

Scottish Hydro-Electric plc

A report on a reference under section 12
of the Electricity Act 1989



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12 of the Electricity Act 1989

**Presented to the Director General of Electricity Supply
May 1995**

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¹These members, together with Professor M Bromwich and Professor J A M Kennerley (selected by the Chairman of the Commission under section 12(9) of the Electricity Act 1989), formed the Group which was responsible for this report.

Note by the Office of Electricity Regulation

In accordance with section 13(6) of the Electricity Act 1989, the Secretary of State for Scotland has directed the Director General of Electricity Supply to exclude from the published report certain matters publication of which appears to the Secretary of State to be against the public interest or the commercial interests of a person. Accordingly certain figures and text have been omitted. The omissions are indicated by a note in the text.

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Part I

Summary and Conclusions

1 Summary

1.1. On 14 November 1994 the Director General of Electricity Supply (DGES) made a reference under the Electricity Act 1989 concerning the licence of Scottish Hydro-Electric plc (HE). The terms of the reference are set out in Appendix 1.1.

1.2. HE, in contrast to the non-Scottish electricity companies, is fully integrated and covers generation, transmission, distribution and supply activities. Transmission and distribution are monopoly activities and the price controls on distribution form part of this reference. Price limits for the transmission business had been agreed between the company and the DGES in 1993. The generation business, which is a licensed activity, is subject to competition and its prices are not directly regulated. The supply business is open to competition for larger customers but remains a monopoly for others. The price controls for supply also form part of this reference.

1.3. HE is the Public Electricity Supplier (PES) for the northern part of Scotland including the Western Isles and the Orkney and Shetland Islands. Although its authorized supply area covers some 54,000 square km, which is about 25 per cent of Britain's land mass, it contains only 2 per cent of the population. Geography and climate have a strong influence on HE's operations. The harsh terrain and low density of population make the electricity system costly to maintain. However, the geography and climate also provide HE with a major benefit—the ability to generate hydro-electric power at low running costs. This has enabled it to finance its high distribution costs without imposing high charges on consumers. At the time of privatization in May 1991 special provisions were set in place to allow a cross-subsidy by way of 'hydro benefit' from the generation business to the distribution business (£29 million per annum uprated by inflation) and the transmission business (£11 million per annum uprated by inflation) to cover their higher costs.

1.4. At privatization the regulatory regimes to which HE and ScottishPower were subjected were more stringent than those applying to the other privatized electricity companies.

1.5. Our terms of reference require us to establish whether the continuation without modification of the existing distribution and supply price controls contained in Schedule 6 of HE's licence together with the hydro benefit provisions in Schedule 7 operates or may be expected to operate against the public interest and, if so, whether any adverse effects could be remedied or prevented by modifications to the licence. We have found a number of respects in which the continuation of the Schedules may be expected to operate against the public interest and have specified appropriate modifications.

1.6. In considering appropriate price limits on the *distribution business* we have:

- (a) established the current capital employed in the distribution business. This is based on current cost accounting (CCA) values used by the Scottish Office in setting prices at the time of privatization and adjusted upwards for inflation and net new investment since privatization;

- (b) established a cost base for the distribution business on the basis of historical trends. This base is considerably lower than that sought by the company and below that allowed for by the DGES in his recent price review. We have applied a 2 per cent per annum cost reduction in the four years following 1995/96 to encourage efficiency;
- (c) determined appropriate levels of investment over the forthcoming five-year period. This amounts to £247 million and is £22 million higher than the amounts allowed by the DGES;
- (d) adopted a cost of capital of 7 per cent to determine reasonable levels of profitability on existing and prospective investment over the next five years; and
- (e) applied a significant portion (£29.2 million at 1994/95 prices) of the available hydro benefit to cross-subsidize the distribution business to ensure that prices remain broadly comparable to those charged by ScottishPower's distribution business.

The overall effect of our distribution price limits would be to generate price reductions over and above those accruing from the present regulatory limits. They would also ensure a substantially enhanced refurbishment programme for the distribution network which should produce better quality of supply, particularly to customers in outlying areas.

1.7. In considering appropriate price limits on the *supply business* we have:

- (a) established a cost base for supply based on historical trends. This is below that sought by the company but above that allowed for by the DGES. We have applied a 2 per cent per annum efficiency cost reduction in the years following 1995/96;
- (b) allowed for a profit of £1.5 million per annum, which is equivalent to a return of about 7 per cent on the assets invested in the supply business and about 0.5 per cent on turnover; and
- (c) allowed for the generation component of the supply price to be reduced over the next four years under the established formula set out in the licence from existing prices to the Great Britain yardstick. The GBY is the average price paid for generation by franchise customers (ie customers using up to a maximum of 100 kW) in England and Wales. This price is substantially lower than the price currently paid by HE's franchise customers and would ensure that, at the end of the four years, customers in HE's area are not disadvantaged in respect of generation costs compared with their counterparts in the rest of Great Britain.

The effect of these changes would be to reduce the overall supply prices to HE customers substantially over the next four years but not to quite the degree proposed by the DGES in his recent review.

1.8. On hydro benefit we have confirmed the principle that this cross-subsidy from the profits of hydro generation should continue to be available in the future to ensure comparability of HE prices with those elsewhere. However, because the present text of Schedule 7 does not properly reflect this principle, and therefore causes misleading regulatory accounts to be produced, we have drawn up a modified text. The maximum amount of hydro benefit would remain at £40 million (increased by inflation).

1.9. We estimate that the overall effect of these price controls would be to reduce real prices to the average HE franchise customer by 8.5 per cent by 1997/98. The prices are sufficient to allow the company to accelerate the refurbishment of its distribution network and so improve the reliability of supply in the Highlands and Islands. We recommend that the DGES sets specific targets for this improvement and monitors performance against them.