

Future Trading Arrangements - Issues and Principles Working Group

Combined 1 st Meeting of the Issues and Principles Working Groups of the Future Trading Arrangements Forum	Date and time of Meeting Location	31 st July 2013, 9:30am – 1.45pm Ofgem, 9 Millbank
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1. Present

Chair:	Giuseppina Squicciarini (Ofgem)
Attendees:	Arthur Probert (Energy Services Partnership) Barbara Vest (Energy UK) Ben Hall (Cornwall Energy) Bill Reed (RWEnpower) Colin Prestwich (Smartest Energy) Duncan Sinclair (Baringa, representing Wartsillia) Emma Pinchbeck (Micropower Council) Esther Sutton (EON) Ivan Olszak (Centrica) James Anderson (Scottish Power) Jill Caaney (Electricity Storage Network) Lisa Waters (Waters Wye Associates) Mark Couldrick (ELEXON) Michael Dodd (ESB International) Nick Geddes (DECC) Olaf Islei (APX) Phil Hicken (DECC) Stephen Powell (CER) Stuart Cotton (Drax Power) Tom Bent (SSE)
Ofgem representatives:	Andrew Ryan Anjli Mehta Andreas Flamm Boaz Moselle (FTI) Emma Burns Grendon Thompson Rene Le Prou (FTI) Stephen Lee
Apologies	Ebba Phillips John (DONG Energy) Eric Graham (TMA Data Management) Magnus Walker (Government Procurement Service) Katharine Clench (National Grid) Nick Frydas (Mott MacDonald) Tim Rotheray (Combined Heat and Power Association)

2. Welcome and opening remarks

2.1. Giuseppina Squicciarini (Ofgem) welcomed attendees to the first working group of the Future Trading Arrangements (FTA) forum, noting significant recent announcements on

by DECC on Electricity Market Reform (EMR), including the draft EMR Delivery Plan, Ofgem's publication of the Electricity Balancing Significant Code Review (EBSCR), as well as the progress made with respect to European reforms, including ENTSOE consultation on the Balancing Network Code.

2.2. Giuseppina noted the importance of the FTA process in this context as a framework for increasing both an understanding of how the different policy initiatives slot together, and the certainty of how wholesale trading arrangements may develop in the future. The FTA process would also provide industry with a means for engaging with Ofgem on these topics at a strategic level (through the Forum) and at a technical level (through the working groups feeding into the Forum) with a forward looking perspective.

2.3. Giuseppina noted that following an action agreed by the Forum, the principles and issues workstreams will be covered by the same working group on the same day to ensure interactions are captured.

3. Operation of the working groups

3.1. Andrew Ryan (Ofgem) gave a presentation on the **purpose and operation** of the FTA Forum and its working groups, noting that there are two stages to the FTA process. The first of these is underway, and will culminate in the Forum developing a view on the principles underlying the future trading arrangements and on the issues that the FTA process should develop further. Subject to GEMA's approval at the end of 2013, the Forum would then consider those issues in detail in 2014. Andrew noted that following feedback at the first FTA Forum, Ofgem had amended the proposed timeline.

3.2. Andrew outlined the Principles and Issues workstreams. The objective of the Principles workstream is to support investors' certainty by providing a common ground in discussion of any future developments of trading arrangements; and to seek agreement on a revised set of principles underpinning future trading arrangements. The objective of the Issues workstream is to analyse the range of issues relating to trading arrangements, undertake a gap analysis of how these issues are being addressed, and to discuss the priorities to assist the Forum to consider the scope of additional work that should be undertaken in the 2nd Stage from late 2013 onwards.

3.3. Andrew outlined the proposed ways of working, noting the Forum would act primarily as an advisory body, while any decisions would remain with GEMA. The role of the working groups is to provide well-developed analysis to feed into the Forum's strategic discussions. The working group approved the ways of working and the work programme.

4. Presentation on principles and issues

4.1. Giuseppina introduced the work that Ofgem, with support from FTI Consulting, developed to stimulate the discussion in the working group on trading arrangements principles, challenges and issues. She noted that the slide pack presented at the working group was meant to promote a discussion of issues and principles. They are not a statement of policy or intent.

4.2. Boaz Moselle (FTI Consulting, on behalf of Ofgem) gave a presentation outlining (i) the guiding principles and key market features of NETA as designed in 2001, (ii) how the market has evolved since 2001 and likely future evolution as driven by changes to market design, changes in markets fundamentals and changes in policy landscape, and (iii) initial suggestions for discussion on the changes which may be required in light of these developments. The presentation included a number of questions to enable discussion.

Designing the electricity market in 2001 – guiding principles and key features of the market design

4.3. Boaz outlined the principles that the NETA were founded on: non-discrimination; efficient dispatch; market signals as the drive for long-run investment; competition where possible; minimum regulatory oversight; risks allocated with those best placed to manage them; and the 'polluter pays' principle (ie that parties should be exposed to the costs that they create). He noted that these principles were based on Ofgem's statutory duties and highlighted the key issues that the market faced at the time, including market power, manipulation of the prices in the England and Wales Pool, the dash for gas and resultant healthy capacity margins, and low liquidity of the power market, compared with the high liquidity in gas trading. He highlighted a number of market features which came about as a result of the principles.

4.4. One working group member suggested that the key founding principle of NETA was that **electricity should be treated as any other commodity**, and the gas market arrangements were used as a model for the electricity trading arrangements, as they were seen as successful in promoting competition. Members highlighted the difficulties of treating electricity as a 'normal' commodity. The process of identifying 'pure energy' balancing actions for the purposes of calculating cash-out prices was described as complex and arbitrary.

4.5. The working group discussed the principle of **efficient dispatch**, and how the principle could be interpreted. There was a question about whether decentralised self-balancing always produces the most efficient outcome, and one working group member suggested that 'efficiency' depends on the timeframe in question. It was suggested that self-balancing may have been more important in 2001 when the market was dominated by thermal generators and the focus was on the reliability of these generators. It was suggested that the focus may now shift from reliability of thermal generation (a key driver in NETA) to flexibility and developing new capabilities (a likely key driver for future arrangements, given the increasing penetration of renewables).

4.6. There was a discussion about the **governance** of the market rules. One working group member highlighted that the Balancing and Settlement Code (BSC) governance arrangements introduced as part of NETA were an improvement to the previous governance arrangements, as they allowed greater flexibility for market participant to raise changes.

4.7. On the market features of NETA one working group member noted that interconnectors were treated as generation rather than as parts of the transmission network, and it was suggested that this could be argued to be unduly discriminatory.

4.8. The working group discussed what **lessons** could be learned from NETA's performance to date. It was agreed that the arrangements were largely beneficial for consumers, and were successful in ensuring investment and providing reliable supplies. It was suggested that there were areas where the market has not performed so well: there is limited involvement of demand side; there is low liquidity in some parts of the wholesale market; prices are not completely transparent, in part due to vertical integration; there have been many changes required since 2001; and there has been limited levels of innovation.

How the market has evolved since 2001, its likely future evolution and changes which may be required

4.9. Boaz noted that Ofgem's statutory objectives have evolved since 2001 to reflect the need to protect the interests of existing and future consumers where, taken as a whole, those interests include the reduction of greenhouse gases and security of supply; and with respect to implementation of and compliance with the European Third Package. He also highlighted the changes in market fundamentals: the increased share of intermittent

generation sources; tightening capacity margins driven by forced closures of ageing and polluting plant; the move from NETA to BETTA; greater interconnection with neighbouring markets, and higher fuel prices. He also noted external factors which are impacting on NETA, including the Third Package and the European Target Model, the 2020 Renewables Target, EMR (CfDs/FiTs; Capacity Mechanism; new nuclear), and the opportunities created by new technologies including smart meters.

4.10. Working group members noted that one of the key questions for the FTA process was whether the **principles** of the Electricity market (or the interpretation of the principles) remain valid in light of how the market has evolved, and how it is likely to evolve in future. It was suggested that there is a question of whether the trading arrangements would need to change to reflect changes in principles. It was noted that the **trading arrangements have changed in scope** since 2001, both geographically, as EU trading rules impact on the current trading arrangements, and in terms of issues, as EMR adds new elements to market design and new governance.

4.11. Working group members suggested other **drivers of change** in the market: the impact of the Regulations on Market Integrity and Transparency (REMIT); the increasing reliance on imported gas; the increasing share of gas-fuelled generation, the fact that demand for gas and electricity has stopped growing; the greater role and involvement of DNOs; and the greater levels of distributed generation and DSR.

4.12. A number of working group members noted that the **policy developments** introduced since 2001 may interact with the original principles of NETA, and questioned whether these policy developments share the same principles as NETA. It was suggested that these developments may adversely impact on **market signals**. One working group member questioned the importance of market signals going forward if every generating plant is receiving a subsidy, and whether incentives to deliver energy under the capacity mechanism might be different to those in the energy only market. It was noted that NETA was based on the fundamental principle that 'the price was right'. Another member suggested that perhaps market signals are becoming more important for near-term dispatch signals, rather than longer term investment signals.

4.13. Boaz suggested some principles which may need to be updated in light of developments since 2001. He noted that **long term signals for investment** will be driven by factors external to the energy-only market, such as the capacity mechanism and renewables feed-in tariffs. As a result, and in light of Ofgem's REMIT obligations, he suggested that the level of **regulatory oversight** might increase. He questioned whether cost-reflective charges would lead to efficiency gains in all instances.

4.14. Some examples of where principles may need to be revisited were suggested. It was suggested that the principle of promoting '**competition where possible**' had evolved to be 'competition where appropriate'. Ofgem's retail market intervention was highlighted as one example where increased regulatory intervention was deemed appropriate.

4.15. The working group discussed the principle of **allocating risks** to those best placed to manage them. It was suggested that the principle of '**polluter pays**' may override this principle. One working group member questioned whether it is appropriate for renewable generation sources to pay high cash-out prices when other initiatives aim to subsidise its production.

4.16. The increasing **cost of managing transmission network constraints** was highlighted, and it was suggested that constraint costs were not a substantive issue when NETA was conceived, and that it was envisioned that the transmission charging arrangements would deliver short and long term locational signals. It was noted that GB is required to consider the case for locational market prices as part of the European Target Model. There was a discussion about whether locational market prices would lead to more efficient investment in transmission assets.

4.17. There was a question as to whether there will be more industry codes going forward as a result of EMR and the European Network Codes. It was suggested that this would create more complexity, and reduce GB market participants' ability to influence these codes.

4.18. There was a discussion about the changing role of the System Operator, in response to requirements introduced as part of EMR, and in light of increasing reserve requirements, and the implications that this has for institutional arrangements.

4.19. The working group committed to discussing what changes might be required in light of developments since 2001 in further detail at the next working group.

5. Date of next meeting

5.1. The date of the 2nd FTA working group will be the 18 September.