



**HYDRO BENEFIT
REPLACEMENT SCHEME
AND COMMON TARIFF**

**THREE YEAR REVIEW OF
STATUTORY SCHEMES**

JULY 2009

HYDRO BENEFIT REPLACEMENT SCHEME AND COMMON TARIFF OBLIGATION – THREE YEAR REVIEW OF STATUTORY SCHEMES

Executive Summary

Section 184 of the Energy Act 2004 gives the Secretary of State 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 (HBRS). The payment must be passed from the distributor to authorised suppliers within the area. The scheme must be funded by charges on suppliers across Great Britain.

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 Great Britain by a significant margin. The Act requires the scheme to be reviewed every three years.

The Common Tariff Obligation (CTO) prohibits suppliers from discriminating among comparable customers in its charges on the basis of their location in the North of Scotland. It is important to note that the CTO 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. Ministers committed to reviewing the working of the CTO in parallel with the HBRS review.

The Government has considered the operation of the two schemes in conjunction with National Grid who are responsible for operating the scheme through conditions included in their licence imposed by Ofgem. In operational terms, the schemes are evidently running smoothly. Government also considers that their original policy objectives remain relevant and both schemes continue to meet those objectives.

On this basis the Government is therefore not at this stage minded to make any changes to the Orders governing both the HBRS and CTO. Comments from stakeholders on this approach would be welcome.

There is no sunset clause included in either scheme, so both continue to operate whilst the review is carried out. Government will also be obliged to carry out a further review after April 2011.

Policy Background

What is the Hydro Benefit Replacement Scheme (HBRIS)?

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 Great Britain by a significant margin. It is important to bear in mind that the policy behind the HBRIS (and the CTO) is not to tackle fuel poverty, but to ensure that those consumers living in the North of Scotland do not face discriminatory pricing as a result of where they live.

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 distribution or transmission 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 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.

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 was effectively free (in that it was basically rain fall and snow melt) 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.

The original scheme was abolished in January 2004, following legal advice to Ofgem that it was incompatible with EU law. The then Energy Minister, Stephen Timms MP, announced that a new scheme would be created to replace it, whereby the high costs of electricity distribution to consumers in the North of Scotland would be spread across Great Britain. This new scheme commenced on 1 April 2005 under the power in section 184 of the Energy Act 2004¹. It maintained the subsidy provided by the old scheme, at the same level. SSE agreed to continue to pay the subsidy on a voluntary basis while the new scheme was being put in place. The subsidy has since been funded by charges on licensed suppliers across GB.

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

How does the HBRs work?

Section 184 of the Energy Act 2004 gives the Secretary of State 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 suppliers across Great Britain.

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.

What is the Common Tariff Obligation (CTO)?

The CTO² 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. The issue is one of avoiding discrimination caused by living in an area where it is significantly more costly to supply electricity and the potential socially undesirable consequences that may otherwise occur.

The CTO prohibits suppliers from discriminating among comparable customers in its charges on the basis of their location in the North of Scotland. It is important to note that the CTO 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.

The CTO 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 CTO would be applied to as 'North Scotland'.

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.

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

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 refers to the CTO 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 CTO work?

The CTO 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”.

The CTO is a self-sufficient scheme requiring no separate funding from Government, taxpayers or other market participants.

Why are we reviewing these Orders?

Section 184 requires the scheme to be reviewed every three years. A Ministerial commitment was made to review the CTO after three years at the same time as the HBRS.

What is Government position?

Government has had informal contact with both Ofgem and National Grid about the operation of the two schemes. In September 2008, officials also wrote to all licensed transmission, distribution and supply companies explaining that the statutory review was taking place, asking for any initial comments and flagging up that a statement would be published for consultation. These contacts contributed to forming the Government's initial view that, in operational terms, the Schemes continue to run smoothly.

On this basis the Government is therefore not at this stage minded to make any substantive changes to the Orders governing both the HBRS and CTO, 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. In addition, Government will be obliged to carry out a further review in another three years.

Rationale for this approach

When the HBRS came into force in 2005 with the switch to 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. Government has seen no evidence subsequently to suggest that this position has changed.

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.

Call for Comments

DECC invites views on any aspects of this statement, but in particular whether stakeholders agree with the view that both the HBRS and CTO continue to meet their original policy objectives and are operationally effective.

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 HBRS Order identified changes in the names of local councils that were used to define the North of Scotland area.

The deadline for responses is 23 September 2009. 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. A written response can be submitted by post or e-mail to:

Steve Davies
DECC
Area D, 4th Floor
3 Whitehall Place
London SW1H 0ET
Tel: 0300 068 6088
e-mail: steve.davies@decc.gsi.gov.uk

Questions about the policy issues raised in this document or the associated annexes should also be sent to this address.

What happens next?

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

Confidentiality and data protection

Your response may be made public by DECC. If you do not want all or part of your response or name made public, please state this clearly in the response. Any confidentiality disclaimer that may be generated by your organisation's IT system will be taken to apply only to information in response for which confidentiality has been requested.

Information provided in response to this statement, including personal information, may be subject to publication or disclosure in accordance with the access to information regimes (primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004). If you want other 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.

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.