Department for
Business, Energy
& Industrial Strategy

Hydro Benefit Replacement Scheme and Common Tariff Obligation

Three-yearly review of statutory schemes: response to consultation

January 2023

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

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Executive Summary

Overview of the schemes

It costs more to distribute electricity in the North of Scotland than elsewhere because of the unique geography of the region, which presents challenges to electricity networks. To help protect domestic and non-domestic consumers from these high costs, the Government's Hydro Benefit Replacement Scheme is providing an assistance amount of £94.97 million in 2022/23 to reduce the distribution costs ultimately borne by consumers in the North of Scotland. Ofgem estimates this is worth around £60 per household in that area. The scheme is funded by charges on all licensed electricity suppliers across Great Britain (GB). It includes an amount to cover the costs of a cross-subsidy for Shetland electricity consumers, which would otherwise need to be met by North of Scotland consumers.

In addition, the Government's Common Tariff Obligation prevents electricity suppliers in the North of Scotland from charging comparable domestic consumers different prices solely on the basis of their location within the region. This is designed to protect consumers in remote rural areas or islands from the relatively high costs of supplying electricity, compared to costs for urban areas of the North of Scotland.

Consultation details

There is a requirement for the Government to review these schemes every three years. As part of the latest review, the Government ran a consultation from 29th July 2022 to 23rd September 2022 which proposed:

- Retaining the Hydro Benefit Replacement Scheme and Common Tariff Obligation
- Continuing to share the costs of the Shetland cross-subsidy across GB consumers through the Hydro Benefit Replacement Scheme
- Making three technical improvements to the funding arrangements of the Hydro Benefit Replacement Scheme. These covered: switching the annual inflator for the assistance amount from the Retail Price Index to the Consumer Prices Index including owner occupiers' housing costs (CPIH); removing an 'embedded benefit'[1] distortion from within the scheme's current operating arrangements; and addressing an ambiguity in licence requirements that could be interpreted as requiring National Grid Electricity System

[1] 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.

Operator (ESO), in its role as the scheme administrator, to charge electricity suppliers twice to recover that element of the assistance amount relating to the Shetland cross-subsidy.

In total, 9 consultation responses were received from interested parties, including the energy industry, local authorities, consumer representatives and one individual. 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, as should GB-wide funding for the Shetland cross-subsidy. Other respondents considered that further measures were needed to increase the level of support for electricity consumers in the North of Scotland.

There was general support for the Government's proposed technical improvements to the funding arrangements of the Hydro Benefit Replacement Scheme. In addition, one respondent suggested three further improvements to the detailed operating arrangements of the scheme.

A list of respondents is attached at Annex A.

Conclusion and next steps

The Government remains committed to protecting consumers in the North of Scotland through the Hydro Benefit Replacement Scheme and the Common Tariff Obligation. This is reflected in the decisions set out in this Government Response document, including the Government's conclusion that both schemes remain effective overall and the technical improvements to the Hydro Benefit Replacement Scheme proposed in the consultation should now be progressed through secondary legislation.

There is a legal requirement to undertake a further review in three years' time[2].

[2] Energy Act 2004, Section 184(11)

Objectives of the schemes

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 costs of the Shetland cross-subsidy should continue to be shared across GB consumers through an additional assistance amount in the Hydro Benefit Replacement Scheme, rather than being met solely by North of Scotland consumers?

Summary of responses

Policy objectives of the schemes

All respondents addressed this point, with general agreement that the specific factors applying to the North of Scotland, including climate, terrain, greater reliance on electric heating and high levels of fuel poverty, justified support for the region. The protections provided by the Hydro Benefit Replacement Scheme and the Common Tariff Obligation were welcomed, but four respondents considered that further interventions were needed to ensure fair and equitable energy costs. Of these, two respondents proposed an uplift in the Hydro Benefit Replacement Scheme's level of assistance, and two others suggested full equalisation of electricity distribution charges across Great Britain should be pursued. One respondent noted that the North of Scotland is a net exporter of generation, and questioned why electricity distribution should therefore be more expensive in the region.

One respondent considered that the Common Tariff Obligation may be unnecessary, as electricity suppliers will typically charge common prices within a region, for reasons of simplicity and administration. It was also noted, however, that the Common Tariff Obligation has some value in providing additional assurance for remote, rural communities across the North of Scotland.

Treatment of Shetland costs

Of the 8 respondents who addressed this point, 7 agreed that the Shetland cross-subsidy should continue to be shared across all consumers in Great Britain. The additional costs needed to ensure Shetland's security of supply were highlighted, with the Hydro Benefit Replacement Scheme regarded as a transparent and efficient way to share these costs. One respondent disagreed with the Government's proposal to continue the Shetland cross-subsidy, but did not provide any explanation for this view.

Government response

Policy objectives of the schemes

The challenges of electricity supply in the North of Scotland mean that electricity distribution costs are inevitably higher for the region than elsewhere. Particular challenges for the operation of the distribution system include weather conditions, a large and sparsely populated terrain, and supply to multiple islands. These factors are not removed by high levels of generation in the region. The Government welcomes respondents' recognition that the assistance provided through the Hydro Benefit Replacement Scheme significantly reduces the cost differential arising from these challenges, and the Government remains committed to the scheme's policy objectives.

On respondents' suggested uplift in the level of assistance provided through the Hydro Benefit Replacement Scheme, the Government does not intend to go beyond measures already in place. As described in the following section of this document, these measures cover annual inflation of the assistance amount and introduction of a Shetland related assistance amount in April 2021. The latter represents a £28 million benefit to North of Scotland consumers in 2022/23[3], who would otherwise need to fund all the costs of Shetland assistance. It is important that this assistance does not eradicate the cost-reflective nature of electricity distribution charges because this cost-reflective approach helps to support efficient running of the whole system and therefore minimise overall GB distribution costs. As such, the assistance provided by this scheme is designed to mitigate but not remove entirely the cost differential in the North of Scotland. Neither is the scheme intended to address issues unrelated to electricity distribution, which are best addressed through other measures, such as the Government's Energy Price Guarantee.

The Government continues to believe that the Common Tariff Obligation's policy intent of protecting domestic customers in the Highlands and Islands remains valid, as it is inevitable that the costs of supplying electricity to the more remote and rural areas will remain higher than to the urban areas of the North of Scotland. Whilst it is possible that suppliers may decide not to increase charges in the Highlands and Islands following any removal of the Common Tariff Obligation, its retention provides helpful assurance.

Treatment of Shetland costs

The Government remains committed to protecting consumers in the North of Scotland from the higher costs currently associated with Shetland's energy infrastructure. As consultation respondents have noted, the Hydro Benefit Replacement Scheme provides an efficient and transparent way of achieving this, by sharing those costs across GB consumers.

[3] Charging Statement for 2022/23, available at: https://www.nationalgrideso.com/industry-information/charging/assistance-areas-high-electricity-distribution-costs-aahedc

Operational effectiveness of the schemes

Consultation questions

3. Do you agree that the Hydro Benefit Replacement Scheme and Common Tariff Obligation remain operationally effective, and main features should be retained in their current form?
4. Do you agree that the inflator for the Hydro Benefit Replacement Scheme should switch from the Retail Price Index to the Consumer Prices Index including owner occupiers' housing costs (CPIH), in line with Ofgem's RIIO price control process?
5. Do you agree that the embedded benefit associated with the Hydro Benefit Replacement Scheme should be removed by changing the basis on which suppliers are charged, from net to gross charging?
6. Do you have any comments on the embedded benefit analysis undertaken by BEIS, as set out at Annex C of the consultation document?
7. Do you agree that the level of GB-wide funding provided through the Hydro Benefit Replacement Scheme for the Shetland cross-subsidy should remain unchanged over the next three years (i.e. £27 million per year, adjusted for inflation)?

Summary of responses

Operational effectiveness

The effectiveness of the schemes was covered by all respondents, with most giving their general support to current arrangements. A preference for an equalised electricity distribution charge across Great Britain was identified in three responses as a more effective approach.

One respondent raised two detailed issues on the Hydro Benefit Replacement Scheme's operation:

- It was noted that the near-term cashflow risk arising from administration of the scheme has increased in materiality since the previous statutory review in 2019/20, as a result of current system and market conditions. An illustration was provided, showing that the ESO is currently expecting to collect £87.1 million from suppliers versus the Total Scheme Amount of £95.0 million. This means that the ESO will be required to fund £7.9 million from its own resources until collection takes place in the following year. It was suggested that the ESO should not be expected to act in this way, and that the impact of cashflow risks should be given further consideration.

- It was proposed that the wording in licence term HBCt-1 should be amended to confirm that the benefit of suppliers' late payments from any prior year can be included in future tariff setting. The scheme is currently operated in this way, but HBCt-1 could be read as only allowing revenue for the previous charging year to be included (ie a late payment relating to 2022/23 can only be taken into account for the 2023/24 tariff, whereas the policy intent is that it can be taken into account in a later year if necessary).

On the operation of the Common Tariff Obligation, two respondents considered that its scope should be extended from households to also cover microbusinesses and small and medium enterprises (SMEs). Support for these sectors in the North of Scotland was regarded as particularly important, with evidence presented that SMEs account for a larger share of employment in rural areas compared to urban areas, and the region's business base is dominated by microbusinesses.

Updating the inflator

Seven responses covered this question, and all agreed that the inflator for the Hydro Benefit Replacement Scheme should switch from RPI to CPIH. It was noted that this change would be in line with other regulatory mechanisms, and there was no reason to treat the Hydro Benefit Replacement Scheme differently.

Alongside changing RPI to CPIH, one respondent suggested that the opportunity should be taken to update the reference to Barclays Bank plc base rate in Standard Condition C20 of the Electricity Transmission Licence, to ensure consistency with Ofgem's RIIO price control process. It was noted that the RIIO price control now uses the average value of SONIA (SONIA being the daily values of the sterling overnight index average, series ID "IUDSOIA", published by the Bank of England (or any other public body acquiring its functions)) to apply to bank rates, and the same approach should apply to the Hydro Benefit Replacement Scheme through amendment of Standard Condition C20. The respondent noted that the base rate is also referred to in Standard Condition C21, regarding late payments, but this should remain unchanged to maintain consistency with late payment terms for other charging aspects.

Removal of embedded benefit

All 8 responses to this question supported the removal of the embedded benefit associated with the Hydro Benefit Replacement Scheme. There was broad recognition that the embedded benefit distortion results in an unnecessarily high tariff to fund the scheme, and has been addressed for similar charging arrangements through a move from net to gross charging[4].

There was no disagreement with the embedded benefit analysis undertaken by BEIS[5].

[4] This would mean a supplier's tariff would be calculated solely on the basis of the total amount of electricity it supplies (gross demand), instead of treating exports as negative demand which are netted off against gross demand

[5] The embedded benefit analysis is set out at Annex C of the BEIS consultation document published on 29 July 2022 https://www.gov.uk/government/consultations/hydro-benefit-replacement-scheme-and-common-tariff-obligation-statutory-review-2022

Shetland cross-subsidy funding

All 8 respondents to this question agreed that the level of funding provided through the Hydro Benefit Replacement Scheme for the Shetland cross-subsidy should remain unaltered at this time. Two respondents noted that there would be more certainty on Shetland costs in 2025, and the next statutory review of the Hydro Benefit Replacement Scheme in three years would therefore represent an appropriate opportunity to review funding.

Government response

Operational effectiveness

In line with consultation responses, the Government continues to believe that, in general, both schemes remain operationally effective. No substantive changes are therefore planned as a result of this statutory review.

The Government recognises that the cashflow risk arising from the ESO's administration of the Hydro Benefit Replacement Scheme is a material issue and is currently exploring with the ESO and Ofgem how this might be addressed.

The intent of the Hydro Benefit Replacement Scheme's licence term HBCt-1 is clear in that it should allow the benefit of any late payments from suppliers to be included in the tariff for any subsequent years as necessary. However, the Government accepts that the wording of the licence term is open to interpretation and will address this through a minor clarification in secondary legislation.

Whilst the case has been well made by consultation respondents that microbusinesses and SMEs are vital to rural areas of the North of Scotland, the Government has still not seen evidence to show that extension of the Common Tariff Obligation to these smaller non-domestic consumers would be necessary, beneficial or practical. Identification of such evidence is particularly important, as there is a risk that this intervention could be counterproductive, by distorting the market and driving out competition amongst suppliers in the region. The Government notes that microbusinesses in the North of Scotland should benefit from Ofgem's strategic review of the microbusiness retail market, which has recently introduced measures to provide greater levels of transparency and enhanced protection for the sector across GB.

Updating the inflator

In line with proposals set out in the consultation document, the Government will take forward secondary legislation to switch the inflator for the Hydro Benefit Replacement Scheme from RPI to CPIH at the earliest opportunity.

It is understood that the respondent's proposed change to the treatment of the Barclays Bank plc base rate in Standard Condition C20 of the Electricity Transmission Licence is not an urgent matter, and the Government will explore this further before deciding how to proceed.

Removal of embedded benefit

The Government continues to believe that the embedded benefit distortion results in higher overall consumer costs and a higher scheme tariff than is necessary, and this view is supported by consultation responses. Measures will therefore be progressed through secondary legislation to remove this embedded benefit distortion at the earliest opportunity. This will be achieved by calculating the scheme tariff on the basis of a supplier’s gross demand (i.e. the total amount of electricity it supplies), instead of its net demand.

Shetland cross-subsidy funding

The next statutory review of the Hydro Benefit Replacement Scheme is scheduled to begin in 2025, at which point consultation respondents agreed there should be more certainty on Shetland costs. The level of funding provided through the Hydro Benefit Replacement Scheme for the Shetland cross-subsidy will therefore remain unaltered until the next statutory review, at which point it will be reviewed.

Conclusion and next steps

The Government remains committed to protecting consumers in the North of Scotland from the inevitably high costs of electricity distribution in the region. The Government has concluded that the Hydro Benefit Replacement Scheme and the Common Tariff Obligation are effective in achieving this, subject to four technical improvements to the funding arrangements of the Hydro Benefit Replacement Review noted in the preceding section of this document. These technical improvements will be progressed through secondary legislation, and the Government will be working with the ESO and Ofgem to ensure readiness for the next charging year in April 2023.

There is a requirement under Section 184 of the Energy Act 2004 to undertake a review of the Hydro Benefit Replacement Scheme every three years, with the next review due to begin in 2025. Before this next review, the Government will progress consideration of two further technical funding points raised as part of the consultation, related to ESO cashflow and treatment of a reference in the scheme arrangements to the Barclays Bank plc base rate.

Annex A: List of respondents

Energy Saving Trust

Highlands & Islands Housing Associations Affordable Warmth

National Grid Electricity System Operator

Orkney Housing Association

Scottish Federation of Housing Associations

Scottish Power

Scottish and Southern Electricity Networks

In addition, one individual responded and one confidential response was received.

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