



# energy perspective

## Are the current electricity market arrangements out-of-date?

Last Tuesday afternoon, nearly 50 people attended our early summer event for customers. Attendees heard from and debated issues with Peter Atherton from Citigroup, Philip Davies from Centrica and Nigel Cornwall under the astute chairmanship of Professor Stephen Littlechild. *Are the current electricity market arrangements out of date?* was the theme, and in this *Energy perspective* we summarise Nigel's remarks.

The central tenet was that the tensions between competing policy objectives—affordability, low carbon, supply security and competition—are at their most acute in the electricity market arrangements. Current power market arrangements may even exacerbate these tensions and raise important commercial risks and challenges for many market participants.

### Market and policy shifts since 2001

The current market framework as embodied by the New Electricity Trading Arrangements (Neta) had been in place for eight years in England and Wales and four across Great Britain as the British Electricity Trading and Transmission Arrangements (Betta). This was a longer period than the Pool had operated before launch of the fundamental review in 1997. Neta was a very radical departure. But despite significant changes in energy policy since, reflecting a profound shift in Britain's place in world energy markets, there has been no substantive evaluation of the effectiveness of the power market design—nor gas as the two share many common principles—since the very limited first year review by Ofgem in 2002<sup>1</sup>.

The review's findings were that the market was “performing well”. But seven years on, these findings contrast with the diverse preoccupations of many market participants including: managing their businesses in volatile and globalising wholesale markets; the investment outlook; switching away from fossil fuel generating technology often to smaller-scale, intermittent alternatives; maximising the efficiency of use of hard-pressed network assets; and delivering energy services and smart metering to consumers. All these challenges had to be managed within over-arching concerns about credit that stretch from securing funding for new investment to how suppliers contract with retail and business consumers.

These changing (and not always consistent) priorities had been reflected in and led by a fundamental shift in policy evidenced through white papers in 2003 and 2007 and more recently still in secretary of state Ed Miliband's call for “more muscular” policy. Policy was now translating into increasing market interventions through, for example, the various supplier obligations for renewables and energy efficiency, “voluntary” commitments by suppliers to social tariffs, the upcoming community energy programme and renewables feed-in tariffs. Several of these interventions had or could distort the competitive process.

There have also been very significant changes in the commercial landscape with the emergence of integration as the preferred business model, the exit of most merchant generators and the retreat of independent suppliers from the fringes of the mass market to a few niches. Ofgem's retail probe belatedly recognised that competition in household and small business supply markets was uneven.

### Time for calm assessment

Despite the received wisdom of fluid governance, the Neta/Betta design had been largely static since 2001. So were Neta and supporting markets delivering against design objectives, especially with regard to increasing competition? Have some elements of the framework performed better than others?

Nigel's view was that the Neta-style market design based around liquid trading and cost-reflective uncontracted trades had turned into a “double jeopardy” of penal cash-out because of illiquid traded markets for unintegrated participants

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<sup>1</sup> [First year review, Ofgem](#)

outside of the Big Six. There were also pressing questions about the adaptability of the current market settings to new challenges. The market penalised intermittency and inflexibility, and the challenge of creating a “new” markets for decentralised energy was inhibited by the “old” barrier of cost and complexity of the wholesale trading arrangements. How will we deal with “surplus” must-run plant? With some limited exceptions, routes to market had to be through six large players who tended to behave similarly. Transmission arrangements continued erroneously to be seen as a separate from the energy market.

Of late there have been a number of significant questions raised by well-respected commentators. Probably most notable was Ofgem chief executive Alastair Buchanan’s recent remarks to the Energy and Climate Change Committee (ECCC) on 20 May. “The fundamental question at the moment is whether the market design is fit for purpose given the fact that 20-30% of our plant is coming off stream and the question is whether we can make it through without the lights flickering between now and 2015 and, thereafter, how we are going to handle the market challenges.” Buchanan went on to focus on transmission access and governance, but the tone of the remarks suggested that the regulator has an open mind on the merits (or otherwise) of current energy trading arrangements.

A recent article<sup>2</sup> by independent consultant Simon Skillings raised two potential development paths for the sector in the next few years. As an alternative to a business as usual scenario, “another one to two years of experience may confirm that the current market framework is failing to bring forward investment of the right sort and in the right scale.” If the latter scenario comes to pass, the Government may then “decide that now is the right time to contemplate a radical change to the market framework.” Skillings concluded that this year provided “a window of opportunity for businesses and policy makers to contemplate the need for radical market reform.”

Another recent paper by Dieter Helm<sup>3</sup> was followed by a letter from the same author late last month in the *Times* warning that we were “six years away from an energy crisis.” In his paper he called for a discrete capacity element to wholesale power prices saying Neta-style pricing was effectively combining capacity and energy elements in to a single price and—in a shorter market than we have been used to—this lack of separation was contributing to volatility and price spikes. As there was no new entry, price spikes were feeding straight through to incumbent profits “and investors would be very foolish to rely on a lack of intervention” from politicians. “Neta creates a wonderful mechanism to increase profits at the expense of sufficient investment. It provides no incentive to provide excess supply”, he added. To combat the loss of transparency caused by weak liquidity, Helm called for “one key reform: to compel the auctioning of generation in the energy market” whose result would be “an evolutionary step back to the Pool model.”

These three commentaries provided high-level diagnoses of the challenges. But what should be done about them?

### **Wholesale—flexing the template**

Nigel said he thought Ofgem had been right to extend its retail probe to address wholesale market interactions, as market access was deteriorating at a time when the number of participants—especially from politically desirable renewables—should be increasing. The emergence of the new APX day-ahead and N2Ex platforms with industry support was encouraging, and Ofgem’s further thoughts on wholesale aspects of the price probe were eagerly awaited.

Some believed, as Helm’s remarks implied, that mandatory trading or auctioning would boost trading activity, encourage smaller participants and new entrants and thus increase confidence in the price signals created in the market. But what would mandatory trading actually achieve for smaller players given that it would probably require significant coercion of the major players? Others said that unfortunately the granularity—small participants want to buy or sell quantities of power that are just too small to be of interest to major players and may impose higher transaction costs—and credit issues meant forced trading would probably not bring significantly greater opportunities for smaller players.

Nigel focused his remarks on the necessary actions in areas that could be addressed independently of a fundamental industry restructuring—which he considered unrealistic—and changes that he considered desirable under any scenario. He felt the industry should broaden the agenda of debate to what could be done to make the Neta market structure more fit for purpose for smaller players and newer technologies. Issues that could be addressed without a fundamental redesign of Neta included recognising the market should be “split”, with scale base-load—must-run and flexible—plant treated differently to intermittent and smaller participants, with carve-outs from unnecessary rules for them. Allowing a shorter gate closure than one hour for some participants should reduce penal imbalance exposure, and consideration

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<sup>2</sup> [Simon Skillings](#)

<sup>3</sup> [Dieter Helm](#)

should also be given to allowing them to swap imbalances during and even after the trading period perhaps through some form of “virtual pool”. Urgent reform of dual price cash-out should also be on the list, notwithstanding the hiatus that will surround implementation of P217A and its subsequent review.

### **Retail—avoiding unintended consequences**

The probe and follow-up measures had shown retail competition was firmly back on the regulatory agenda. But there was acute political pressure on Ofgem to deliver as a result of political concerns about increasing fuel poverty. As Ofgem acknowledged in its second *Quarterly wholesale/retail price report*, increasing social obligations on suppliers have complicated the task of evaluating competitive pricing levels and thus the effectiveness of the retail market. But as highlighted in *Energy spectrum* last week, Ofgem had not finalised its retail remedies package without controversy. Professor Yarrow’s recent resignation from the Authority highlighted the fact that some proposed remedies may constrain rather than revive competition. Nigel also referred to risks of reregulation in the small business markets, as well as risks that the regulator was subject to the tyranny of the timetable given the political imperative of implementing retail remedies ahead of the coming winter.

More generally Nigel expressed concern that the retail remedies reflected a growing tendency to intervene first, and then think later. Measures to improve information and disclosure and codes of practice to raise the game of suppliers should be taken forward. But, it would be retrograde to unnecessarily limit suppliers competing for business at a time when many larger players concerns over the credit-worthiness of some customers, and some elements of the package needed to be rethought.

### **Better governance—means to an end, not an end in itself**

Good governance is a prerequisite for competition in markets with complex trading rules. In his Beasley lecture in October 2000, Professor David Currie (then a special advisor to the regulator), argued that flexible governance arrangements should allow the Neta regime to evolve in response to wider market conditions. Despite this optimistic view—and an awful lot of rule change activity from stakeholders since—the key principles of the regime at its start had endured even though market and political objectives have been transformed.

Ofgem’s industry governance review had therefore been essential when it was launched two years ago. So far it has identified many problems and issues, and thrown up many examples of bad governance. But Nigel was concerned that the debate on governance had become characterised by a focus on low-level tinkering and a major policy mechanism for the regulator. A number of key change options in-between might be over-looked.

Instead there were a number of strengths in the current arrangements that could be built on, including the more extensive use of independent panels, clarifying the mandate of code administrators to act as “critical friends” and taking-over responsibility for reports from modification groups, transferring ownership so that they were owned by trading parties to improve accountability and developing mandatory codes of practice to raise their and participants’ standards.

### **Pulling it all together**

The basic Neta concepts focussed on competition are as valid today as they were a decade ago. What has changed is that the tensions with other government policy objectives, which have arisen as gas import dependency and the political priority attached to climate change have increased. The Big Six have become instruments for delivering energy policy across renewables, social and emissions reductions spheres. But the scale players can only go so far in responding to politically-set incentives and meeting the politicians’ objectives. In an area where the range of applicable technologies is widening all the time, diversity of supply and innovation require diversity of participant. But under current market structures important details of market design, proposals for reregulation in key areas of the retail market and industry governance are at risk of inhibiting the realisation of this objective.

In terms of recommendations, Nigel concluded wholesale market rules need a significant refresh but as yet not a fundamental redesign. Proposed retail interventions should be more carefully targeted. Better governance is a critical element of ensuring adaptability of the market arrangements, and going forward the industry must devote clearer focus on developmental issues, especially those that look across codes, with major policy reviews being needed only as a last resort. But the industry and its regulator have it largely within existing powers to take these essential steps.