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to customers*

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Dear Colleague,

Decisions in respect of proposals to remove “Hydro Benefit” following consultation under section 11(2) of the Electricity Act

On 28 November 2003 Ofgem¹ issued a consultation paper, including notices under Section 11 of the Electricity Act, proposing to remove an obligation placed on SSE Generation Limited (“SSEGL”) to pay a specified sum of money (the so-called “Hydro Benefit”) each year to Scottish Hydro-Electric Transmission Limited (“SHETL”) and to Scottish Hydro-Electric Power Distribution Limited (“SHEPD”)². On 3 December 2003 Ofgem issued an amendment to this notice to address inconsistencies in the notice of 28 November 2003³. Views were invited no later than 5 January 2004. This letter summarises responses to the consultation and sets out Ofgem’s decision.

Background

The Gas and Electricity Markets Authority (“the Authority”) has its principal objective and statutory duties set out in respect of matter relating to Electricity markets in the Electricity Act⁴. However, the Electricity Act makes it clear that the Authority’s principal objective and duties do not affect the obligation of the Authority to comply with any other duty or requirement including European law⁵. Therefore the Authority must take remedial steps if it considers that any particular licence obligations are in breach of the requirements of European law. This duty is irrespective of whether such remedial steps would conflict with its other statutory duties, including its principal objective of protecting the interests of consumers.

¹ Ofgem is the office of the Authority. The terms ‘Ofgem’ and ‘the Authority’ are used interchangeably in this letter.

² 153/03 – Proposals to remove “Hydro Benefit” – Consultation under Section 11(2) of the Electricity Act

³ The consultation paper and the relevant notices (as amended) are available on Ofgem’s website, www.ofgem.gov.uk.

⁴ See sections 3A – 3C Electricity Act 1989

⁵ See section 3D(5) Electricity Act 1989

Following detailed legal analysis, the Authority concluded that it has no choice but to remove Hydro Benefit in order to ensure compliance with European law. It therefore consulted on the licence modifications required to effect this change.

On 17 November the Energy Minister, Mr Stephen Timms, issued a statement including the following:

"I understand the need for Ofgem to consult on proposals for lifting of Hydro Benefit on the basis of legal advice which it has received that it may be discriminatory under European legislation. I recognise the difficult position Ofgem are in, but I am concerned about the potential impact this could have on consumers' bills in the North of Scotland.

"Due to the unique circumstances in this particular part of Scotland I have asked my officials, as a matter of urgency, to investigate all possible means whereby the effect of the Hydro Benefit can be best mitigated. I will be making a further announcement on their findings at the earliest possible time."

Summary of responses

Four parties responded to the consultation notice.

Two parties stated that the proposed changes served the purpose of removing Hydro Benefit, while the other two parties did not express any views that the legal drafting consulted upon in the notices failed to achieve the objective of removing Hydro Benefit.

Three parties noted the Government's announced intention to seek to gain legislative powers to introduce a new subsidy to offset the otherwise high distribution charges in SHEPD's area. Two accepted the principle that the customers in northern Scotland should not be fully exposed to the exceptionally high distribution costs in that area. One of these respondents strongly supported the proposed new legislation in terms of the effect on customers in northern Scotland, but stressed that any replacement measure for Hydro Benefit should be subject to regular and rigorous review to ensure that distortion to the market was minimised. One party also stated that any replacement measure should not distort competition between suppliers.

The same respondent sought further clarity on the rationale for continuing the subsidy at the current level. The respondent also requested that Ofgem's legal advice be published, so as to establish why it was the case that the form of replacement measure envisaged by Government complied with the relevant European law, while the current arrangements were deemed to be in breach.

The other party who commented on the anticipated action by Government consequent to the removal of Hydro Benefit noted that while there were no details on the planned replacement measure, it would appear that the plan was to replace a subsidy funded by SSE with a subsidy funded by customers, and that this would represent a windfall of some £750m to SSE. The respondent cited a 1995 MMC report into Scottish Hydro-Electric plc, which included consideration of Hydro Benefit. In particular, the respondent noted the statements in the report that if there were to be a disposal of assets or a further restructuring of the industry, then measures should be taken to maintain the effect of the subsidy through, for example, the establishment of a fund, presumably funded by SSE shareholders. The respondent considered

that the combined plans of Ofgem and Government undermined the conclusions of the Monopolies and Mergers Commission ("MMC"). Consequently, the respondent encouraged Ofgem not to make the proposed licence changes while this avenue of action was considered further with DTI.

This respondent also highlighted the fact that the future value of Hydro Benefit was uncertain, because it depended on relative movements in distribution and transmission costs, and could be higher in future than current levels. The respondent noted that, consequently, the adverse effect on customers could be higher than anticipated.

One party noted the undertaking, formalised in the licence drafting proposed, for SHEPD to continue to operate (in setting charges) as if Hydro Benefit remained in place until 1 April 2005. The respondent also noted, however, the DTI press release statement that SSE have pledged not to raise tariffs until the legislation comes into effect. The respondent considered it appropriate for this undertaking to be formalised also (in the event that the legislation was not in place by 1 April 2005).

Ofgem's views

Ofgem notes that no respondent commented that the legal text consulted upon failed to meet the objective of removing Hydro Benefit.

In respect of the wider issues raised relating to the Government's intentions to legislate to create a replacement subsidy, this is a matter to be progressed by Government through the legislative process and through wider consultation. Given the Government's stated objective, Ofgem will advocate replacement measures that are most consistent with its statutory duties, and in particular its principle statutory duty to protect the interests of customers where appropriate through the promotion of effective competition.

In response to the point raised concerning the conclusions of the MMC report of 1995, and the potential establishment of a fund to continue the effect of the subsidy in the event of industry restructuring, Ofgem would like to make the following points. In forming its views on Hydro Benefit Ofgem explored thoroughly all avenues that would have the effect of reducing the impact on customers, in northern Scotland and in other parts of GB, of removing Hydro Benefit. Ofgem concluded that no further action would be consistent with its statutory duties and its over-riding obligation to ensure compliance with European Law. It was Ofgem's view, in the light of its legal advice, that such all such measures would raise similar legal issues to those raised by the legal analysis of the current Hydro Benefit arrangements.

In response to the comment raised concerning the legality or otherwise of possible alternative measures legislated for by Government, it is not for Ofgem to comment in advance of more detail of the anticipated scheme being brought forward by Government.

Ofgem's decision

Ofgem has decided following consultation and having regard to the representations made to it to direct the changes to the licences of SHETL, SHEPD and SSE Generation Limited as consulted on in the published notices under section 11(2) of the Electricity Act to effect the removal of Hydro Benefit. The changes will be made with effect from 12 January 2004.

Copies of these directions can be found on Ofgem's website⁶.

Yours sincerely

David Haldearn
Director, Scotland

Signed on behalf of the Authority and authorised for that purpose by the Authority

⁶ www.ofgem.gov.uk