Promoting choice and value for all gas and electricity customers

New Electricity Trading Arrangements (NETA) – One Year Review

Introduction

The New Electricity Trading Arrangements (NETA) were successfully introduced in March 2001 – known as NETA Go-Live.

This review provides an in-depth analysis of NETA over its first year of operation.

Main findings

- NETA is performing well against objectives set by Ofgem and the Department of Trade and Industry (DTI) when it was decided that the Electricity Pool, whose flawed rules and inflexible governance arrangements failed to reflect falling costs and increased competition, should be replaced.
- NETA reforms – alongside other factors such as falling fuel prices, a generous capacity margin and increased competition in generation – have resulted in a 40 per cent reduction in the costs of wholesale electricity since 1998, when NETA reforms were first proposed by Government.
- Prices over the first year of NETA (March 2001-March 2002) fell by 20 per cent.
- Flexible governance has allowed significant changes to be made to the balancing and settlement rules in the last year to the benefit of all market participants.
- Those smaller generators who replied to Ofgem's latest survey reported that output levels – the amount of electricity generated – were slightly up compared with the previous year. This is in contrast to the reduced output reported after two months of NETA operation in the last review in August 2001.
- Prices for smaller generators compare with prices received by larger generators and in some cases, where they attract Government help, are better.

Ofgem addresses key issues

1. What impact has NETA had on retail prices?

The current situation is that:

- industrial and commercial purchase prices have fallen between 20 and 25 per cent since October 1998. Prices have fallen by 9 per cent in the April 2002 contract round and indications show further reductions in the October 2002 contract round
- domestic customers need to claim their savings by switching supplier. Today, people switching can save as much as 25 per cent on direct debit tariffs, representing £63 off the average bill, and as much as 24 per cent on standard credit tariffs, representing £64 off the average bill
- customers who have switched suppliers have seen their electricity bills fall by 8 per cent during the last four years, representing £21 off the average domestic bill
- domestic customers who have stayed with the former monopoly electricity boards have seen some benefit – their electricity bills fell by 3.5 per cent during the last four years, representing £8 off the average domestic bill.

Why have domestic electricity tariffs not fallen in line with wholesale prices?

- In a competitive market, supply companies have focused the savings on offer to attracting customers away from their existing, incumbent suppliers. That is why switchers have seen more substantial savings.
- New environmental costs which suppliers are now passing on to customers, eg the costs of the Renewables Obligation and Energy Efficiency Commitment, have added 1.5-2 per cent on domestic customers' bills.

2. How is NETA affecting Combined Heat and Power (CHP) and renewable (smaller) generators?

As part of this review, Ofgem has again surveyed all smaller generators.

In the competitive wholesale market…

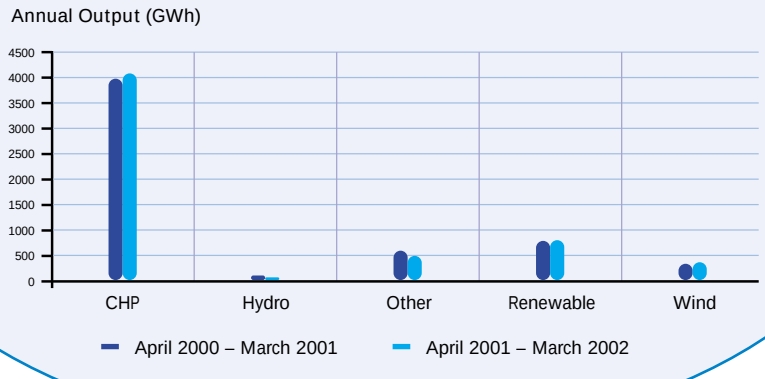
…smaller generators who responded to the survey reported that they are producing about the same amount of electricity today as they were before NETA.

This differs from the two month review, published in August 2001, where smaller generators reported a 44 per cent reduction in output.

Prices for smaller generators have fallen, as have those for all generators, but are either in line with prices for other generators, or are much higher where they attract Government subsidy, eg wind.

To encourage consolidation, Ofgem – following a joint Ofgem/Department of Trade and Industry (DTI) working group – approved a number of proposals by participants to help the growth of independent consolidation services. These services enable generators, including smaller generators, to combine their output and negotiate better terms for selling it.

Output by technology type



Prices by technology type

	Minimum price (£/MWh)	Average price (£/MWh)	Maximum price (£/MWh)	Number of responses
CHP	16.00	19.44	30.43	21
Hydro	20.00	26.56	28.75	4
Renewable	16.54	20.87	36.00	5
Wind	16.00	41.30	77.50	13
Other	17.83	19.32	19.53	8

Under the Balancing and Settlement Code...

...the impact of changes to the NETA balancing rules have helped all participants but particularly those generators less able to predict their output, eg wind.

An important modification has been the decision to reduce gate closure from three and a half hours to one hour, giving market participants more flexibility to balance their positions before Gate Closure and, therefore, reduce the risk of exposure to charges for being out of balance.

Several other modifications have been approved by Ofgem which help smaller generators.

The costs of balancing the system on a daily basis have reduced by more than a half since Go-Live. This has been the result of NGC responding to its incentives as system operator – and greater competition in the provision of balancing services, particularly from demand-side participants.

3. What has been the effect of lower prices on future security of supply?

Today, as would be expected in a market which has a generous capacity margin of 25 per cent and where prices have fallen, some generators have decided to 'mothball' plant.

This must be seen in context – just 4 per cent of total installed capacity has been 'mothballed' from April 2002, and some plant has already been returned to the system.

Importantly, a forward price curve extending for two to three years is now established.

This will help ensure security of supply by signalling the need for 'mothballed' plant to be returned to the system, or for new plant to be built.

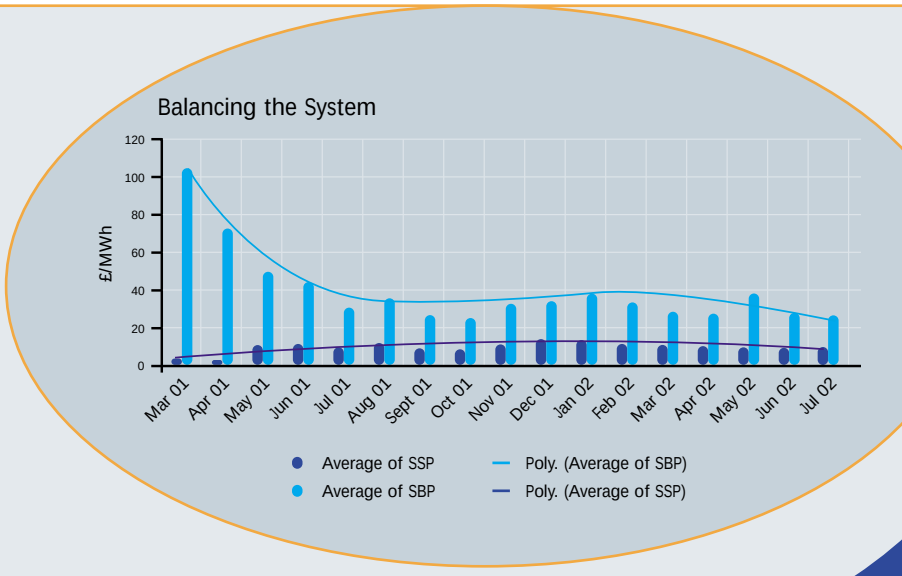
Other main findings of the review

Market operation

- The majority of electricity is now being traded like any other commodity.
- Market liquidity has continued to increase by more than 200 per cent in the first year of NETA.

The balancing arrangements

- Modifications and experience have led to significantly reduced price volatility in the balancing mechanism. For instance, the difference between the prices at which participants have to buy and sell electricity from National Grid Company (NGC) to balance their positions reduced from £70 per MWh at Go-Live to £17 per MWh today.
- Market participants are successfully managing their portfolios to avoid exposure to imbalance charges.



- Participants imbalance costs make very little impact on overall wholesale electricity costs.
- Significant Ofgem-approved changes to the balancing and settlement rules have helped all market participants.
- More rule changes have been proposed and are being developed by the industry.

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Looking Forward

Ofgem will continue:

- to review the workings of the retail markets to ensure they are acting competitively and in the interests of consumers
- to encourage the growth of independent consolidation services
- to encourage the development of demand-side participants in NETA to help provide additional balancing services and increased competition for generation, and
- to ensure that the operation of NETA balancing arrangements do not create distortions and enable all generators, large and small, to participate efficiently.

Background

NETA was successfully introduced in England and Wales on Tuesday 27 March 2001.

A market

The former flawed and much-criticised arrangements under the Electricity Pool meant that wholesale prices failed to reflect falling costs and increased competition. NETA created a market where electricity is traded like any other commodity through bi-lateral contracts, where prices are agreed between the two contracting parties, or on power exchanges.

Balancing arrangements

Electricity cannot be stored and, to ensure system security, has to be balanced on a second-by-second basis by the system operator, National Grid Company (NGC).

NGC operates a balancing mechanism to achieve this. About 2 per cent of electricity demand is bought and sold by NGC in this mechanism.

Generators are out of balance if they cannot provide all the electricity they have contracted to provide, or they have generated too much.

Similarly, suppliers who have not contracted enough electricity to meet their customers' needs or who have not consumed the amount of electricity that they have contracted for, will be out of balance.

This will mean that NGC will face additional costs because it may have to buy or sell electricity at short notice to keep the system in balance. The charges (prices) participants face for being out of balance are based on these additional costs.