

Future Trading Arrangements – Issues and Principles Workgroup

Combined 2 nd Meeting of the Issues and Principles Working Groups of the Future Trading Arrangements Forum	Date and time of Meeting Location	18 th September, 11:00 – 15:30 Ofgem, 9 Millbank
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1. Present

Chair

Giuseppina Squicciarini (Ofgem)

Attendees

Arthur Probert (The Energy Services Partnership Ltd)
 Bill Reed (RWE npower)
 Colin Prestwich (Smartest Energy)
 Ebba Phillips John (DONG Energy)
 Esther Sutton (E.On UK plc)
 James Anderson (Scottish Power)
 Katharine Clench (National Grid)
 Mari Toda (EDF Energy)
 Mark Couldrick (Elexon)
 Melle Kruisdijk (Wärtsilä)
 Nick Frydas (Mott MacDonald Group Ltd)
 Nick Geddes (DECC)
 Noelita Rajadurai (DECC)
 Olaf Islei (APX, Inc.)
 Stephen Powell (CER)
 Philip Davies (Centrica plc)

Ofgem representatives

Andreas Flamm
 Andrew Ryan
 Anjali Mehta
 Boaz Moselle (FTI)
 Emma Burns
 Grendon Thompson
 Jason Mann (FTI)
 Steffen Felix
 Stephen Lee

Apologies

Barbara Vest (Energy UK)
 Ben Hall (Cornwall Energy)
 Lisa Waters (Waters Wye Associates)
 Michael Dodd (ESB International Ltd)
 Emma Pinchbeck (Micropower Council)
 Tim Rotheray (CHPA)
 Tom Bent (SSE)

2. Welcome and opening remarks

2.1. Giuseppina Squicciarini (Ofgem) welcomed the attendees to the second working group of the Future Trading Arrangements (FTA) forum. She noted that the first working group had discussed NETA principles and market features and what had changed in the

years since NETA was introduced. She outlined that this working group would focus on how NETA principles may need to evolve and specific issues and potential policy levers in the trading arrangements that could address existing and future issues. Giuseppina noted that current thinking reflected the views and input of the first Working Group and Forum, and that material presented did not reflect GEMA views.

2.2. Recapping from the first working group, Jason Mann (FTI) outlined how the generation mix is likely to change over the next decade due to increasing intermittency, plant closures and new technologies. He noted that increasing levels of intermittent generation would result in greater output uncertainty and volatility and therefore greater reserve and flexibility requirements would be required. He also highlighted the issue of greater congestion costs going forward, as a result of generators locating far from load, and noted that GB was becoming increasingly connected with other electricity markets, due to greater harmonisation of the market rules as part of the European Target Model. He highlighted EMR as key driver of change and increasing complexity in the trading arrangements. The working group agreed with how the issues had been characterised.

3. Key principles

3.1. Jason outlined the fundamental NETA principle of '**competition where possible**', suggesting that it was a core aim of NETA to make the electricity market more like other commodity markets and allow competition to drive efficient investment and operations. Boaz Moselle (FTI) suggested that promoting competition is part of Ofgem's statutory duties, so the principle is likely to remain valid in the long-term. However, he noted that the areas of the arrangements where competition is possible or appropriate may change, highlighting government and regulatory intervention where market failures have been identified. Conversely, he noted that competition may be increasingly important in the procurement of reserve and other ancillary services, as requirements for these increase going forward. It was also noted that DECC had indicated in recent publications that the EMR arrangements would transition to a market where all technologies compete fairly on price. The working group considered that this principle will remain important in the future.

3.2. The group then discussed the principle of '**efficient dispatch**', and the challenge of how this principle should be defined. It was agreed that this principle should be interpreted in an economic sense: promoting overall minimisation of costs while recognising technical constraints. The group agreed that efficient dispatch should remain valid in the future and also encompass long-run efficiency.

3.3. The group discussed the principle of '**non-discrimination**' that suggests that there should be equal treatment for all participants in the market with no undue discrimination for or against any participant. It was noted that this principle is reflected in Ofgem's statutory duties and so is likely remain valid in the long term, but that the challenge lay in how to define 'undue'. It was agreed that the principle should be interpreted so that discrimination is allowed only if there are objective reasons to do so.

3.4. The group discussed '**minimum regulatory oversight**', and it was suggested that the original NETA intention was that the market would police itself through competition and flexible governance arrangements, but that regulatory oversight has increased since NETA was introduced. It was noted that the Markets in Financial Instruments Directive (MiFID) is still evolving, and it has been suggested by the Financial Conduct Authority (FCA) that all physical forwards products could be treated as financial products and therefore fall under the FCA's remit to police. It was suggested that there are multiple regulators in this space and that their responsibilities will need to be set out.

3.5. It was suggested that in light of increasing regulatory intervention and oversight, a stable regulatory regime is important. Market participants need confidence that they will continue to be able to trade within the regulatory regime. The group recognised that the principle is important but would need to reflect changing external circumstances.

3.6. Jason highlighted that a new principle that had been added since the last working group: **'prices should reflect scarcity'**. Margins were healthy at the time of NETA, but it was suggested that security of supply concerns had become more prominent in recent years, and the intention of this new principle is to recognise the importance of security of supply more explicitly going forward. There was a discussion about whether the principle should be amended to say that price signals should reflect market conditions. Most stakeholders felt that this principle was appropriate.

3.7. Jason noted that the principles of **'polluter pays'** and **'risks allocated to those best placed to manage them'** had been combined. He noted that it was a key principle of NETA that participants who generate costs should face them. One stakeholder noted that there are some costs which cannot be targeted and should be socialised. Another suggested that it was important that the 'polluter pays' principle is balanced with other objectives, such as those related to transitioning to a low carbon market.

3.8. Jason highlighted the risk and cost created by the **uncertainty of intermittent generation sources**, and asked whether renewable generators should be exposed to these risks, or whether the trading arrangements should be adjusted so that intermittent generation sources are not exposed to these risks. There was a discussion about whether these risks would be best managed centrally, and a central aggregator for intermittent renewable generation was suggested as one method for doing so, or whether these risks could be managed by the participants themselves, for example through distributed energy storage and individual generators making better wind forecasts. One stakeholder questioned whether the trading arrangements currently provide all the appropriate tools for participants to manage these risks themselves.

3.9. There was consensus that the high-level principle of 'polluter pays' remains valid going forward, however there was a recognition that trading arrangements may need to evolve to ensure that market participants have the necessary tools to manage risks.

3.10. Jason outlined the principle of **'market signals drive long-run investment'**, noting that it was intended under NETA that signals to invest would be driven by prices of trades between market participants in the forward markets. It was agreed that in the medium term investment signals would primarily come from EMR but that the trading arrangements would play a role in providing signals for flexibility and investment in technologies which may not be covered by EMR (such as storage and interconnectors). It was noted that the capacity mechanism is intended to be transitional and there is no guarantee that capacity will be procured through an auction every year (ie that the capacity auction could clear at zero). In light of this, it was agreed that it is important that the trading arrangements are robust and could provide investment signals in the absence of other support mechanisms.

4. Issues and potential policy levers

4.1. Giuseppina introduced Jason's presentation on issues. She noted that the issues identified and the policy levers presented were intended to provoke discussion and did not represent an expression of Ofgem's or GEMA policy intent. She also noted that the policy levers for discussion in this meeting were not to be considered a comprehensive list of options, but ideas of potential levers which could be considered as part of FTA workstreams.

4.2. Jason gave a presentation about the key issues facing the market and some potential policy levers that could help address them.

4.3. Jason outlined the trading arrangements under NETA: participant to participant trading in the forward markets up until gate closure; participant to system operator trading in the balancing mechanism and through ancillary services contracts; and imbalance prices based on balancing actions taken by the system operator. He noted that gate closure is the

point at which participant to participant trade stops and that an adjustment to gate closure could be a potential lever if it would better deliver the principles. He noted that there is a single price zone in NETA, meaning that participant to participant trading does not account for location.

4.4. One stakeholder questioned whether more fundamental changes could be considered, such as a change in the role of the System Operator (SO). He suggested that it may be worth considering the potential for the SO to be more active in the market before gate closure, or allowing market participants to be active after gate closure.

4.5. Jason outlined **issues faced by renewable generators**. He suggested that the first issue faced by renewable generators was related to output uncertainty, and suggested that requirements to trade out imbalances close to gate closure would become increasingly important. The second issue that he highlighted related to the **route to market for renewables**, suggesting that intermittent generators may need additional tools to manage their risks as existing trading arrangements were not designed with high proportion of intermittent generation in mind.

4.6. Jason highlighted potential policy levers which could help solve the issues faced by renewable generators: changing timing of gate closure; enhanced trading close to real-time; improved intra-day trading; and a central aggregator for renewable generation. It was suggested that some form of close to real-time trading could be another potential policy lever to help renewable generators manage imbalance risk. A balancing energy market was outlined as a possible example. This would help market participants trade out imbalances close to real-time and be used to set an imbalance price.

4.7. One stakeholder suggested that it may be more useful to consider barriers to independent aggregation before a central aggregator is considered as mechanism to help intermittent generation sources manage imbalance risk. Most working group members did not consider making imbalance prices faced by renewable generators more benign desirable, but recognised that intermittent generators may need additional tools to deal with intermittency.

4.8. There was a discussion of issues related to **efficient balancing and system operation**. Jason noted that congestion costs had increased significantly due to lack of locational signals in the market and intermittent generation locating in areas far away from demand. Some stakeholders suggested that network reinforcement may reduce these costs going forward. It was noted that in light increasing renewable generation and the need for network expansion to catch up, constraint costs may continue to be an issue. Stakeholders noted the interactions with transmission charges.

4.9. It was noted that **how ancillary services are procured** has an impact on the market and it was suggested that are two broad options for procuring ancillary services: through grid code requirements or more market-based arrangements. The group discussed how reserve is procured in light of an **increasing reserve requirement**. It was suggested that the existence of a capacity mechanism may mean that the system operator will have access to a large amount of low cost reserve capacity.

4.10. Potential policy levers were suggested: consideration of locational signals; innovation in procurement of reserve, such as a near real time reserve market; mitigation measures to address negative prices; and a review of ancillary services. It was suggested that shortening of the balancing period could be added to potential policy levers.

4.11. There was a question about whether **negative prices driven by support mechanisms** are likely to be an issue going forward. There was agreement that negative prices are a reflection of policy design. There was a discussion about whether reflecting subsidies in the market price may produce unintended consequences. One stakeholder questioned why a distinction should be made between negative prices driven by support

mechanisms and other factors. One stakeholder suggested that negative prices driven by support mechanisms weren't an issue, and would serve to indicate a scarcity of demand, and incentivise technologies which can arbitrage between energy prices such as storage and DSR. Another stakeholder highlighted that GB shouldn't be considered in isolation when it comes to negative prices, and another impact of negative prices might be an increase in exports when prices are negative.

4.12. There was a discussion about issues related to **integration with the wider European market**. There was a question about the requirements to consider bidding zones, and it was explained that TSOs are required to undertake a technical assessment of the existing zone configuration within six months of the entry into force of the Capacity Allocation and Congestion Management (CACM) network code. National Regulatory Authorities (NRAs) would use this information to inform their decision on whether to launch a Bidding Zones Review, which would involve a TSO assessment of alternative zone configurations and a recommendation on the future zone configuration. The latest draft of the CACM network code states that NRAs then make the final decision about the bidding zone configuration based on the TSO recommendation.

4.13. It was noted that many of the issues related to **incentives to invest** had already been discussed, but it was suggested that barriers to new technologies should be added as an issue.

4.14. The next issue raised was related to **facilitating DSR**. It was suggested that there may be an issue related to the ability of DSR providers to capture the complete value that it can offer to the electricity system across the value chain.

4.15. There was a discussion about the **institutional arrangements** of the future trading arrangements, and it was suggested that an increasing number of actors would create increasing complexity going forward. DNOs, the FCA, power exchanges, and DECC were all highlighted as actors that would influence the trading arrangements in the future and it was suggested that they may need to be work done to establish how these different actors fit together.

4.16. Jason highlighted two issues related to **gas market interactions**. Firstly, that the higher value of flexibility in the future may impact may affect the gas price, balancing arrangements and valuation of line pack. Secondly, the European gas Target Model will be a factor influencing gas trading arrangements, quality and security of supply arrangements. The interactions between the two markets were noted, and it was suggested that given the increasing reliance on gas to provide electricity market flexibility in the future, the system as a whole will become more sensitive to these interactions. It was suggested that one potential policy lever would be to evolve the gas market arrangements to ensure that flexibility is sufficiently available in terms of products, and that these products are valued.

4.17. The implications of **new financial regulations** were discussed. It was suggested that the Markets in Financial Instrument Directive (MiFID II) and European Market Infrastructure Regulation (EMIR) could lead to increased requirements to use power exchanges rather than over-the-counter trading. It was further suggested that the regulations could have implications for capital requirements, trading strategies, market liquidity, and when combined with European market coupling developments, could lead to more centralised trading in GB more generally. It was suggested that Regulation on Energy Market Integrity and Transparency (REMIT) would lead to increased reporting requirements for parties, as well as the need for robust processes to provide additional data on inside information to the regulator. One stakeholder suggested that the increasing level of financial regulation represented a departure from the NETA principle that allowed freedom to market participants about how to trade, and risked hindering development of innovation in financial products and risk management tools. It was agreed that it would be worth considering the implications of new financial regulations further. The group then discussed potential grouping of potential policy levers in the medium term.

5. Conclusions and next steps

5.1. Giuseppina concluded the meeting, and invited working group members to feed any additional views through via email. She noted that the high-level messages from the working group would be presented at the next meeting of the Forum on 30th September.

6. Date of next meeting

The next working group of the FTA will take place on **30th October**.