



Balancing and Settlement Code Panel, suppliers and distribution companies, consumer representatives and other interested parties

Promoting choice and value for all gas and electricity customers

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Dear Colleagues,

Way forward on longer-term electricity settlement reform

This letter sets out how we plan to progress work to put in place electricity settlement arrangements that can help create retail energy markets that work better for consumers. Over the coming year, we plan to scope out in more detail the problem that may require reform of existing arrangements and how best to address this problem.

Background

In July 2012, Ofgem published a work programme setting out the steps we will take to use the opportunity that smart metering presents to create 'smarter markets'.¹ Our ambition is for retail energy markets that are more efficient, dynamic and competitive, delivering better outcomes for consumers. The work programme identified four priority areas of reform, which are now being progressed as the first projects in the Smarter Markets Programme.² One of these projects concerns the electricity settlement arrangements.

One of the principles of the electricity market is that suppliers and generators should trade bilaterally to meet the needs of energy consumers. The Balancing and Settlement Code (BSC) sets out the process for comparing the amount of energy that a generator or supplier has arranged to be put on to the network with the volume of energy that they produced or their customers consumed respectively. This calculation is made for each settlement period (defined as a period of 30 minutes). Generators and suppliers pay charges for any difference between their contracted positions and the amount of energy that they produced or are allocated as consumption.

The allocation of energy volumes to suppliers is governed by the Supplier Volume Allocation (SVA) arrangements. Our work on settlement as part of the Smarter Markets Programme (and hence the use of the term 'settlement' in this letter) focuses on the SVA arrangements (and associated processes such as performance assurance).

Under the existing settlement arrangements, the majority of energy is settled using estimates of consumption. This is because most sites do not have meters capable of recording consumption in each settlement period. In addition, final allocation of volumes takes at least 14 months and can take up to 28 months in some cases.

¹ *Promoting smarter energy markets: a work programme*, Ofgem, July 2012.

² More information on the Smarter Markets Programme is available on the Ofgem website: <http://www.ofgem.gov.uk/Markets/sm/strategy/Pages/Strategy.aspx>

The roll-out of smart metering has the potential to increase the accuracy and speed of the settlement arrangements through improved access to more granular consumption data. The potential benefits to consumers may come from more effective competition and reductions in the costs to supply electricity. Using data from smart metering may also enhance security of supply, for example by increasing the incentives on suppliers to contract for demand-side response.³

In our July 2012 work programme, we identified that changes to the settlement arrangements may be required to facilitate the longer-term development of smarter markets. In this context, we set out that our longer-term objective in relation to settlement is to put in place arrangements that use smart metering data to allocate energy in an accurate, timely and cost-effective way. We also committed to publishing an open letter in Q1 2013 setting out how to progress longer-term settlement reform.

To help inform our assessment on the best way to proceed, we asked the BSC Panel ('the Panel'), which oversees the BSC, to prepare a report describing how it would develop and deliver reform. Elexon prepared this report on the Panel's behalf with the help of an expert group. The Panel submitted its report to us in December 2012.⁴ The Panel proposed to undertake a review of the settlement arrangements. Among other things, its report set out the scope and objectives of this review, as well as the outputs it would deliver. We have considered carefully the Panel's report and the proposals made in it in coming to our conclusions on the way forward. The report has been a valuable input to our thinking and we are grateful to the Panel for preparing it, as well as to all the parties who contributed to its development.

Way forward

We have concluded that it is prudent to undertake a further stage of scoping in consultation with stakeholders. We aim to define in greater detail the problem that may require changes to the existing arrangements and identify the most effective approach for addressing this problem. This will provide a robust platform for subsequently identifying, assessing and implementing any reforms that may be necessary to facilitate the development of smarter markets.

Our decision to undertake a further stage of scoping is driven by two factors. First, we consider that without a clear understanding of the problem, there is a risk of nugatory work and missed opportunities. In particular, we need to understand how the outcomes that settlement needs to achieve may evolve over time with wider market developments. Second, we consider that there is a risk that an industry-led process may not deliver reform in the interests of consumers, such that potential benefits may be delayed or are not realised. This risk might materialise because the interests of market participants may not be sufficiently aligned with those of consumers. Further scoping of the approach to reform, informed by a clear definition of the problem, can help to mitigate this risk. This includes the appropriate stage at which to initiate industry-led processes, if appropriate. Given the potential risks, we have concluded that Ofgem is best placed to lead the scoping work.

We describe in more detail below why we have decided to proceed in this way and the other options considered. Our plans have been informed by detailed consideration of the Panel's report, as well as the responses to Elexon's consultation on a draft version of this report and the discussions of the expert group. We have also held bilateral meetings with stakeholders to understand their views on how to progress reform.

³ Demand-side response refers to temporary changes in energy taken off the grid by individual consumers in response to a signal, such as a price.

⁴ *Delivering electricity settlement reform*, Elexon, December 2012.

Defining the problem

As described above, changes may be required to the existing arrangements to realise the benefits of using more granular and timely consumption data from smart meters in settlement. We plan to explore in detail the drivers underpinning the need for reform in the context of our ambition for smarter markets. This will provide a clear understanding of the problem that we are seeking to address.

For example, one potential driver of reform relates to the outcomes that settlement seeks to deliver today to support the effective operation of the market. Smart metering presents an opportunity to address issues that might undermine the delivery of these outcomes. These might include the long timescales of the current process, the use of estimates or the complexity of the arrangements. Identifying and understanding such issues is an important first step in the reform process. It will help to ensure that the full potential of smart metering to address existing issues is realised.

Another potential driver of reform is that the outcomes that settlement needs to deliver to support the operation of the market may change over time. This could be caused by:

- changes in the market relevant to the settlement of energy, such as increasing uptake of small-scale generation or the emergence of new opportunities for existing and new market participants to contract with consumers for demand-side response
- evolving or new requirements on settlement data for the calculation of non-energy charges, such as those levied on suppliers for using the network or under government programmes designed to increase the use of low-carbon technologies
- ongoing regulatory change.

As with existing issues, it is essential to identify these future outcomes at the outset. This will help to ensure that any reform creates an enduring solution that enables market development and is compatible with future changes.

Without a clear definition of the problem, there is a significant risk that reform will not deliver in the interests of consumers. This could happen because an opportunity is missed to address existing issues or because such issues become embedded in new arrangements. Alternatively, changes may be implemented unnecessarily or may not be sufficient to enable settlement arrangements to support the development of smarter markets. As a result, the potential benefits of market development may not be delivered, or may be delivered later or at a higher cost than would otherwise be the case.

Ofgem is well placed to define the problem that reform is seeking to address. Our ability to look across the supply chain will allow us to take a holistic view of the drivers of reform. This is particularly important because these drivers (especially those relating to future outcomes) are likely to be wide ranging and extend beyond the settlement arrangements. In addition, we are also managing many of the key interactions with other regulatory changes. This includes Ofgem's proposal to launch a new project to develop a long-term vision for trading arrangements. Settlement is a component part of these trading arrangements.⁵ Should Ofgem proceed with a project on the trading arrangements as proposed, it will be essential that settlement reform is consistent with a long-term vision.

Addressing the problem

Through our first stage of work, we will define the problem that may necessitate reform. We will then be in a position to consider the best approach for addressing this problem.

⁵ *Update on the Electricity Balancing Significant Code Review (EBSCR) and request for comments on proposed new process to review future trading arrangements*, Ofgem, February 2013.

Establishing a robust approach will be critical to the successful delivery of any future reforms. This is because the interests of market participants may not be sufficiently aligned with those of consumers. For example, using data from smart metering in settlement presents an opportunity for suppliers to reduce the costs, complexity and risks that they face in supplying energy to consumers as a result of the existing arrangements. However, there are also potential risks from reform to suppliers if one consequence is that they are more exposed to their customers' actual consumption. Some options for reform that could deliver benefits for consumer may also increase costs to suppliers, both from one-off system changes and on an ongoing basis.

Furthermore, it may be the case that not all the potential benefits of reform will flow directly to market participants and specifically to those who will incur the costs. This might include benefits relating to the operation of competition, such as the potential for innovative products around demand-side response. Another example is the potential for settlement reform to help in the transition to a low-carbon electricity system. This could come from facilitating the offer of new products and services that help consumers use energy more efficiently.

The approach to progressing any reforms will need to mitigate the risk that the potential benefits are delayed or are not fully realised because the interests of consumers and market participants may not align. Our work to establish a robust approach is likely to include identifying:

- the objectives of reform. We will use the objectives set out in the BSC Panel's report as a starting point
- the scope of reform. Building on the work of the BSC Panel, we will explore the core components of a settlement process that could be examined. A subsequent stage of work could seek to identify and assess how these core components can be varied as the basis for identifying options for reform
- the process for progressing the next stage of work to identify and assess the options for reform, including the timing of this work and Ofgem's role.

Other options considered

Given the extent of regulatory change, we considered whether there is a need to progress work now on settlement reform. As outlined above, stakeholders have argued that reform will be important in delivering the benefits of smart metering. However, there were mixed views among respondents to Elexon's consultation on the Panel's draft report relating to the timescales for progressing reform. The majority expressed support for starting work now, with a small number advocating implementation of changes at the earliest opportunity. Others expressed concerns relating to stakeholders' capacity to engage with settlement reform, given other regulatory change. There were also suggestions that reform should wait until there is greater certainty around other aspects of the commercial and regulatory framework, including the Data and Communications Company.⁶

Settlement will have a key role to play in creating the right conditions for smarter markets. We concur with stakeholders that changes are likely to be necessary to existing arrangements to enable market development to happen, including to help facilitate efficient use of demand-side response. For this reason, we have decided to progress work now. Through our scoping work, we can help to manage the uncertainty identified by some stakeholders, in particular by examining the outcomes that settlement needs to achieve and how each could shape reform. We will also take account of other demands on stakeholders' resources in planning our engagement.

⁶ The Data and Communications Company will be responsible for managing all the messages and data transferred between domestic consumers' smart meters and suppliers or other authorised parties.

We also considered whether to ask the BSC Panel to take forward its proposed review of the settlement arrangements (as set out in its report). The outputs of this review would have included a vision for settlement, as well as a package of detailed requirements for implementing this vision. As set out above, we consider that further work is necessary to define the problem that reform is seeking to address before starting to develop the potential solution. We believe that Ofgem is best placed to undertake this work, given our ability to take a holistic view of the drivers of reform as described above.

Our work over the coming year seeks to build on the Panel's report and the work undertaken by stakeholders last year. For example, the Panel identified the importance of understanding what settlement needs to achieve in the future as an important step in progressing reform. As described above, this will be a key focus of our scoping work. We also note that respondents to Elexon's consultation on the draft report expressed strong support for a 'blank sheet of paper' approach to reform that is unconstrained by existing arrangements. Our scoping work can help to provide further definition around this approach.

Next steps

We plan to define the problem and scope out the approach for addressing it over the coming year. Our intention is to publish our conclusions on both in Q1 2014. This will include details of any next steps, including the process for identifying and assessing potential options for reform.

As we progress thinking, we are committed to providing all stakeholders with the opportunity to input to our work. Our timetable has been designed to allow us to engage fully with all interested parties. We plan to publish a consultation document in Q4 2013 to seek views on our definition of the problem and the proposed approach for addressing it through reform. Prior to the publication of this document, we are keen to consult widely with stakeholders. To this end, we plan to hold two workshops to discuss the potential drivers of reform and the approach to addressing the problem.

Our work is focused on longer-term reform. Prior to any potential changes coming in to place, it is essential that settlement arrangements continue to function effectively in the short and medium term. This work is currently being progressed by an expert group reporting to the Panel called the Profiling and Settlement Review Group (PSRG). We would encourage this work to continue alongside thinking on longer-term reforms. We will continue to support the PSRG and will work with industry to ensure that any short- or medium-term changes are consistent with our longer-term work.

If you have any comments or questions on this letter or would like to register your interest in our work to progress reform, including the workshops, please contact Jonathan Amos at smartermarkets@ofgem.gov.uk.

Yours sincerely,

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