

11 Views of other parties

Contents

	<i>Page</i>
The Scottish Office	154
Electricity generators	155
National Power PLC	155
Nuclear Electric plc	156
PowerGen plc	156
Scottish Nuclear Limited	157
Scottish Power plc	157
British Nuclear Fuels plc	158
London Electricity plc	158
Scottish regional and local councils	159
Fife Regional Council	159
Highland Regional Council	159
Lochaber District Council	159
Moray District Council	160
Orkney Islands Council	160
Perth & Kinross District Council	161
Shetland Islands Council	161
Skye & Lochalsh District Council	161
Sutherland District Council	162
Western Isles Island Council	162
Scottish bodies	163
Aberdeen Chamber of Commerce	163
Association for the Protection of Rural Scotland	163
CBI Scotland	163
Energy Action Scotland	163
Highlands & Islands Enterprise	164
North of Scotland Electricity Consumers' Committee	164
Scottish Energy Buyers Group	165
Scottish Enterprise	166
Scottish Natural Heritage	166
Scottish Tourist Board	166
Other bodies	167
Association for the Conservation of Energy	167
Chemical Industries Association	167
Others	167
BOC Gases Europe	167
Highland Power Cabling Ltd	168
Individuals	168
Mrs Christine Davis	168
Mr Yogi Dutta	168
Mr John H Sheddon	169

The Scottish Office

11.1. The Scottish Office explained that the Secretary of State, in privatizing the non-nuclear Scottish electricity supply industry, was keen to ensure that the two new companies, ScottishPower and HE, replacing the SSEB and the NSHEB respectively, would be economically viable and would compete with each other. He also favoured overall tariff continuity at the point of privatization of the successor companies. Having considered alternative structures for the proposed privatization, the Secretary of State decided that HE and ScottishPower should be privatized as vertically integrated companies, ie undertaking transmission, distribution, supply and generation functions. The provision for vertical integration continued a difference in the structure of the electricity supply industry north of the border compared with that south of the border.

11.2. The Secretary of State recognized the importance of the unique geographical aspects of the area covered by HE. The low density of population together with the nature of much of the terrain covered made the distribution network expensive to maintain. On the other hand the company inherited the major financial benefit of the availability of hydro-electric power with low running costs.

11.3. The Scottish Office explained that a broad calculation of both factors was made prior to privatization. In order to enable HE to meet its high distribution costs without imposing a heavy financial penalty on consumers, provision was made within the company's composite licence for a cross-subsidy up to a given limit from within the company's generation costs. This mechanism for providing for such a cross-subsidy to the transmission and distribution systems was viewed by the Scottish Office as having a degree of permanence in the sense that the Secretary of State had made such a provision in HE's licence. There was, however, no necessary permanence attaching to the amount of the cross-subsidy. The Secretary of State had included provision for its review.

11.4. The Scottish Office explained that hydro benefit was calculated as part of an exercise to ascertain the long-term cost of supply. However, this was an earlier exercise and the final supply price along with the prices for generation, transmission and distribution did not depend on considerations of the long-run cost of supply. Instead, tariff continuity was a key concern in establishing the initial prices and, in order to achieve the latter, it was not in the event necessary to draw on hydro benefit, although the principle that it remained available for any necessary cross-subsidy remained important.

11.5. The Scottish Office noted that although there was overcapacity in generation both north and south of the border the flow of electricity (via the interconnector) had thus far tended to be largely from Scotland to the south. As a result of earlier investment decisions the Scottish companies had inherited modern efficient generating stations which were able to produce electricity at lower marginal costs than their competitors south of the border. They expected that this pattern might change over time. In the short term, however, the England-based generators had not required to create new capacity. The Scottish electricity exports were deemed by OFFER to attract exemption from the nuclear levy until the levy itself ended.

11.6. The Scottish Office said that the Secretary of State had recognized that Scottish circumstances including the proportionately high generation capacity might lead to a slower build-up in direct competition from new entrants to the market to ScottishPower and HE. He had therefore put in place a number of regulatory measures which would in effect ensure that Scottish electricity consumers would benefit from competitive pressures. The Scottish Office pointed out that under these arrangements a supplier based in England did not necessarily have to transmit electricity northwards over the interconnector to supply a Scottish customer. Under the non-discriminatory arrangements put in place HE and ScottishPower were obliged to sell electricity to other generators at the market price. The Scottish Office thought there was increasing evidence of competition from non-Scottish suppliers in gaining supply contracts with Scottish customers. They expected that this competition would increase over time even amongst companies which at present thought of the Scottish market as being separate from that in England and Wales.

Electricity generators

National Power PLC

11.7. National Power PLC told us that though it was not privy to all the information relating to distribution price control, it recognized that companies needed to earn a reasonable return on their assets in order to attract capital for new investment, to provide efficient signals for the use of resources, and to provide a fair return for investors. Available information suggested that the proposal by the DGES allowed a rate of return which was markedly below a level to satisfy these criteria and below the level allowed by the DGES and other regulators for other price control assessments.

11.8. National Power said that it was seriously concerned about the combined effects of the operation of the Scottish supply price controls and the 'green ticket' arrangements for non-nuclear exports to England and Wales. These effects were:

- (a) competition in the England and Wales market for generation was distorted;
- (b) consumers in England and Wales cross-subsidized nuclear production for the Scottish market; and
- (c) electricity prices in England and Wales were higher than they would otherwise be.

National Power explained that under the green ticket arrangements exports over the interconnector were exempt from the fossil fuel levy. Suppliers in England and Wales were normally required to pay this levy of about 10 per cent of the delivered price of electricity. The benefits of this levy exemption were likely to be shared between HE and the purchasing supplier(s) and distorted competition in the England and Wales market. National Power complained that the present and proposed supply price controls allowed HE to export nuclear electricity at prices subsidized by Scottish franchise consumers. This also distorted competition and was contrary to the public interest. National Power added that though the DGES had proposed that the subsidy paid by Scottish franchise consumers should be reduced to the extent of HE's green ticket benefits this would do nothing to alleviate the distortion in the England and Wales market.

11.9. National Power complained that English and Welsh consumers were not only paying for the excess costs of nuclear generation in England and Wales but also making a contribution to the excess costs of nuclear generation in Scotland. National Power considered that this cross-subsidy and its impact on prices was also against the public interest. It suggested that the public interest detriments it had identified would be rectified by a recognition in the price control licence condition that Scottish nuclear output must be allocated to the Scottish franchise. HE's price control should then be set at a level sufficient to recover the full excess costs of its purchases from SNL.

11.10. Regarding the question of supply within Scotland, National Power referred to the DGES's latest annual report which had identified a complete lack of competition in the Scottish market other than from HE and ScottishPower. This had been borne out by National Power's own attempts to enter the market. It argued that the present institutional framework and regulatory structure was not sufficiently conducive to competition in Scotland. Potential new entrants to the Scottish market were deterred by the fact that they were required to purchase their requirements at pool selling price (the price at which purchasers might obtain electricity from the England and Wales pool), whereas the Scottish companies could charge their own supply businesses less. National Power believed this should be rectified by imposing on HE's generation business a requirement similar to that which was included in the generation licences of the major England and Wales generators, namely that it should offer prices to independent suppliers similar to those charged to its own competitive supply business.

11.11. Secondly, National Power said that pool selling price included pool uplift which it believed exceeded uplift costs in the Scottish system. More generally, pool selling price represented the market price in the England and Wales system. National Power assumed that the market price in the Scottish system must normally be expected to be lower, which would explain the volume of exports from Scotland to England and the upgrading of the interconnector.

11.12. National Power concluded by saying that it believed the public interest would be best served by the development of a transparent, open and unbiased market for buying and selling electricity in Scotland. This

would reinforce National Power's proposal for a non-discrimination condition and would help ensure that all suppliers had equal access to competitively-priced generation. Provided these changes were made, new entry and competition in the Scottish supply market would be successful and the present regulated customer price control would be redundant. In addition, it would be appropriate to replace the under 1 MW control with one for under 100 kW customers.

Nuclear Electric plc

11.13. Nuclear Electric said that it was not in a position to comment in detail on the appropriateness of the distribution price control formula recommended by the DGES for HE. However, in making an assessment, Nuclear Electric stressed that account would clearly need to be taken of the level of distribution revenue currently permitted, the need for further investment in the distribution system, and the geographic environment in which HE was required to provide and operate a distribution system. Taking account of these factors Nuclear Electric believed HE should not be penalized or compensated more than other public electricity suppliers.

11.14. Regarding supply, Nuclear Electric considered that the business of supply was not fundamentally different from one part of the UK to another. Accordingly, it thought it appropriate that the same price control formula should apply throughout England, Wales and Scotland to monopoly regulated electricity supply businesses.

11.15. Nuclear Electric observed that the growth of competition in supply to customers with demands in excess of 100 kW in England and Wales had not been reflected in Scotland. Nuclear Electric thought the absence of a transparent competitive wholesale market in Scotland was a major contributory factor to the apparent lack of competition in supply.

11.16. Nuclear Electric believed transparency and competition in the wholesale sector of the Scottish electricity market could be enhanced if the generation sector in Scotland was opened up to competition from England and Wales by introducing reciprocal trading arrangements across the England/Scotland interconnector, which was presently under the effective control of the Scottish companies.

11.17. Nuclear Electric mentioned that it was a relative newcomer to the supply business. Although it had a second-tier supply licence for Scotland, it had not yet attempted to secure customers in the areas operated in by either HE or ScottishPower. Nuclear Electric explained that its reluctance was predicated by its understanding from other participants in the market that the necessary associated trading arrangements offered by the two vertically integrated Scottish power companies served to discourage new entrant suppliers. In the light of these comments, Nuclear Electric said that it would welcome consideration as to whether the regulatory structure for the overall trading arrangements applicable to HE were appropriate for encouraging open competition in supply in addition to the specific supply price control.

11.18. Finally, regarding the transfer of revenue from the generation business to the distribution and transmission business, Nuclear Electric said that it recognized this issue as being unique to HE and it could not therefore draw immediate equivalent parallels in England and Wales. Nuclear Electric added that the principle of cross-subsidy was a concern. Unless it was correctly recognized and openly administered, it might be used anti-competitively by discriminatory or predatory pricing between the different business interests of a single organization.

PowerGen plc

11.19. PowerGen said that, as the leading second-tier supplier of electricity to non-franchise premises in England and Wales, it had considerable concerns over the lack of competitive access to the electricity supply market in Scotland. PowerGen added that whilst it was pleased to see competition amongst electricity suppliers it was nonetheless concerned that Scottish suppliers had apparent advantages which it was denied.

11.20. PowerGen explained that it had started to quote to Scottish companies as an electricity supplier in 1991/92. It had tendered mainly to large customers, particularly to those whose sites it already supplied in England and Wales. PowerGen thought these customers would want to benefit from savings in administrative

costs by having only one supplier. However, PowerGen said that though it had quoted what it thought were competitive prices it had only won three sites in its first year in Scotland. In the past year PowerGen had quoted for 423 sites in Scotland. It had so far secured one site for 1995/96, which was its first win in Scotland for four years. PowerGen added that an incumbent supplier in Scotland clearly had a number of competitive advantages which other suppliers could not match. Many Scottish companies had requested quotes but had evidently found the price gap so wide that they were not prepared to switch supplier.

11.21. PowerGen explained that it was also disadvantaged regarding the export of electricity between England and Wales and Scotland. Although electricity could flow both ways through the interconnector, it tended to flow only in one direction—from Scotland. The way that the trading arrangements were set up for the interconnector were such that the Scottish generating companies in effect controlled the direction in which the power flowed. Also, PowerGen understood that the Scottish companies benefited from a 'green ticket' arrangement which gave them a significant price advantage and allowed them to undercut other suppliers to the England and Wales pool. PowerGen added that it had only become aware that all Scottish exports were levy exempt when it had read OFFER's price control proposals for Scotland. These suggested that the benefits of the green ticket should be netted off against the excess cost of Scottish nuclear power. PowerGen said that it opposed the idea of a green ticket: it considered such a subsidy unnecessary for any section of the electricity supply industry. Non-Scottish suppliers were also disadvantaged by the fact that there were no pooling or metering arrangements in Scotland. PowerGen argued that if obvious forms of discrimination existed in the industry, OFFER should intervene to ensure that fair competition existed amongst suppliers.

Scottish Nuclear Limited

11.22. SNL said that it sold all of its output to ScottishPower and HE under the NEA, a take-or-pay contract which ended in 2005. HE was therefore an extremely valued customer and SNL would do all it could to ensure its continued commercial success. SNL's continuing pressure to reduce its costs was aimed at positioning the company as a competitive, reliable and profitable supplier to HE and others. Equally, SNL said that it saw the need for HE to be able to make a reasonable return from its assets and to facilitate investment in a reliable and efficient grid. SNL concluded by saying that it hoped that the outcome of the inquiry fully reflected these factors and would allow a fair return which would encourage investment in the industry.

Scottish Power plc

11.23. ScottishPower explained that, apart from the populous industrial belt of central Scotland, which included Glasgow and Edinburgh, much of its area encompassed large tracts of sparsely populated rural country similar in nature to that covered by HE. Next to HE, ScottishPower was the second least densely populated of all the PESSs.

11.24. ScottishPower said that at present it had access to 27 per cent of hydro capacity in Scotland—11 per cent was owned by ScottishPower, whilst the remaining 16 per cent was obtained via a restructuring contract with HE under which ScottishPower was required to pay fossil fuel rates. ScottishPower pointed out that whilst HE's share of cheap hydro energy was 89 per cent, its own share was only 11 per cent. This gave HE a definite competitive advantage.

11.25. ScottishPower told us that it competed vigorously for customers both in Scotland and in England and Wales. Competition was mainly price-driven. HE was ScottishPower's main competitor within Scotland. ScottishPower had retained 90 per cent of its sales whilst the remainder had been lost, mainly to HE. ScottishPower had in turn enjoyed some success in winning over former HE customers.

11.26. ScottishPower explained that its sales to England and Wales were of increasing importance. Exports for the previous year accounted for just over 12 per cent of unit sales in Scotland whilst more than 50 per cent of ScottishPower's profit growth came from exporting. ScottishPower said that it was also active as a second-tier supplier in England and Wales and had opened offices in London and Birmingham. ScottishPower added that it bought electricity at the common pool price for its retail operations in England and Wales.

11.27. ScottishPower explained that its interest in the inquiry was twofold:

- (a) given the nature and location of its business it was concerned about any change in arrangements which might alter the relative competitive position of ScottishPower and HE; and
- (b) the DGES, in commenting on the terms of reference for the inquiry, had indicated that he would consider 'the implications, if any, for the RECs and ScottishPower'.

ScottishPower said that it understood that hydro benefit was introduced at vesting to ensure that, within the principle of tariff continuity, the charges for the use of HE's transmission and distribution systems were broadly kept in line with those of the rest of the electricity supply industry. Since the benefit was an integral part of the vesting arrangements, investors were led to believe that the benefit mechanism would remain in place for the foreseeable future.

11.28. ScottishPower pointed out that, in isolation, any adjustment to the size of the hydro benefit would result in a reallocation of wealth between HE's customers and its investors. ScottishPower thought the MMC would want to consider, during the course of their inquiry, whether or not it would be appropriate for investors to gain at the expense of consumers. ScottishPower said that its main concern was that any decrease in the size of the benefit would change the competitive environment in Scotland and might encourage HE to behave in a non-commercial way, whilst still allowing it to make sufficient generation profits.

11.29. ScottishPower argued that at vesting the two Scottish companies were subject to the tightest regulatory parameters of the whole of the electricity supply industry in Great Britain, principally because of different approaches adopted by the Scottish Office and the Department of Energy at that time. In arriving at his proposals for the control of generation prices, the DGES chose not to adapt the control to reflect the differences in the characteristics of the reduced franchise market to which the new control applied.

11.30. In relation to the distribution and supply business price controls, ScottishPower was concerned that the Scottish companies were not treated equitably with the RECs. Differences between the way in which the RECs and the Scottish companies allocated costs between supply and distribution initially led OFFER to adjust the Scottish companies' distribution costs upwards. OFFER subsequently made a number of other adjustments which appeared to have little justification and subsequently distorted the outcome of the reviews.

11.31. Nevertheless, ScottishPower concluded by saying that in spite of these concerns it had taken a commercial decision to accept OFFER's proposals, based on the assumption that the current competitive environment in Scotland would remain broadly unchanged.

British Nuclear Fuels plc

11.32. BNFL pointed out that as the inquiry was centred around the distribution and supply business it would only have an indirect impact on BNFL's joint generation venture with HE at Fellside. BNFL thought that as the output from the venture was part of HE's unregulated activities in England and Wales it would not form part of the MMC's deliberations.

London Electricity plc

11.33. London Electricity said that it understood that OFFER's proposals for HE's price controls were developed using similar methodologies to those used when reviewing price controls for the RECs. However, London Electricity considered that there were important differences in the way the Scottish companies were constituted and issues specific to HE were raised by these proposals.

11.34. London Electricity said that whilst it had no specific views on the proposals relating to the inquiry it did have general views about price cap regulation. London Electricity believed, in particular, that any assessment of operating costs should take into account the operating environment of the company. In addition, it had to recognize that distribution businesses had long-term responsibility for network assets. Price caps had to allow for sufficient funds to be raised for reinvestment in those assets and to provide for a sufficient return on that investment.

Scottish regional and local councils

Fife Regional Council

11.35. Fife Regional Council (Fife) pointed out that the electricity supply it received from HE was minimal at present, with most of its demand being satisfied by ScottishPower. Fife said that its enquiries had shown that the subject of the distribution and supply price levels for HE was extremely complex. Considerable time would be needed to examine the issues thoroughly to give an objective assessment of the situation. Fife understood that the main complaint from HE seemed to be the punitive effect of the withdrawal of the hydro benefit from the generation side to the 'wires' side, which would effectively reduce HE's scheduled refurbishment programmes.

11.36. Fife stated that its main concerns were that electricity supplies were reliable and commercially competitive. Fife added that as long as OFFER maintained this position with HE it was happy to leave the complex factors in the costing of generation and supply to OFFER's expertise.

Highland Regional Council

11.37. Highland Regional Council (HRC) told us that it was the major employer in the Highlands. It had some 1,500 sites taking supply from HE. At least 60 sites had demands in excess of 100 kW, with none in excess of 1 MW. Over 1,200 of the sites were totally reliant upon electricity for their power supplies.

11.38. HRC mentioned that in many areas of the Highlands the supply voltage was in excess of the declared 240 V. This created a number of problems, including a reduction in the life of fluorescent tubes and tungsten light bulbs, electrical equipment running less efficiently, damage to equipment from over-voltage and voltage surges (including the loss of computer memories and programs), and the additional cost of providing stand-by generation plant in rural areas.

11.39. HRC pointed out that electricity prices in the Highlands area were probably amongst the cheapest in the UK. HRC already benefited from discounts at a number of its sites. Generally, consumers within the area were content with electricity prices and preferred to see improvements in the quality of service, already regarded as high, rather than see a reduction in prices.

11.40. HRC said that it was concerned at the impact of privatization on a market where the majority of the population relied on electricity as their sole energy supply. The newly-evolving market did not appear to meet the needs of the community to the same extent as its predecessor. Also, HRC considered that the introduction of the competitive market, with its metering obligations, would have serious financial implications for the authority, even if it chose to stay with HE. HRC also pointed out that it might be unable to seek competitive supplies owing to the nature of its current connection agreement with HE. This agreement raised liability issues which had not yet been resolved but which were currently unacceptable. If this remained unresolved competition would not take place. HRC had investigated putting its electricity supply contracts out to tender but as yet HE remained its sole supplier.

11.41. HRC added that the cost of new connections had created a real social problem. The removal of the cross-subsidy and the requirement by HE to charge market prices made it increasingly impossible for migration to take place to rural communities.

11.42. HRC concluded by saying that although it was in dispute with HE on a number of issues, it nevertheless supported HE's claim that investment was urgently needed in the general transmission system and that the necessary funds must be found to enable that work to proceed.

Lochaber District Council

11.43. Lochaber District Council said that it agreed with the DGES's recommendations regarding HE's distribution and supply control mechanism.

Moray District Council

11.44. Moray District Council (Moray) told us that it supported the revised price control mechanism proposed by the DGEN as this would ensure that HE's existing distribution price controls were tightened and that supply charges would remain at the present level for the forthcoming year. In reaching this conclusion, Moray said that it took full account of HE's position and the principal grounds on which it was not accepting the proposals; namely, that they would leave HE with insufficient money to fund its distribution business and a supply control which would not allow the supply business to break even and could reduce levels of customer service.

11.45. Moray added that HE's perceived difficulties appeared to relate primarily to the fixed nature of hydro benefit. In Moray's view it would be more germane if the requirement for a more flexible mechanism was addressed, rather than seeking to increase generation prices to domestic customers in line with those paid by customers of the English RECs.

Orkney Islands Council

11.46. Orkney Island Council (OIC) explained that it represented an islands community with a sparse population and no heavy industry. With no other power supply Orkney was heavily dependent on HE for reliable and economic electricity supplies.

11.47. OIC said that given the diversity of consumers and the geography of Orkney, electricity supplies, provided by a submarine cable from the mainland, were reasonably reliable. The incidence of power cuts and the time taken to restore loss of supply were also considered reasonable. HE had made some improvements over the years, particularly in replacing worn-out distribution equipment, and customers were generally satisfied with the quality of service provided. OIC pointed out that it had received few complaints regarding the stability of voltage and the quality of supply. Concerns had, however, been expressed about the reliance on a single cable to the mainland, but this had not emerged as a major issue.

11.48. On the question of prices, OIC thought prices had been maintained at an acceptable level. Though it would obviously prefer prices to be pegged or reduced, OIC appreciated that if the supply lines were to be maintained then reasonable charges must be levied to pay for effective maintenance and capital improvements. OIC added that it would be concerned if HE tried to impose higher charges in Orkney than elsewhere to cover the higher costs of maintaining supplies to the islands. OIC pointed out that the only occasion when consumers had been mobilized in opposition to an HE policy occurred when a 'diesel surcharge' was proposed for the islands some ten years previously, before the cable to the mainland was installed. HE was forced to drop its proposals in the face of fierce opposition. Any move to a differential pricing structure would therefore be strongly opposed.

11.49. OIC said that it regarded connection charges as a necessary burden on developers. However, no great dissatisfaction had been expressed regarding the current level of charges. OIC added that some years ago it had contributed jointly with HE in a scheme to bring electricity to some small islands. OIC hoped that in future OFFER would ensure that connection charges were set at a reasonable level.

11.50. OIC mentioned that since privatization it and other major Orkney users had been approached by other suppliers, apart from HE, offering alternative electricity supplies. HE had countered these attempts by competitors to enter Orkney by offering discounts to a number of its users and, as far as OIC was aware, no users had as yet changed supply from HE.

11.51. OIC concluded by saying that it accepted the principle that extra profits accruing from hydro generation should be used to offset the higher charges for transmission and distribution in HE's area. OIC considered that any formula to calculate the amount available should be based on results over several years to ensure fairness to both consumers and HE.

Perth & Kinross District Council

11.52. Perth & Kinross District Council said that it had considered the proposals put forward by the DGES regarding HE, and HE's reasons for not accepting them. The Council explained that as its first priority was to the consumer, a satisfactory distribution system should operate which would enable consumers to benefit from the lowest price available. If this could be achieved by HE's proposals then the Council would support HE's case.

Shetland Islands Council

11.53. Shetland Islands Council (SIC) told us that Shetland's location and the prevailing weather conditions meant that the islands had an extremely high energy requirement for heating and lighting, with SIC being the largest user. This demand was primarily met by a diesel-fuelled power station on Shetland operated by HE. SIC understood that this was relatively more expensive to run than mainland-based alternatives. At times the station ran at full or nearly full capacity. SIC added that Shetland's vulnerability was increased by it not being connected to the national grid. No significant alternative energy sources were currently being exploited on a commercial basis in Shetland other than peat, oil and bottled gas, none of which offered a complete alternative to electricity.

11.54. SIC explained that the population of Shetland was relatively small (22,500 people) and that the islands were largely rural in nature. This resulted in a low number of customers per distribution line. The relatively small volume of supply/demand and the age and poor quality of much of the distribution network meant that power cuts and voltage surges were a common problem, though HE had recently taken steps to improve the quality of service.

11.55. SIC pointed out that HE had already set in motion a substantial programme of generation and distribution work. SIC considered it important that sufficient funds were allocated to ensure that this programme continued and that assets were properly maintained and managed, to improve the security and quality of supply and prevent further deterioration of the supply system.

11.56. SIC's Technical Department believed domestic electricity prices on Shetland were now below pre-privatization prices in real terms, although commercial tariffs had increased slightly. Whilst tariffs were perhaps lower compared with the national average, consumption was higher due to the colder and darker winters. Whilst it anticipated that Shetland would be unwilling to see prices rise, it would probably be prepared to support present price levels rather than see a reduction in the funds allocated to upgrading the distribution infrastructure.

11.57. On the question of connection charges, SIC said that these varied from the reasonable to the excessive depending on the location. Often there appeared to be inconsistencies where the initial connection cost was high but was much lower for adjacent sites. SIC raised the question of subsidization of connection to remote and expensive sites. SIC emphasized that high connection charges could threaten the economic viability of rural communities in remote areas and it felt that OFFER should reconsider the structure of these charges.

11.58. In conclusion, SIC said that it would not wish to see HE in the position where it would have to reduce investment in the much-needed augmentation and rebuilding of its inadequate local electricity infrastructure. SIC stressed that a cheap and reliable electrical energy source was essential for the future viability of small peripheral communities like Shetland.

Skye & Lochalsh District Council

11.59. Skye & Lochalsh District Council considered that the proposals put forward by the DGES should be applied.

Sutherland District Council

11.60. Sutherland District Council (Sutherland) said that it strongly supported OFFER's recommendations. It felt that the transfer of revenue from the generation business to the distribution and transmission businesses of HE operated against the public interest. Sutherland pointed out that the Highlands had a low wage economy combined with a high cost of living. The failure of HE to accept the DGES's proposals would serve to exacerbate an already serious situation.

Western Isles Island Council

11.61. Western Isles Island Council (WIIC) told us that the Western Isles comprised ten populated islands, spanning a chain running some 130 miles north-north-east to south-south-west, with a total population of about 30,000. Communications within the islands and from the islands to the mainland depended on sea and air services, which in turn were directly affected by weather and tidal conditions.

11.62. WIIC pointed out that, as with most of the Highlands, the service provided by HE was of vital importance. Apart from a limited town gas supply for Stornoway and its immediate environs the Western Isles had no major alternative power supply.

11.63. WIIC explained that since 1991 the electricity supply to the Western Isles came from the mainland via a submarine cable. Previously, electricity had been provided by an oil-fired diesel power station at Stornoway. WIIC added that though HE had given assurances about the security of the line it was concerned about its vulnerability. Power supplies had failed on a number of occasions and the diesel power station had not provided back-up within the time it was supposed to. WIIC mentioned that the average number of customer hours lost per annum (ten hours) had been stable over a number of years, notwithstanding HE's claim that in recent years it had invested significantly to improve supplies in the Western Isles. WIIC stressed, however, that the HE workforce was highly regarded, particularly for its standards of service, and the Western Isles were probably well served in terms of the number of maintenance staff on stand-by to deal with interruptions of supply.

11.64. WIIC pointed out that power surges and power reductions were an unfortunate feature of the supply system. WIIC explained that it was trying to attract new information processing businesses to the islands, an area of high unemployment. However, the cost of providing power breakers to protect the equipment from variations in the supply put up the costs of services and meant that the Islands were once again an expensive location from which to operate. WIIC added that connection charges also varied considerably but it pointed out that HE would consider a reduction in its charges if a consumer objected strongly to an estimate. WIIC argued that though consumers should be prepared to pay a reasonable connection charge they should not be charged an unduly high figure simply because they lived in a rural area.

11.65. WIIC said that it had 15 large (over 100 kW) users of electricity within its area. It understood that two of these users were now supplied by ScottishPower. WIIC was concerned that other suppliers such as ScottishPower could come in and cherry-pick HE's main customers. It doubted whether such action made commercial sense and thought it unrealistic to expect that other suppliers could come into rural areas like the Highlands to compete for those services when such services would always be expensive to supply and maintain. WIIC said that it imagined that whilst some large users around Inverness, Aberdeen and Dundee might benefit from competition, it doubted whether competition would have any effect on peripheral areas such as the Western Isles.

11.66. WIIC argued that it found it difficult to reconcile the public service element of HE's business with the increasing commercialization of the company. It was concerned that as a private company HE might be more conscious about ensuring a suitable return for its investors and would put investors' interests ahead of those of its consumers.

11.67. WIIC said that it relied upon the DGES to safeguard the uniform pricing tariff, reliability of supply and investment in the infrastructure to ensure that customers living in rural areas were not disadvantaged. The DGES had said quite clearly that there was no reason why hydro benefit should not be used for meeting the high cost of infrastructure in some parts of the Highlands. WIIC asked that the MMC look carefully to see

whether hydro benefit might be reworked to ensure that all parties, including HE's shareholders, could benefit from the outcome of the inquiry.

Scottish bodies

Aberdeen Chamber of Commerce

11.68. Aberdeen Chamber of Commerce (ACC) said that it was difficult to comment on whether or not OFFER's proposals were reasonable without access to the detailed information which formed part of the investigation. However, ACC stated that it was aware that HE's network, covering a large area of country with a low population density, was expensive to maintain and that a balance had to be struck between affordable prices and maintenance of supply. ACC believed that, given the particular circumstances which related to the area in which HE operated, consideration should be given to maintaining the supply, rather than concentrating on lowering costs which could in the long run reduce the reliability of service.

11.69. ACC concluded by saying that the total cost of supply to the consumer remained its main concern. ACC would be reluctant to see proposals implemented, which might reduce prices in the short term, but in the long term could lead to increased charges if the distribution system was not fully maintained.

Association for the Protection of Rural Scotland

11.70. The Association for the Protection of Rural Scotland said that it considered that the DGES's proposals were reasonable and it wished to register its support of his proposals.

CBI Scotland

11.71. CBI Scotland (CBI) said that it wanted to confine its comment to one issue of principle-HE's need to ensure a reasonable rate of return on capital employed, to help secure capital expenditure on the refurbishment of its distribution network.

11.72. CBI thought the DGES's proposals offered too low a rate of return to enable the necessary investment in network refurbishment to be made. This appeared to place at risk continuity of supply to CBI's members in Tayside, Grampian and Highlands & Islands.

11.73. CBI added that it also hoped that the MMC's inquiry would settle the current uncertainty about the value of the hydro benefit and would make HE's operations transparent to all concerned.

Energy Action Scotland

11.74. Energy Action Scotland (EAS) pointed out that it was a national charity representing the interests of the low-income domestic consumers, and its comments would therefore reflect this.

11.75. In the revised distribution and supply price controls, the DGES had said that if electricity prices to customers were reduced by 10 per cent, typical households might benefit by about £74 in total over the next three years. EAS said that it welcomed any reduction in tariff prices which would help low-income households keep warm in winter.

11.76. However, EAS stressed that any price reduction must not be to the detriment of current services provided, in particular to consumers living in rural areas, and debt and disconnection procedures.

11.77. EAS said that the most beneficial way of achieving affordable warmth was to increase the thermal efficiency of the housing stock and invest in efficient heating systems and controls. EAS therefore supported the allowance of £1 per customer to be made available for programmes to secure the more efficient use of electricity and to reduce distribution losses.

Highlands & Islands Enterprise

11.78. Highlands & Islands Enterprise (HIE) explained that it was a government-funded agency set up in 1965 to encourage economic development in the Highlands and Islands area and it formed a well-established part of the local economic development framework. HIE supported commercial development through the provision of grants, loans and other forms of subsidy and also assisted in marketing and training and with other activities. In some cases this included financial assistance with electricity connection costs where a new business was locating in a remote area.

11.79. HIE said that over the years it had pressed hard for HE to extend its network to the further corners of the area and this had now almost entirely been achieved. HIE stressed that reliability and quality of supply were of fundamental importance to all commercial and industrial users in the area. HIE said that as far as it was aware customers were satisfied with the quality of service provided by HE and HIE had noted an improvement in service over the last four to five years. HIE accepted that other suppliers could now enter the area and compete with HE for supply but it knew of no users who had as yet exercised this option.

11.80. HIE pointed out that under normal circumstances it approved of measures which would reduce the price of electricity to commercial operators and domestic premises in the Highlands and Islands. This had an important bearing upon the operating costs and efficiency of businesses, and upon the quality of life of the resident population. HIE applauded the DGES's vigilance on this issue. HIE added that it did not sense any dissatisfaction amongst customers regarding prices. Since privatization HE had restructured its commercial tariff and most customers had benefited.

11.81. HIE was concerned that HE might be unable to maintain its programme of investment in its distribution network to sustain the security and quality of electricity supply in the future. HIE understood that the DGES's proposals might seriously restrict HE's future investment in system refurbishment.

11.82. HIE pointed out that most of HE's distribution network was built in the 1950s and 1960s and was now due for replacement. The terrain and climate of the Highlands and Islands put exceptional demands upon equipment, and these factors (combined with remoteness) greatly complicated emergency repair operations and meant that HE's infrastructure costs were significantly higher than in the rest of the UK.

11.83. HIE said that it had serious concerns that, if the required investments did not take place, there could be a progressive deterioration in the security of supply, particularly in the remote areas of HE's territory. If such a situation persisted, it could lead to a massive 'catch-up' investment requirement at the end of the decade. Meanwhile, the reduction in the scheduled programme of investment by HE could reduce continuity of contractors' activity and employment levels in the area. On balance, HIE thought the advantage to HE's business and domestic consumers of having a secure supply outweighed the short-term benefit of a reduction in the price of supply.

North of Scotland Electricity Consumers' Committee

11.84. North of Scotland Electricity Consumers' Committee (NSECC) explained that its role was to represent and promote the interests of all electricity consumers-domestic, commercial and industrial-within the geographical area served by HE. It advised the DGES of any matters affecting those interests of which he should be aware.

11.85. NSECC stressed the uniqueness of the area served by HE, which included large areas of remote and sparsely-populated country and outlying islands, including all of Scotland's islands.

11.86. NSECC said that its main concern was to maintain reliable supplies of electricity throughout the area at a universal price. It pointed out that before privatization HE was unique amongst electricity boards in operating within the conditions of a social clause which made it compulsory for customers to be charged at similar tariffs throughout the region. NSECC was concerned that this clause could now be lost and that rural and island communities might have to pay more for their electricity supplies.

11.87. NSECC said that though it accepted some power cuts as an inevitable consequence of the weather and terrain of much of the region, it expected such cuts to be of a relatively short duration. It added that though prices might have to rise to achieve this, it thought there was nevertheless room for improvement in performance without a significant price rise. NSECC thought customers were prepared to pay higher prices if this guaranteed the integrity and security of supply. It pointed out that in the past HE had invested heavily in refurbishing and improving the distribution system. This had led to an improvement in standards and a reduction in the numbers of customer complaints.

11.88. Regarding connection charges, NSECC said that in principle the cost of new connections should be borne by the people benefiting from them. It pointed out that aid was available through local authority development grants and enterprise companies. It added that dissatisfied customers had the right to appeal to OFFER if they disagreed with the level of charges. NSECC said that it would welcome competition from outside contractors in this area.

11.89. On the question of competition in the supply market, NSECC said that the market had not yet come to terms with the competitive situation. It was concerned about the impact of competition on HE's long-term ability to maintain its commitment to supply remote communities. Competitors could cream off the more attractive customers in low-cost areas leaving HE with the higher-cost customers in the rural areas. This could eventually result in a two-tier pricing structure. NSECC argued that, should this occur, some form of regulation would have to be imposed to address the situation.

11.90. NSECC concluded by saying that it supported the principle of hydro benefit. It had doubts about how accurately hydro benefit had been quantified and argued that any final figures would need to be fairly calculated.

Scottish Energy Buyers Group

11.91. The Scottish Energy Buyers Group (SEBG) explained that it was part of an independent advisory service and information clearing house for over 400 industrial, commercial and public service organizations in the UK, including over 40 in Scotland. SEBG's interest was primarily related to the provision of a quality power supply in Scotland at prices that were competitive with those charged in other parts of Great Britain. SEBG asked that the following points should be considered in the inquiry:

- (a) The likely annual shortfall of £35 million in HE's calculated revenue requirement against that proposed by OFFER might require a one-time increase of up to 35 per cent in distribution charges. Such an increase would clearly be onerous for business and domestic users alike.
- (b) To some extent HE's claim of a current 3 per cent return on its distribution business was misleading as it appeared to ignore the hydro benefit. Calculating this on an annual basis and applying relief to transmission and distribution charges retrospectively was important. The ability to use the hydro stations for meeting peak winter demand would allow the benefit to be calculated more precisely as between the cost of running and maintaining the stations against the realizable pool purchase prices at peak.
- (c) The radical separation of HE's four core activities into separate companies would not necessarily be beneficial given the small scale of its sales and its customer base. However, SEBG said that it would be in favour of steps designed to extend customer choice from the two existing Scottish electricity companies.
- (d) The Scottish market did not currently require the sophistication of a half-hourly pool. SEBG said that it was mindful of the difficulties encountered south of the border with the opening of the over 100 kW market. Given the surplus in generation capacity likely to prevail at least until 1998, SEBG believed a pool was unnecessary until this date at the earliest and after the first experiences of the Northern Ireland pool were known.
- (e) SEBG believed prices available to Scottish over 1 MW sites in competitive negotiation had compared reasonably well with those in England and Wales, but the group had been disappointed with rates provided to the newly competitive Scottish over 100 kW sites. The need for English suppliers to

purchase power from the two generation businesses at the pool selling price was perceived to be a major barrier. The surplus in capacity, combined with the ready transmission of power across Scotland, indicated that a more equitable basis would be the SMP plus a small OFFER- or MMC-determined increase for capacity and uplift.

Scottish Enterprise

11.92. Scottish Enterprise (SE) said that due regard should be given to the additional costs associated with trying to establish a fair and equitable cost for the production and distribution of power to a sparsely-populated area, located in a difficult transmission terrain. HE currently operated in an area of over 54,000 sq km representing the largest and most diverse area of any of the UK utilities.

11.93. SE pointed out that from a recent study it had carried out, in association with HE, ScottishPower, the DTI and HIE, to consider the potential of renewable energy in Scotland, it was evident that one of the major issues confronting HE in the future was the urgent need to upgrade and reinforce the power grid network on a line north from Dundee. This in itself would have significant cost implications for HE's operational costs over the next few years if the work were carried out.

11.94. Other matters that required consideration when assessing costs were the need to recognize that HE, because of its Highland territory, had greater costs in maintaining its power supply during the winter months. There were also the many island communities that required servicing from local generators which, naturally, were less efficient and less profitable.

11.95. SE added that whilst, in its role as an economic development agency in Scotland, it would wish all energy costs to be kept to a minimum, it recognized the importance of ensuring that there was a well-funded, highly-efficient power company in the Highlands area capable of supplying the power requirements of the community and those of industry, in a steady and uninterrupted way well into the next century. SE thought a degree of flexibility should be applied to HE's pricing policy to achieve this.

Scottish Natural Heritage

11.96. Scottish Natural Heritage (SNH) explained that the extensive area covered by HE's transmission and distribution businesses, although sparsely populated, was in general of very high natural heritage value. This interest was reflected in the high proportion of HE's territory bearing national landscape and nature conservation designations, but was not confined to such areas.

11.97. SNH pointed out that the development and maintenance of HE's infrastructure had an impact on the natural heritage. SNH sought to ensure that any such effects were minimized. This might require HE to implement options which were not necessarily the cheapest available. SNH considered that HE's transmission and distribution businesses might have to bear a relatively high cost for the provision of its services if the interests of national heritage were recognized.

11.98. SNH added that in principle it supported the DGES's proposals for the provision of allowances for energy efficiency programmes and incentives for the reduction of electrical losses in the system. SNH thought that measures for energy efficiency were in general the most desirable and effective means of reducing the overall impact the energy industry might have on the environment, whilst also satisfying the needs of the consumer. SNH added that its support for this policy was based on the assumption that energy efficiency measures were applied consistently across the electricity generation and supply industry.

Scottish Tourist Board

11.99. The Scottish Tourist Board (STB) said that it was anxious that the infrastructure of a modern economy was maintained throughout the whole of Scotland so that tourism could prosper. In particular, it was important that efforts were made to ensure that, for example, full postal services, good ferry services and reliable electricity supplies were available in remote rural areas.

11.100. STB explained that as it did not know the commercial details concerning electricity production and distribution in rural Scotland, it was not in a position to comment fully on HE's rejection of OFFER's price control proposals. STB stressed, however, that it knew that the economy of many rural areas in Scotland was very fragile, and that tourism in such areas was often one of the few sources of employment that was likely to expand in the future. STB argued that if tourism was to prosper in rural areas a reliable source of electricity should be provided at a fair price.

Other bodies

Association for the Conservation of Energy

11.101. ACE said that it was greatly concerned about the distribution price control proposals recently rejected by HE. In particular, it was concerned about the 'revenue driver' proposed for HE's (and all the other PESs') distribution business. If introduced, the proposals would, in ACE's view, distort the development of competition in the energy market.

11.102. ACE argued that a volume incentive in the distribution business would distort competition whether between electricity suppliers, between fuels, or between increasing capacity and measures that might avoid the need for that capacity (demand-side measures). ACE emphasized that there was a fundamental contradiction in attempting to promote competition in supply, whilst at the same time having a price control which ensured that a PES could not ignore the interrelationship between its supply and its distribution businesses.

11.103. ACE considered that, to the extent that competition was distorted, the proposed price control would be operating against the public interest and could be expected to lead to higher prices than would otherwise be the case. More importantly, such a situation could be avoided simply by adopting price controls similar to those adopted for the transmission business where forecasts were used.

11.104. ACE proposed that if sales volume or peak demand were seen as the most appropriate variables to account for the non-customer-related costs in the distribution business, then suitably independent forecasts of these figures should be used. ACE thought these changes would considerably improve the prospects for developing more effective competition, both between fuels and between electricity suppliers. Furthermore, ACE added, the PES would also be able to look impartially, for the first time, not only at the profits they could make by increasing sales, but also at the profits they could make by offering services which would reduce customers' energy costs. As a result, ACE emphasized, the PES would have an incentive to place greater emphasis where it should be placed: on serving the customer.

Chemical Industries Association

11.105. The Chemical Industries Association (CIA) said that it had taken a great deal of interest in the recent review of distribution price controls by the DGES. The CIA pointed out that charges for the use of the distribution system typically represented about 20 per cent of the final price of electricity to an industrial consumer. The CIA was concerned to ensure that the review resulted in a more cost-reflective pricing structure and achieved a more equitable balance between the interests of shareholders and customers through a tighter price control. The CIA said that it was not satisfied by the outcome of the review on either count.

Others

BOC Gases Europe

11.106. BOC Gases Europe (BOC) told us that, as one of the largest electricity users in Great Britain, it had always maintained a keen interest in the electricity supply industry and matters relating to it. Since the privatization of the industry BOC had seen an increase in delivered prices ahead of general inflation. Prices to BOC's large plants were considerably higher than those obtained by similar large and intensive users in the majority of countries in mainland Europe and were far too high in relation to the inherent risk of electricity supply industry businesses.

11.107. BOC was keen that the level and make-up of electricity charges from electricity companies were carefully examined. BOC argued that as part of the examination of HE's charges the MMC should also take the opportunity to examine the distribution charges of the other 13 RECs in Great Britain.

Highland Power Cabling Ltd

11.108. Highland Power Cabling Ltd (HPC) said that it was a main contractor to HE in the field of overhead line construction. HPC was concerned at recent press reports regarding possible cut-backs to HE's ongoing refurbishment programme to its distribution and transmission lines. HPC felt that HE should be allowed to proceed with its essential programme of refurbishing and rebuilding its distribution network, which had the greatest route length of line per consumer in the UK. HPC stressed that the safety and security of supply must remain HE's highest priority, but this could only be achieved with continued investment. Any cut-backs could also have a detrimental effect on HPC, a Highland company employing all local staff, and on the local economy.

Individuals

Mrs Christine Davis

11.109. Mrs Davis, a former Chairman of the Electricity Consultative Council for the North of Scotland District and a member of the NSHEB, submitted that the DGES's proposals for distribution price controls had not taken sufficient cognizance of rural consumers or of the specific requirements of the north of Scotland licensed area.

11.110. Mrs Davis pointed out that the costs of a rural network were not only in distribution losses. Consumers understood that line maintenance was vitally important. When a line supplied few customers the costs were proportionally higher. The north of Scotland included systems connected by submarine cable, with its associated high costs, and lines exposed to wind and weather damage. These factors added up to extra maintenance needs and costs for which the DGES's formula did not fully allow.

11.111. Mrs Davis added that a reliable supply of electricity was essential to small businesses, tourism and to the retention of a rural population in the north of Scotland. The cost to HE of providing such a service was, however, greater than customers realized, as much of this was met by hydro benefit. Mrs Davis pointed out that the DGES's formula did not permit any transfer of costs between sections of HE's overall operation which had historically supported each other.

11.112. Mrs Davis concluded by saying that the Electricity Act 1989 envisaged a future in which there would be a free market for electricity from 1998 onwards. She argued that the DGES's formula threatened the maintenance of the distribution system in the north of Scotland to such an extent that it might limit free competition in that area, which was not the intention of the legislators.

Mr Yogi Dutta

11.113. Mr Dutta submitted a report on the pricing policies of ScottishPower in particular, and the electricity industry in general. Mr Dutta considered that the pricing policy in the industry was against the interests of the regulated market and in certain important aspects was also in breach of the licence conditions and competition laws in the UK and EC.

11.114. Mr Dutta argued that a regulatory framework using an RPI-X formula had consistently failed in all the major privatized utilities and had given the utilities considerable scope for abuse of their monopoly positions. The regulatory framework of the electricity industry was fundamentally flawed and remained so despite the DGES's recent review. To date, the franchise market subsidized the non-franchise market by some £2 billion and this subsidy would continue to rise unless realistic steps were taken to remedy the flawed and discredited price controls.

Mr John H Sheddon

11.115. Mr Sheddon said that he strongly opposed the present monopoly of supply enjoyed by HE and ScottishPower within Scotland. He argued that the vertically integrated structure of the two companies, along with the restructuring agreements, militated against the efficiency of the companies concerned and against competition in the industry in general. He suggested that the structure of the industry should be changed and that arrangements in Scotland for generation, transmission, distribution and supply were brought into line with those applying in England and Wales, with separate functions being undertaken by separate companies; and that the NGC should have control over the transmission grid throughout the UK.

G D W ODGERS (*Chairman*)

C M BLIGHT

M BROMWICH

N H FINNEY

J A M KENNERLEY

D J MORRIS

A J NIEDUSZYNSKI (*Secretary*)

24 May 1995