

EXPLANATORY MEMORANDUM TO

THE ENERGY ACT 2004 (ASSISTANCE FOR AREAS WITH HIGH DISTRIBUTION COSTS) (AMENDMENT) ORDER 2020

2020 No. 146

1. Introduction

- 1.1 This explanatory memorandum has been prepared by the Department for Business, Energy and Industrial Strategy and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

- 2.1 The Energy Act 2004 (Assistance for Areas with High Distribution Costs) Order 2005 (“the Order”) established a scheme for offsetting the costs of distributing electricity in the North of Scotland (the “Hydro Benefit Replacement Scheme”). This instrument amends the Order to increase the level of annual assistance provided under the Hydro Benefit Replacement Scheme to offset high electricity distribution costs in the North of Scotland. This increase is needed to take account of a rise in electricity distribution costs to cover the cost of upgrades in Shetland’s energy infrastructure.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

- 3.1 None.

Matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business (English Votes for English Laws)

- 3.2 As the instrument is subject to negative resolution procedure there are no matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business at this stage.

4. Extent and Territorial Application

- 4.1 The territorial extent of this instrument is England and Wales and Scotland.
4.2 The territorial application of this instrument is England and Wales and Scotland.

5. European Convention on Human Rights

- 5.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

6. Legislative Context

- 6.1 Section 184 of the Energy Act 2004 enables the Secretary of State to establish a scheme to require an annual payment to be made to the operator of an electricity distribution network in a specified area in Great Britain, if the cost per customer of distributing electricity in that area is significantly higher than elsewhere in Great Britain. The cost of this payment is recovered from electricity suppliers across Great

Britain. The distribution network operator in receipt of the payment must pass this benefit on to suppliers supplying electricity in the area.

- 6.2 Under this power, the Energy Act 2004 (Assistance for Areas with High Distribution Costs) Order 2005 (“the Order”) established a scheme to offset the high costs of distributing electricity in the area of the North of Scotland described in Schedule 1 to the Order. Schedules 2-9 to the Order made amendments to the licence conditions of electricity suppliers, transmitters and distributors to facilitate the implementation of the scheme. The scheme came into force in April 2005 with a payment (referred to as the ‘assistance amount’) in the first year of £41.95 million, as specified in Article 5 of the Order. In accordance with the amendments made by Schedule 6 to the Order, the payment is recalculated in each subsequent year to take account of the Retail Price Index (RPI), so that the payment has increased to £63.32 million in 2019/20.
- 6.3 This instrument amends the Order to increase the level of the annual payment by £27 million in the financial year beginning 1 April 2021 to take account of upgrades in Shetland’s energy infrastructure; this payment will also be recalculated in each subsequent year to take account of RPI. The instrument implements the outcome of a BEIS consultation which confirmed that the costs of subsidising the higher distribution costs in Shetland should be recovered from electricity suppliers across Great Britain through the Hydro Benefit Replacement Scheme, instead of being paid solely by the North of Scotland as now. These Shetland related costs are currently recovered through the electricity distribution charges paid by electricity suppliers in the North of Scotland, and ultimately paid by end-consumers in that region. For transparency purposes, the licence modifications made by the instrument provide distinctly for the existing and Shetland-specific assistance amounts, but the Shetland assistance amount will generally be collected and paid under the arrangements already in place for the existing assistance amount. For example, it covers the same geographic area of the North of Scotland, and the level of the Shetland assistance amount will be recalculated in subsequent years to take account of the RPI.
- 6.4 Amendments made by Schedule 6 to the Order provide for an annual administration allowance of £150,000 in the first year to be retained by the authorised transmitter (National Grid Electricity System Operator) to cover its costs in administering the scheme. For the second year, the amendments made by Schedule 6 to the Order provide for the annual administration allowance to have a value of £80,000 and to change in years after that in line with the Retail Price Index. As there are no additional administration arrangements required for the Shetland assistance amount, the level of the administration allowance remains unchanged.
- 6.5 The instrument omits articles 6 and 7 and schedules 2 to 5 of the Order as they no longer have effect. Those articles and the accompanying schedules 2 to 5 inserted new licence conditions in April 2005 applying to authorised suppliers and authorised distributors. Those licence conditions have since been replaced by subsequent conditions which are modified by this instrument.

7. Policy background

What is being done and why?

- 7.1 The purpose of this instrument is to increase the amount of assistance collected and paid under the Hydro Benefit Replacement Scheme to offset high electricity distribution costs for consumers in the North of Scotland. This increase is needed to

take account of a rise in electricity distribution costs to cover upgrades in Shetland’s energy infrastructure. Even before this cost rise, consumers in the North of Scotland have incurred distribution costs which are consistently higher than any other region in Great Britain, and the intended increase in the assistance amount is therefore consistent with the terms of the Hydro Benefit Replacement Scheme.

- 7.2 Shetland’s power system is unique because it is not connected to the electricity transmission or distribution grids in Great Britain, and instead Shetland’s licensed distribution grid is entirely local in nature. Local generation through the Lerwick Power Station is required to meet Shetland’s electricity demand, which leads to very high average costs of electricity supply per customer. Consumers on Shetland benefit from a cross-subsidy arrangement under the Common Tariff Obligation (formalised in the Electricity Act 1989 (Uniform Prices in the North of Scotland) Order 2005) which prevents price differentiation in electricity supply prices across the North of Scotland on the basis of location. The resulting costs are currently spread across all suppliers in the North of Scotland - and ultimately all consumers in the North of Scotland - through electricity distribution charges.
- 7.3 Lerwick Power Station is vital to Shetland’s electricity distribution arrangements but is reaching the end of its operational life. This means that a new energy solution is needed to maintain Shetland’s security of supply. Any new energy solution can be expected to increase Shetland electricity distribution costs. Ofgem, as the independent energy regulator, has recently concluded that the most cost-effective approach in the near-term will be to implement an interim solution which involves extending the operation of Lerwick Power Station through targeted investment until at least 2024/25. The expectation is that a full new energy solution would then follow. In 2017/18, the total Shetland cross-subsidy amounted to £18.69 million, but is estimated to increase to £27 million in 2020/21, 2021/22 and 2022/23 due to this targeted investment.
- 7.4 If the existing cost-recovery arrangement remains unchanged, the £27 million Shetland cross-subsidy will result in an additional burden to consumers in the North of Scotland of an estimated £17 per household annually. The Government is concerned about this increase because, even with the existing level of assistance provided through the Hydro Benefit Replacement Scheme, consumers in the North of Scotland already pay the highest distribution costs in Great Britain. As the following table shows, distribution costs in the North of Scotland are 9-19% higher than the next highest cost region over the last four years, based on a typical electricity consumption of 3,100 kWh for single rate households. Some respondents to the recent BEIS consultation have argued this comparison undervalues the cost differential between the North of Scotland and elsewhere because households there tend to have higher consumption, primarily due to the greater proportion of households in the North of Scotland that are not connected to mains gas and hence depend on electric heating. Without the assistance currently provided through the Hydro Benefit Replacement Scheme, which is £63.32 million in 2019/20, it is estimated that the typical household distribution cost in the North of Scotland would be around £40 higher than shown in this table.

Table: Regional estimates of typical GB distribution cost (£ Real (2017-18 price base) per typical domestic customer)

Region	Apr-16	Apr-17	Apr-18	Apr-19
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North West	96	79	78	82
North East	101	91	85	88
Yorkshire	83	76	73	73
Midlands	96	83	80	78
East Midlands	86	76	71	71
South Wales	116	102	98	99
South West	126	113	100	97
London	79	67	65	71
South East	107	91	81	87
East Anglia	82	79	76	78
South Scotland	99	91	91	92
Merseyside & N Wales	112	104	99	110
Southern	90	81	74	71
North Scotland (with existing assistance amount applied)	142	125	123	121
% higher cost in North Scotland compared to next highest region	13%	10%	19%	9%
GB weighted average	101	90	85	87

Source: Ofgem's RIIO Electricity Distribution Annual Report 2017/18 (March 2019)

- 7.5 By increasing the assistance amount to include the £27 million of costs relating to the Shetland cross-subsidy, this will have the effect of reducing electricity distribution costs for all consumers in the North of Scotland. The increase in the assistance amount will be funded by all licensed electricity suppliers across Great Britain, and ultimately all consumers, at an estimated average cost of less than 50 pence per household per year, or less than a 0.1% bill impact. This is in addition to the existing assistance amount, which costs each household less than £1 per year.
- 7.6 In line with the requirements of section 184 of the Energy Act 2004, the Government undertakes a review of the Hydro Benefit Replacement Scheme every three years, involving public consultation. All respondents in the most recent consultation supported some form of action to subsidise the higher electricity distribution costs borne by consumers in the North of Scotland, and the majority agreed that the Hydro Benefit Replacement Scheme was effective and should continue.
- 7.7 This instrument does not concern the actual cost of ensuring Shetland's security of supply, which remains a matter for Ofgem and Scottish Hydro Electric Power Distribution (as the distribution network operator for the North of Scotland).
- 8. European Union (Withdrawal) Act/Withdrawal of the United Kingdom from the European Union**
- 8.1 This instrument does not relate to withdrawal from the European Union.
- 9. Consolidation**
- 9.1 As this is the first time the Order has been amended, consolidation is not considered necessary. Consolidated versions of the licence conditions modified by this instrument will be available on Ofgem's website once these modifications come into force.

10. Consultation outcome

- 10.1 The Secretary of State is required to consult before making any Order under section 184. BEIS carried out a public consultation on the scheme, which ran from 19th July to 6th September 2019. In total, 26 consultation responses were received from a range of interested parties including the Scottish Government, the energy industry, local authorities, consumer representatives and individuals. Most respondents had a direct interest in electricity costs for the North of Scotland. All those respondents who expressed a view agreed with the Government's proposal to revise funding arrangements for the Shetland cross-subsidy so that it is delivered through the Hydro Benefit Replacement Scheme. The practical difficulties for suppliers of needing to adjust consumer tariffs at very short notice, particularly for fixed price consumer tariffs, were highlighted through the consultation process. As a consequence, it was suggested that the Government should require implementation of increased funding from April 2021, so that suppliers would be able to reflect the full value of the benefit in customer prices and contracts.
- 10.2 The amended licence conditions which appear in the Schedules to this Order are the product of this consultation. The government response to the consultation will be published at the same time as the Order is laid before Parliament.

11. Guidance

- 11.1 Guidance in addition to this memorandum is not required.

12. Impact

- 12.1 There is a positive impact from this instrument for business, charities and voluntary bodies in the North of Scotland, who will receive a reduction in their electricity costs of around 2%. In line with the Order, business, charities and voluntary bodies throughout Great Britain will contribute towards funding this reduction through their electricity bills. This does not represent a significant impact on those organisations, as it equates to less than a 0.1% increase in electricity bills in Great Britain. There is no overall impact as the total loss nationally is exactly offset by the overall gain for the North of Scotland.
- 12.2 There is no significant impact on the public sector.
- 12.3 An Impact Assessment has not been prepared for this instrument. A full impact assessment of the effect that the Order has on the costs of business, charities, voluntary bodies and the public sector is available from the Electricity Systems team, Department for Business, Energy and Industrial Strategy, 1 Victoria Street, London SW1H 0ET or from www.gov.uk/beis. The effects of spreading the costs of the Shetland cross-subsidy across Great Britain were considered as part of the Impact Assessment undertaken on support for non-domestic electricity consumers on Shetland (IA number DECC0169, 20 March 2015), which is also available from the Electricity Systems team. Relevant aspects of that analysis have been updated for the government response document published at the same time as this Order.

13. Regulating small business

- 13.1 The legislation applies to activities that are undertaken by small businesses, on the basis that they are electricity consumers in the North of Scotland and Great Britain.

13.2 The legislation will not have a disproportionate effect as the costs will be charged in relation to the amount of electricity used. No specific action is therefore proposed to minimise regulatory burdens on small businesses.

14. Monitoring & review

14.1 The approach to monitoring of this legislation is to review it as part of statutory reviews of the Hydro Benefit Replacement Scheme established under section 184 of the Energy Act 2004. Section 184(11) requires the scheme to be reviewed every three years. The next review is due in 2022.

15. Contact

15.1 Ian Lomas at the Department of Business, Energy and Industrial Strategy, Telephone: 0300 068 5827 or email: ian.lomas@beis.gov.uk can be contacted with any queries regarding the instrument.

15.2 Teresa Camey, Deputy Director for Electricity Systems, at the Department of Business, Energy and Industrial Strategy can confirm that this Explanatory Memorandum meets the required standard.

15.3 The Rt Hon Kwasi Kwarteng MP at the Department of Business, Energy and Industrial Strategy can confirm that this Explanatory Memorandum meets the required standard.