties, and if this distortion exists, it will consult in due course on proposals to address this if considered appropriate.

It is important that consumers engage in competition to get the best prices, and there are a wide range of suppliers and tariffs available to consumers in the North of Scotland. For those who are unable or unwilling to shop around, the Government's price cap provides protection by limiting what can be charged for standard variable and default tariffs. The Government also welcomes the measures introduced by the Competition and Markets Authority on restricted meters that enable greater switching in the North of Scotland. But the best deals can be found by switching and it is through competitive pressure that the Government expects relevant sums, such as that provided by the Hydro Benefit Replacement Scheme, to be passed on by suppliers to end-consumers.

Whilst any potential funding shortfall needs to be taken seriously, the Government considers that the level of a shortfall that could arise from a future supplier default would not justify the

⁸ Electricity networks are divided into the high voltage transmission network, which takes electricity around GB, and the lower voltage distribution networks which are primarily designed to connect customers to the national transmission network. Transmission charges are paid by generators and suppliers, with the charges for suppliers (and ultimately end-consumers) in the North of Scotland being lower than elsewhere in GB to reflect the relatively high levels of generation (which is largely renewable) located in the region.

system costs of moving from quarterly to monthly collection of the assistance amount. On the funding source of the scheme, we consider that the lowest administrative costs can be expected through using a cross-subsidy mechanism rather than general taxation.

Operation of the Common Tariff Obligation

The Common Tariff Obligation's focus on helping to protect domestic consumers is well-established, and the Government has seen no evidence to indicate that its scope should be extended to cover larger non-domestic consumers. As regards microbusinesses, Ofgem is undertaking a Strategic Review of the GB microbusiness energy market to better understand the issues faced by microbusinesses, so that they are able to access a competitive retail market and secure adequate levels of protection. The Strategic Review is ongoing until March 2021, however, Ofgem expects to be able to outline an action plan and next steps in winter 2019/20. The Government would want to take account of the review's findings when considering whether any action may be appropriate in relation to the Common Tariff Obligation. This consideration would also need to take account of the practical challenges involved in potentially extending the scope of the Common Tariff Obligation. For example, the range in consumption levels and characteristics among smaller non-domestic consumers may make it difficult to determine a comparable supply of electricity, which is a key feature of the Common Tariff Obligation.

Broader points

Broader points raised by respondents have not been considered further as part of this consultation process, as they are not directly within its scope.

3. Delivering the Shetland cross-subsidy

Consultation questions

3. Do you agree that the Hydro Benefit Replacement Scheme is the most appropriate way to deliver revised funding arrangements for the Shetland cross-subsidy? If not, why not and what other mechanism(s) should be considered?
4. Do you agree that the proposed design of the revised funding arrangements for the Shetland cross-subsidy is likely to be effective? If not, what changes or additions should be made?
5. Does the proposed design of the revised funding arrangements for the Shetland cross-subsidy achieve predictability of charges, transparency and efficiency of operation? Are there other important aspects that should be taken into account?

Summary of responses

Use of the Hydro Benefit Replacement Scheme

Of the 17 responses to these questions, none opposed use of the Hydro Benefit Replacement Scheme to deliver the revised funding arrangement and most offered strong support. It was noted that this is likely to represent the most efficient and transparent approach, and the Shetland cross-subsidy is relevant to the objectives of the Hydro Benefit Replacement Scheme.

Design of the funding arrangement

On the design of the revised funding arrangements, 8 respondents offered unqualified support for the Government's proposals. Other respondents offered a variety of comments:

- Three respondents said that their support for the proposals was qualified because their first preference would be to see more fundamental changes. These changes are described in the 'summary of responses' section of [Chapter 2](#), and entail either funding through general taxation or a single electricity distribution charge across GB.
- On the actual level of the assistance amount, one respondent noted that the accuracy of Ofgem's estimates for Shetland expenditure would be important, and another thought that the fixed subsidy approach was reasonable but it needed to be as close as possible to the actual cost.
- One respondent noted that the Government's proposed arrangement and mechanism for funding of the Shetland cross-subsidy should be reviewed in light of any outcomes

from Ofgem's Access and Forward-Looking Charges Review⁹ and RII02 price control process¹⁰.

- Transparency of arrangements was highlighted as an important consideration by two respondents, who regarded the separate identification of the existing and Shetland-related assistance amounts as beneficial. One respondent added that transparency could be further enhanced by introducing a licence condition requiring suppliers to apply the Shetland-related assistance in full.
- One respondent supported Government's view that the Default Tariff Cap and Prepayment Cap should reflect the costs of the assistance amount. To help achieve this, the respondent suggested that National Grid Electricity System Operator (as the administrator of the Hydro Benefit Replacement Scheme) may need to publish its annual scheme charging statement earlier in the year. The same respondent suggested that any unpaid charges arising from supplier defaults should be recovered by uplift to the standard Hydro Benefit Replacement Scheme charge, rather than separate mutualisation, so that it would be caught within the price cap methodology.

Predictability, transparency and efficiency of operation

In response to Question 5, two consultees considered that there would be insufficient time for suppliers to adjust consumer tariffs by April 2020 to take account of the proposed £27m increase in the scheme's funding level. This could mean that much of the benefit would not be passed on to end-consumers in the short-term, and it would be particularly difficult to adjust tariffs for those consumers on fixed price contracts. Instead, it was suggested that the Government should implement the increased funding from April 2021, so that the full benefit could be properly reflected in customer prices and contracts.

Government response

Use of the Hydro Benefit Replacement Scheme

The Government welcomes the strong support given by respondents to use of the Hydro Benefit Replacement to deliver GB-wide funding of the Shetland cross-subsidy. This revised funding arrangement will reduce the substantial burden that would otherwise be placed on North of Scotland consumers and also helps to underpin Shetland's long-term security of supply. As respondents have noted, the Hydro Benefit Replacement is well-established, understood and transparent, whilst use of an alternative mechanism would be likely to result in additional costs to establish and administer.

⁹ Through this recently launched review, Ofgem is seeking to ensure that electricity networks are used efficiently and flexibly. The scope of the review includes charges for use of the distribution network. Ofgem is aiming to implement any changes required, following the review, in 2023. Further details are available at: <https://www.ofgem.gov.uk/electricity/transmission-networks/charging/reform-network-access-and-forward-looking-charges>

¹⁰ Ofgem's RII0 (Revenue=Incentives+Innovation+Outputs) price control set a ceiling on the amount of revenue network companies can earn through network charges. The new price control for electricity distribution networks will begin in April 2023. Further details are available at: <https://www.ofgem.gov.uk/network-regulation-riio-model/network-price-controls-2021-riio-2/what-riio-2-price-control>

Design of the funding arrangement

The Government's proposal to set the Shetland related element of the assistance amount at £27m is based on the best estimates of the level of Shetland cross-subsidy produced by SHEPD and approved by Ofgem. The next statutory review of the Hydro Benefit Replacement Scheme is due in 2022, and this will provide an opportunity to review the accuracy of the funding level. The next statutory review will also provide an opportunity to take account of any relevant changes introduced by Ofgem's Access and Forward-Looking Charges Review and RII02 price control process, which are both due to be implemented in 2023. The Government confirms that updated scheme documentation, such as the charging statement published by National Grid Electricity System Operator, will separately identify the existing and Shetland-related assistance amounts, on the basis that this supports transparency. As noted in Chapter 2, the Government does not intend at this time to place a licence condition on suppliers to ensure the assistance amount is passed to end-consumers, but we will keep this under review.

On the Default Tariff Cap and Prepayment Cap, the Government has discussed the revised funding level of the Hydro Benefit Replacement Scheme with Ofgem and understands that it should be possible to take this into account without changing the scheme's existing arrangements.

Predictability, transparency and efficiency of operation

The Government is keen that North of Scotland consumers should receive the benefit of the increased assistance amount in full and at the earliest practical opportunity. We recognise the importance to suppliers of predictable costs when setting their consumer tariffs, and the challenges that would arise from needing to make changes at relatively short notice. We therefore intend to lay the necessary secondary legislation before Parliament to enable the changes to be implemented from April 2021, but we expect suppliers to pass on the full value of benefit to end-consumers from this point onwards.

Annex A: List of respondents

Argyll, Lomond and the Islands Energy Agency

Citizens Advice

Citizens Advice Scotland

Energy UK

Highland Council

Highlands & Islands Housing Associations Affordable Warmth Group

Highlands and Island Enterprise

National Grid Electricity System Operator

Npower

Orkney Housing Association

Scottish Government

Scottish Power

Shetland Islands Council

SSE

Viking Energy

In addition, 11 individuals responded

This consultation is available from: www.gov.uk/government/consultations/hydro-benefit-replacement-scheme-and-common-tariff-obligation

If you need a version of this document in a more accessible format, please email enquiries@beis.gov.uk. Please tell us what format you need. It will help us if you say what assistive technology you use.