



**REVIEW OF ELECTRICITY
TRADING ARRANGEMENTS:
REPORT ON CONSULTATION ON
TERMS OF REFERENCE**

MARCH 1998

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1. INTRODUCTION

- 1.1 On 28 January 1998 the Director General of Electricity Supply (DGES) published advice to the Minister for Science, Energy and Industry, on terms of reference for a review of electricity trading arrangements in England and Wales¹. The Minister accepted the terms of reference, but he and the Director General indicated that they would welcome comments from others on the proposed terms. Thirty eight responses have been received. These include responses from the Chairman of the Electricity Pool Review Steering Group (PRSG), eight generators and their representatives, seven regional electricity companies (RECs), two second tier suppliers, three Electricity Consumers' Committees (ECCs), the Electricity Consumers' Committees' Chairmen's Group (ECCCG), eight industrial and commercial customers and their representatives and eight from other interested parties, including consultants and lobby groups. A list of those who responded is attached at Appendix 1. Copies of submissions have been placed in the OFFER library.
- 1.2 Most respondents welcomed the review and indicated that they were keen to participate in the review process. Some respondents expressed disappointment regarding the emphasis on or exclusion of certain issues from the review process. In the light of the views submitted, this paper contains further advice to the Minister on the terms of reference for the Review.
- 1.3 This document adopts the same format as the January 1998 advice paper. Chapter 2 deals with the objectives of the Review, Chapter 3 with further considerations, Chapter 4 with scope and deliverables, Chapter 5 with organisation and resources and Chapter 6 with process and timetable. Each section sets out the main views of respondents together with a discussion and recommendation on the points made. Chapter 7 contains the terms of reference proposed for confirmation.

¹ Review of Electricity Trading Arrangements: Advice on Terms of Reference, OFFER, January 1998.

2 OBJECTIVES

Views of Respondents

- 2.1 Many respondents agreed that the objectives of the Terms of Reference covered all the issues they or their members had identified as priorities. Others were concerned that the objectives had been drawn too narrowly. In particular, many respondents said that the proposals gave insufficient focus to competition in generation and argued that the trading arrangements could not be reviewed in isolation from this issue. Others took the view that the structure of the market was less important than robust trading arrangements.
- 2.2 Several large customers expressed disappointment that the Review objectives did not explicitly recognise the importance of internationally competitive prices to industrial customers, particularly those competing in international markets. They said that their competitors in Europe already enjoyed a relative advantage compared with domestic customers; they did not believe that this was the case in England and Wales.
- 2.3 Some respondents said the terms of reference were too wide, suggesting that issues such as diversity, sustainability, environmental and social issues were important issues for government to deal with rather than the Review.
- 2.4 Some respondents suggested that the first objective should be to identify the lessons of experience; changes should follow as a response to those lessons. Another suggested that, to avoid prejudging the issue, it could be sensible to consider whether changes to the trading arrangements would better meet the objectives than did the existing arrangement.

Discussion and Recommendations

- 2.5 It is inevitable that there should be differences of opinion as to the focus and objectives of the Review. On the whole, however, respondents supported the objectives set out in the DGES' advice to the Minister in January.
- 2.6 Most of the points made by respondents were also made in response to the previous consultation and considered carefully before the proposed terms of reference were drawn up. The DGES has nonetheless considered again the points made. He concluded that the focus of this Review should continue to be on electricity trading arrangements. This does not in any way belittle the importance of other issues, which can best be taken forward separately.
- 2.7 The DGES recognises the concerns of customers about market power in generation. The DGES closely monitors the development of competition, in both generation and supply, and investigates allegations of anti-competitive behaviour. The Review itself will take account of the present and prospective extent of

competition in generation. It will also look at actual and prospective interactions in both directions, between competition and trading arrangements. It would not, however, be sensible to overload what is already a very full agenda for the Review, which has to be carried out in a very tight timescale. There are also a number of issues which could impact on a review of competition in generation. The five year coal-backed contracts are about to end; the monopoly franchise on supply is about to be lifted, putting new market pressures on all participants; new gas-fired plant under construction is coming on stream; and the government's review of energy sources. The DGES will therefore take careful note of the concerns about competition in generation and keep the situation under active review. He will take such steps to act or investigate further as seems appropriate as the situation evolves.

- 2.8 The DGES is sympathetic to the aims of large users to achieve internationally competitive prices. UK electricity prices have fallen significantly in real terms in recent years, and in many respects compare favourably with those in many other countries. Increased efficiency and competition still need to be sought to enable prices to reduce further. Prices in each country are, of course, dependent on a range of factors including fuel sources, technology, efficiency, the degree of competition in generation and supply and the extent of government assistance. Price differentials between groups of customers may similarly arise from a variety of factors. The ability of industry to compete internationally also depends on a number of other factors including the monetary and fiscal policies of government and the strength of sterling which are not within the remit of the DGES and are not appropriate considerations for this Review. Given the variety of factors which impact on international competitiveness, it would not be sensible to set this up as a benchmark for the Review. What the Review will do, however, is to seek trading arrangements that best protect all customers, including those who compete internationally, by offering them choice, transparency, and the prices associated with increasingly efficient and competitive markets.
- 2.9 Fuel diversity, sustainability, environmental and social issues are indeed primarily matters for government. It is nonetheless relevant to ensure that revised trading arrangements are compatible with and appropriately responsive to government policy and changes in legislation.
- 2.10 The Review will indeed seek to learn from experience. The terms of reference explain that the deliverables of the Review exercise include a review and evaluation of experience in the Pool to date. It is also relevant to learn from experience in other countries and other more competitive markets. Given the forward-looking focus of the Review it would not be appropriate to focus unduly on judging the performance of the Pool in the past. Nonetheless, it will be helpful to make clear, as part of the objectives, that consideration of possible changes to the trading arrangements will take place in the light of experience of trading arrangements in the UK and elsewhere and in other markets.

2.11 To avoid the implication that the issues have been prejudged, it will also be helpful to confirm that the Review will consider whether and, if so what, changes will best meet the objectives of the Review.

3 FURTHER CONSIDERATIONS

Views of Respondents

- 3.1 Most respondents accepted the relevance of the further considerations identified. Several parties expressed concern that the Review would not explicitly encompass trading arrangements in Scotland. They suggested that its omission represented a lost opportunity to improve competition in that area particularly given the ability of the Scottish companies to compete in the UK electricity market, from a position not shared by or available to UK generators and suppliers. Some customers said that there was less competition in Scotland and that this led to unnecessarily high prices, and that leaving Scotland out of the Review would place Scottish customers at a disadvantage compared with their English and Welsh counterparts. However, one party was glad to note that the arrangements in Scotland were outside the terms of reference suggesting that it was not clear that the generation market structure in Scotland currently had the potential to sustain effective competitive market arrangements.

Discussion and Recommendations

- 3.2 The Minister asked the DGES to indicate how he might carry out a review of the trading arrangements in England and Wales, rather than Great Britain. This is sensible since the industry structure and trading arrangements are presently quite different in Scotland, and there is limited capacity to trade between the two systems. The implications for Scotland of possible changes to the England and Wales trading arrangements will be addressed as part of the Review process.

4 SCOPE AND DELIVERABLES

Views of Respondents

- 4.1 Several respondents suggested that Review's objectives should be expanded specifically to include governance of the Pool as well as of the trading arrangements generally. Unless the governance arrangements for the Pool were adequate, efficient and reflected stakeholders' requirements there was a significant risk that detailed implementation would take too long or fail to deliver against the original intent of the review.
- 4.2 Some respondents including The Pool Review Steering Group said that the deliverables should include a clear definition of the aims of the trading arrangements. All assessment of performance should be by reference to these aims, both of actual and proposed trading arrangements. As part of its own review, the Pool is consulting on what such aims should be.

Discussion and Recommendations

- 4.3 The present terms of reference explain that the scope will include an examination of governance of the electricity trading arrangements and the role of the DGES. This was intended to include governance of the Pool. To avoid ambiguity it will be helpful to make this explicit by adding the phrase "including the Pool".
- 4.4 The terms of reference set out the objectives that changes to the trading arrangements should seek to achieve. However, it will be helpful to expand the wording of the terms of reference to make it clear that all the deliverables, including the evaluation of previous experience and of prospective changes, are against the specified objectives.

5 ORGANISATION AND RESOURCES

Views of Respondents

- 5.1 The appointment of a panel of independent senior advisers was welcomed.
- 5.2 Concerns were expressed about the role of the Review carried out by the Electricity Pool of England and Wales within the DTI/OFFER Review and the interaction between the two Reviews. Some parties argued for the Pool's own review to be integrated with the DTI/OFFER review to avoid duplication of effort. Others said that they disagreed with the initial findings of the Pool consultation process, noting that the Pool's response could not fully reflect the diverse contributions and views of its members.

Discussion and Recommendations

- 5.3 The DTI/OFFER review of trading arrangements will cover a broader set of issues and considerations than the Pool review. Steps have been taken to cooperate with the Pool where appropriate. For example, the Pool Review Steering Group is in the process of identifying a new set of aims for the trading arrangements. The Chief Executive's Office has also indicated that, in conjunction with Pool Members and others, it will provide technical advice on issues related to the trading arrangements. These contributions will provide a useful input to the Review process.

6 PROCESS AND TIMETABLE

Views of Respondents

- 6.1 Respondents were generally positive about the transparent process proposed for the review and in particular welcomed the explanatory workshops, the degree of consultation and open forums (seminars).
- 6.2 Some respondents suggested that there should be greater clarity as to how any proposals to meet the objectives would be evaluated. The Chairman of the PRSG suggested that the process should incorporate an objective method of measuring performance. He said that the PRSG had appointed consultants to develop a practical methodology which should be suitable for testing actual and proposed trading arrangements according to whether they meet the defined aims.
- 6.3 Some parties said that they remained concerned about the timetable for the Review and were unclear about how and when to respond at various stages of the exercise. Some questioned whether there would be adequate time to respond and others said that the compressed timetable increased the risk that the Review would not deliver a satisfactory conclusion.

Discussion and Recommendations

- 6.4 The Review process will seek to examine, explain and consult on how proposals for change will impact on the Review's objectives and the extent to which they offer improvements over the existing arrangements. Whether a more "objective" method can be found is debatable. It will be helpful to see the development of the Pool's work on "methodology" for testing alternative arrangements, and to take advantage of the Pool's advice on these matters as far as practicable. This can usefully be incorporated into the description of the process.
- 6.5 The DGES accepts that the requirement to report to the Minister in July imposes a demanding timetable. The timetable is consistent with the government's requirement to consider what, if any, legislative changes may be required following its review of utility regulation. The government has instigated a number of reviews with implications for the energy sector, including energy sources for power stations, new and renewable energy policy and utility regulation. It envisages that these reviews will, together, help to deliver its energy policy of secure, diverse and sustainable supplies of energy at competitive prices. There is close liaison between these reviews. The recommendations that the DGES makes to the Minister in July will be proposals of broad directions of change. Considerable effort and further work will be required to translate these recommendations into detailed proposals for change, and this work will need to take place after July. There will also be an opportunity for further public discussion and consultation on these matters.

- 6.6 An updated and expanded timetable is provided in Chapter 7. It sets out specific dates arranged for workshops. It also identifies specific deadlines on which written responses are invited about specific sections of the Review process. This does not preclude earlier submissions but will facilitate their timely appraisal and publication. In addition, to increase the time for public discussion of interim conclusions, the June seminar, originally scheduled for one day, has been expanded to a two-day session. It will now take place on 15 and 16 June. The National Exhibition Centre, Birmingham will be the venue for all the workshops and seminars. A number of parties, including, Accord Energy Limited together with British Gas Trading, the International Petroleum Exchange, ScottishPower, the National Grid Company, the Electricity Pool and OM Energy Solutions have said they will submit papers for the April workshop.
- 6.7 Appendix 2 sets out the agenda for the April seminar. The seminars will be structured to allow very brief summaries of key issues, typically as presented in published papers by OFFER consultants and interested parties. There will be an opportunity to put comments and questions to those involved.

7 TERMS OF REFERENCE

7.1 In the light of the above discussion, the following are proposed for confirmation as the terms of reference for the Review.

Overall Purpose of the Review

7.2 To consider whether and if so what changes should be made to wholesale electricity trading arrangements in England and Wales, and to provide advice accordingly to the Minister for Science, Energy and Industry.

Objectives of the Review

7.3 In the light of experience in the Pool, overseas and in other markets to consider whether and if so what changes in the electricity trading arrangements will best:

- meet the needs of customers with respect to price, choice, quality and security of supply;
- enable demand to be met efficiently and economically;
- enable costs and risks to be reduced and shared efficiently;
- provide for transparency in the operation of the pricing mechanism and the market generally;
- enhance the ability to respond flexibly to changing circumstances in future;
- promote competition in electricity markets, including by facilitating ease of entry and exit from such markets;
- avoid discrimination against particular energy sources; and
- be compatible with government policies to achieve diverse, sustainable supplies of energy at competitive prices and with wider government policy, including on environmental and social issues.

Further Considerations

7.4 In doing so, to consider the implications of and for:

- the role of the National Grid Company with respect to trading inside and outside the Pool;
- the development of competition in generation and supply;

- trading arrangements in Scotland;
- the development of contracts markets (including for physical delivery, contracts for differences and futures contracts);
- interactions between electricity and gas;
- legislation on competition and utility regulation in Great Britain and the European community; and
- other government policy initiatives including on energy sources for power stations and generator emissions.

Scope

7.5 To examine:

- the Electricity Pool of England and Wales, including the interconnectors with Scotland and France;
- possible revised arrangements for trading inside an electricity pool; and
- possible revised arrangements for trading outside an electricity pool;
- governance of electricity trading arrangements including the Pool and the role of the DGES in their regulation.

Deliverables

7.6 Against the objectives of the Review to:

- review and evaluate experience in the Pool to date;
- identify the most important changes in Pool arrangements, on the basis that all trading continues within the Pool;
- consider the implications of trading outside the Pool, including arrangements for access to transmission and distribution facilities, maintaining system stability, setting associated charges, and appropriate changes to Pool procedures;
- evaluate the merits of allowing trading outside the Pool, and of changes to Pool arrangements, both with and without trading outside the Pool; and

- make recommendations for actions, including further analysis as necessary, to identify and implement the appropriate changes to meet the objectives outlined above, and to identify responsibilities for carrying matters forward.
- to take account of the Pool Review Steering Group's consultation on defining the aims of trading arrangements.

Organisation and Resources

7.7 OFFER will lead the Review, seek independent advice, co-operate with other parties and secure the necessary resources in terms of funds, information and expertise, and in particular will:

- enlist the advice of a panel of independent senior advisers whose role will be to appraise arguments and options put forward, with a view to ensuring that conclusions are reached and explained on the basis of adequate and open evaluations;
- draw on the experience of all interested parties;
- liaise closely with the DTI;
- co-operate with the Pool's own review;
- seek the advice on technical matters of the Pool, the Chief Executive's Office, Pool members and the National Grid Company;
- provide appropriate internal resources to co-ordinate contributions, conduct the Review and ensure a timely report; and
- employ professional consultants with experience in the British electricity industry and with knowledge of international electricity trading arrangements.

Process and Timetable

Process

7.8 Conduct the Review process in a transparent and timely way by:

- informing discussants about relevant developments and analysis, including from UK and overseas;
- canvassing views widely and facilitating the exchange of views between interested parties;
- taking into account the views of customers, industry participants and other interested parties, including the Pool Review Steering Group's work on defining the aims of trading arrangements and methodology for testing alternative arrangements, in reaching conclusions;
- setting out clearly the recommended courses of action and the reasons for recommending them.

7.9 This will be achieved through:

- the publication of OFFER background, working and consultation papers;
- explanatory workshops on:
 - the operation of the electricity trading arrangements in England and Wales;
 - electricity trading arrangements in other countries;
 - possible models for electricity trading arrangements in England and Wales.
- public seminars where options for change will be openly examined and discussed and interim conclusions presented; and
- making publicly available responses to consultation documents, inputs to the consultation process and papers provided by third parties.

Timetable

w/c 16 February	Publication of OFFER background papers on (a) present electricity trading arrangements in England and Wales and related issues and (b) electricity trading arrangements in other countries.
23 February	Explanatory workshop on issues raised in the background papers.
w/c 23 March	Publication of OFFER working papers on trading arrangements both inside and outside the Pool.
30 March	Explanatory workshop on the trading arrangements models.
Early April	Publication of the third party working papers on electricity trading arrangements.
14 April	Explanatory workshop to discuss the third party working papers.
15 and 16 April	Two day seminar to consider possible models for electricity trading arrangements both within and outside the Pool.
8 May	Deadline for submissions of comments on the March and April working papers, workshops and seminar.
Early June	Publication of interim conclusions.
15 and 16 June	Seminar on interim conclusions.
30 June	Deadline for submission of comments on interim conclusions paper and seminar.
July	Publication of final report to Minister on conclusions and recommendations.

APPENDIX 1 - Review of Electricity Trading Arrangements - responses to the Terms of Reference

Association of Electricity Producers
ALP Energy Ltd
Blue Circle
BOC Gases
British Biogen
British Steel
Centrica
Mr Roy Chadwick - Simco
Chartered Institute of Purchasing & Supply
Confederation of British Industry
CO-STEEL SHEERNESS plc
Eastern Electricity - Power & Energy Trading
East Midlands Electricity
Electricity Consumers' Committees (Chairmen's Group)
Electricity Consumers' Committees (Midlands Region)
Electricity Consumers' Committees (North West Region)
Electricity Consumers' Committees (South West Region)
Electricity Market Services Ltd
Energy Intensive Users Group
Energy Saving Trust
Enron Europe Limited
Mr Alex Henney - EEE Limited
First Hydro
IVO Energy Limited
Mr Tony Lane - Chairmen of the Pool Review Steering Group
Major Energy Users' Council
Midlands Electricity plc
National Right To Fuel Campaign
Nuclear Electric
Mr John Pickin
PowerGen
Scottish Hydro-Electric
Scottish Power
Seeboard
Southern Electric
SWALEC
Utility Buyers Forum
Yorkshire Electricity

APPENDIX 2

REVIEW OF TRADING ARRANGEMENTS SEMINAR

15 AND 16 APRIL 1998

National Exhibition Centre, Birmingham

Programme

The programme for the two days will be structured around a series of brief presentations by OFFER consultants and other interested parties, typically summarising published papers, followed by opportunities to put comments and questions to advisers/consultants and panels of interested parties.

It will run from 9.30am to 5.30pm on each day.

DAY 1

- Introductory remarks
- Experience to date
- International experience
- Central features of competitive trading arrangements
- Pool building blocks
- Alternative Pool models
- Trading outside the Pool
- Closing remarks

DAY 2

- Opening remarks
- Role of NGC
- Governance
- Electricity trading (contracts markets)
- Competition
- Scotland
- Electricity and Gas
- Evaluation against objectives
- Other issues
- Closing remarks