EXPLANATORY MEMORANDUM TO

THE ENERGY ACT 2004 (ASSISTANCE FOR AREAS WITH HIGH DISTRIBUTION COSTS) (AMENDMENT) ORDER 2023

2023 No. 43

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 His Majesty.

2. Purpose of the instrument

2.1 The Energy Act 2004 (Assistance for Areas with High Distribution Costs) Order 2005 ("the 2005 Order") established a scheme for offsetting the costs of distributing electricity in the North of Scotland (the "Hydro Benefit Replacement Scheme"). This instrument makes a number of modifications to the licence conditions of electricity suppliers and transmitters, which improve or clarify the way in which the scheme is funded. It also amends overarching text in the 2005 Order regarding the implementation of the scheme. These changes will take effect from April 2023.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

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 2005 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 2005 Order. Schedules 2-9 to the 2005 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 2005 Order. In accordance with the modifications made by Schedule 6 to the 2005 Order, the payment is recalculated in each subsequent year to take account of the Retail Price Index (RPI).

6.3 The Energy Act 2004 (Assistance for Areas with High Distribution Costs) Order 2020 ("the 2020 Order") amended the scheme established under the 2005 Order to increase the level of the annual payment by £27 million in the financial year beginning 1 April 2021. This instrument implemented the outcome of a BEIS consultation[1] which confirmed that the costs of subsidising the higher electricity 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 consumers in the North of Scotland as was the case up to that point. As with the original assistance amount, the 2020 Order confirmed that this assistance (referred to as the 'Shetland assistance amount') should be recalculated in each subsequent year to take account of RPI.

6.4 The 2020 Order omitted provisions of the 2005 Order which had inserted new licence conditions applying to authorised suppliers and authorised distributors. Those licence conditions had been superseded by licence conditions made by Ofgem using its concurrent powers to modify licence conditions under section 11A of the Electricity Act 1989.

6.5 For 2022/23, the combined assistance amount is £94.97 million[2].

6.6 The amendments now being made to the scheme (as implemented through the licence conditions referred to above), and to the 2005 Order, and the reasons for them, are described in section 7.

7. Policy background

What is being done and why?

7.1 The main purpose of this instrument is to make four technical changes to the way in which the Hydro Benefit Replacement Scheme is funded by electricity suppliers across Great Britain. In line with the requirements of section 184(11) of the Energy Act 2004, the Government undertakes a review of the Hydro Benefit Replacement Scheme every three years, involving public consultation. Government proposed the first three technical changes described below as part of the recent consultation[3] for the current three-yearly review, and the fourth point was proposed by a respondent to that consultation. Further information on the consultation is set out in section 10.

7.2 The first and most substantive change is removal of a so-called 'embedded benefit'[4] distortion from the scheme's current operating arrangements. This distortion arises

[1] Government consultation of 12 July 2019 and Government Response of February 2020, both available at: https://www.gov.uk/government/consultations/hydro-benefit-replacement-scheme-and-common-tariff-obligation

[2] Published letter of 15 July 2022 from National Grid Electricity System Operator to all interested industry parties confirming final tariff, available at: https://www.nationalgrideso.com/document/263936/download

[3] Government consultation of 29 July 2022, available at: https://www.gov.uk/government/consultations/hydro-benefit-replacement-scheme-and-common-tariff-obligation-statutory-review-2022

[4] Embedded benefits relate primarily to network charging arrangements, and their exact nature varies depending on the specific context. Broadly, they arise where generators connected to the lower voltage distribution network

from the fact that the scheme is currently charged to electricity suppliers on the basis of their net demand. Any supplier contracting with an embedded generator (i.e. a generator connected to the distribution network) will have output from that generator netted off from their total demand, and hence reduce their liability for the scheme charge. In turn, this increases the scheme tariff because the same total assistance amount still needs to be recovered, but from only a portion of the total units of electricity supplied. The Government estimates that the scheme tariff will be almost 18% lower with removal of the embedded benefit distortion. Moreover, embedded benefits can provide an incentive for suppliers to contract with embedded generators, even in those circumstances where a transmission-connected generator could potentially be more efficient for the overall system than an embedded generator. Schedule 2 of this instrument addresses this by amending the definition of 'units of electricity supplied' introduced by the 2005 Order so that it covers all electricity supplied, and makes clear that there is no reduction for electricity exported onto the distribution network.

7.3 Second, the instrument amends the scheme to switch the annual inflator used for the Hydro Benefit Replacement Scheme's assistance amount, from RPI to Consumer Prices Index including owner occupiers' housing costs (CPIH). This change is being made because CPIH is considered to be a more comprehensive measure of inflation. In addition, it will maintain consistency with Ofgem's regulatory processes for determining the level of electricity distribution costs in the North of Scotland and elsewhere, where the same change has recently been made.

7.4 Third, a possible ambiguity has been identified in the wording of the requirements for the Hydro Benefit Replacement Scheme's funding which could be interpreted as requiring electricity suppliers to pay twice for the Shetland assistance amount relating to the Shetland cross-subsidy. Clearly, it was not the intention to double-charge electricity suppliers, and Ofgem issued an interim clarification letter on 20 July 2021[5]. This instrument follows up that letter by removing the ambiguity from the legal terms of the scheme's operation.

7.5 Finally, the instrument is also making a clarification to the treatment of supplier late payments, in light of an ambiguity identified by a respondent to the Government's recent consultation. The policy intent has always been that the benefit of suppliers' late payments from any prior year should be taken into account in future tariff setting, and this is how the relevant licence conditions are interpreted in practice. However, the definition of licence condition term HBCt-1 could be read as only allowing revenue for the previous charging year to be included. Accordingly, the instrument is amending the definition of licence condition term HBCt-1.

7.6 The instrument also makes a number of additional non-substantive modifications to the licence conditions of electricity suppliers and transmitters.

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can access revenues or cost reductions which are not available to generators connected to the high voltage transmission network. As an example, a distribution connected generator can reduce a supplier's demand from the transmission network, thereby reducing the supplier's liability for transmission-related charges, and be paid by the supplier for doing so. A concern with this arrangement is that, if it is assumed that the supplier's action does not reduce the total level of transmission costs that need to be recovered, other suppliers (and ultimately end-consumers) will have to pick up the shortfall.

[5] https://www.ofgem.gov.uk/publications/clarification-standard-licence-condition-c21

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 / trigger the statement requirements under the European Union (Withdrawal) Act.

9. Consolidation

9.1 This instrument does not consolidate legislation.

10. Consultation outcome

10.1 The Secretary of State is required to consult before making any Order under section 184. The Government carried out a public consultation on the scheme, which ran from 29th July to 23rd September 2022. In total, 9 consultation responses were received from a range of interested parties including the energy industry, local authorities, consumer representatives and one individual. Most respondents had a direct interest in electricity costs for the North of Scotland.

10.2 All respondents supported some form of action to protect electricity distribution consumers in the North of Scotland, and the majority agreed that the Hydro Benefit Replacement Scheme should continue. There was general support for the Government's proposed technical improvements to the funding arrangements of the Hydro Benefit Replacement Scheme. In addition, one further improvement suggested by a respondent to the scheme's detailed operating arrangements is being progressed through this instrument.

10.3 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 no, or no significant, impact on charities or voluntary bodies.

12.2 There is no, or no significant, impact on the public sector.

12.3 An Impact Assessment has not been prepared for this instrument as it falls within the statutory exclusion around tax, duties, levy and other charges under Section 22 of the Small Business Enterprise and Employment Act 2015.

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 does not have a disproportionate effect as the costs are 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 2025.

15. Contact

15.1 Ian Lomas at the Department of Business, Energy and Industrial Strategy, Telephone: 07471 358130 or email: ian.lomas@beis.gov.uk can be contacted with any queries regarding the instrument.

15.2 Paul van Heyningen, Deputy Director for Net Zero Electricity Networks at the Department of Business, Energy and Industrial Strategy can confirm that this Explanatory Memorandum meets the required standard.

15.3 Graham Stuart, Minister for Climate at the Department for Business, Energy and Industrial Strategy can confirm that this Explanatory Memorandum meets the required standard.