

## Electricity cash-out SCR—ready for take-off

In issue 313 dated 23 January 2012 the [Energy perspective](#) sets out our response to Ofgem's consultation on whether to hold a Significant Code Review (SCR) of the electricity cash-out arrangements. We recently looked at the context of the proposal and some of the problems with the current arrangements ([ES305, p2, 14/11/11](#)). We now consider how they should be addressed.

### On the runway

Ofgem has invited responses on whether a SCR should be conducted on electricity cash-out and its timing. We have long argued that effective cash-out arrangements are central to ensuring that the trading arrangements function efficiently. However there are significant problems with the current arrangements both in terms of efficiency (system pollution, complexity) and in terms of their effects on competition (loading of imbalance risk, lack of transparency). These defects are compounded by the wider market context, which is characterised by trading illiquidity.

With this in mind, our view is unsurprisingly that an SCR is needed now to drive forward change and address the many unresolved issues. But there are new challenges too posed by EMR (increasing volume of must run contracts, interaction with the capacity mechanism) and an increasingly intermittent generation system. As Ofgem also notes, we also have new pressures arising from the desire to implement a target model that is convergent with European markets.

### Filing a flight plan

In terms of timing of the review, the government set out its timetable and institutional arrangements for taking forward the EMR proposals before Christmas. Current plans are for the first contract for differences feed-in tariff agreements to be signed in 2014 with power delivery from 2016. Capacity auctions are also pencilled in from 2015, with scope for secondary trading from then until the first capacity becomes eligible from 2019.

The regulator's timetable sees any review lasting no longer than 12 months if it is started early this year, though with the reservations that the scope and complexity of the project together with the industry's ability to resource and support changes may mean that more time is likely to be required. These are real practical constraints. So it is important to make a start urgently. A year has already elapsed since the government's EMR green paper signalled the need for change. Close linkages will need to be kept with the EMR programme, which itself is still only in the middle game. We must avoid the pitfall experienced on the Transmit SCR of losing months on unnecessary academic reflection.

The other key interaction is with European work-streams. Ofgem has invited views on the extent to which future EU guidelines on cross-border allocation and congestion management and on cross-border balancing should shape the scope and timing of an SCR. The guidelines will form the basis of network codes, which will be legally binding on GB participants and could anyway require changes to the way the market operates.

It is likely that the SCR review will reach conclusions before detail is available in both these areas. There are of course other major change programmes underway, including smart metering, the Green Deal and Project Transmit. We are already hearing views from other industry governance groupies that this latest SCR would be one review too far, that change processes are already facing overload. But we think it would be dangerous to delay the cash-out review, and this is evidenced by the depth of the issues that Ofgem has suggested need to be looked at.

### On the radar

Ofgem has set out with clarity a comprehensive series of issues with the current cash-out arrangements, inviting views on whether these could be material and on any other areas of concern which should be considered by a review. We think the broad set of issues identified is appropriate and they represent material issues that require addressing. We explored these in some detail in the previous *Energy perspective* on cash-out, but several are worth highlighting again to suggest particular areas of focus of the SCR.

A key area of the review should be the dual cash-out approach. It creates different prices for being long or short against the meter. Many believe the dual pricing rules with their wide spreads have incentivised vertical integration and magnify risk to new entrants. Surely we are talking about the same product? And if the objective is to move to more marginal

pricing of energy, it is hard to sustain an argument that there are two marginal prices at any one time. Moving to a single price regime would also remove the illogicality of having two separate methodologies for calculating the prices.

### **Poor visibility**

Whether or not dual pricing continues, a key issue has always been the pollution of the energy imbalance price by system actions. Work here is still not complete and until it is no move to a more marginal energy price should be considered. We urgently need to understand why in some trading periods imbalance prices are higher in the post P217A world than under the old methodology despite the fact that transmission constraints are now flagged and neutralised.

Ofgem also needs to consider how demand-side response and in the future smart meters can be coaxed out of balancing services contracts and into imbalance arrangements, which in effect means better enabling supply aggregators. Above all we need cash-out arrangements that are transparent and predictable and preferably readily understandable, which will aid all participants and help encourage demand-side participation.

There is also a pressing need to provide more information to trading parties ahead of delivery. Ofgem canvasses views on whether the system operator should publish its views on the likely net imbalance volume (NIV), to which we answer yes. But many trading systems post provisional or forecast prices, and we need to follow suit. At present fear of cash-out simply drives parties long, which is neither efficient nor fair.

### **Soft landing**

The issue of the NIV is an interesting one, and one which is worth focussing on. It is perverse that the SO is incentivised on managing the net imbalance position but trading parties are cashed-out on gross volumes (on both production and consumption accounts). Further they are in effect prevented by the rules from taking compensatory action after gate closure other than offering into the Balancing Mechanism, which suppliers do not do.

One approach that may help parties manage their own imbalance exposure (if ex post trading is not to be permitted) could be to permit use of a single trading account. Combining generation and supply by merging production and consumption would probably be a massive step in terms of rewriting the rule book. But it would be possible to use reallocation mechanisms to transfer volumes more extensively. At present it is possible to reallocate a generation volume to another lead party provided the quantity is assigned to the recipient's production account. But this restriction could be relaxed. It should also be possible to allow a trading party to transfer volumes across its own accounts, effectively allowing it to crystallise a net imbalance volume for its trading position.

We invite Ofgem to consider these issues: they are modest in scope but could have a significant and beneficial commercial impact.

### **Sky's the limit**

The regulator has set out a set of principles for comment on which to base the SCR. These seem broadly appropriate but the ordering is wrong. Given the growth in intermittent generation, Ofgem should consider whether there should be greater emphasis now on the efficient operation of the system (the fourth principle) than on necessarily providing incentives for market participants to balance their positions as the end in itself. And if the SO can balance more efficiently on behalf of trading parties, why prevent it from doing so?

Ofgem outlined two potential alternative approaches for the SCR. The first is a narrower approach that would see further development "in accordance with the current direction of travel" seeking incremental improvements but leave the wider balancing arrangements unchanged. A second approach, which we think is the only realistic option given the need to address the implications of the EMR and increasing intermittency, is broader and would consider more fundamental reform to the balancing arrangements. We agree with the regulator, however, that a return to a gross mandatory pool (as in the old Electricity Pool) should be out of scope.

Past experience of change with regard to cash-out has been very piecemeal, despite attempts at a fuller review. The SCR provides a critical opportunity to consider holistically the wide range of pressing issues. It may be a long-haul but it is worth the journey