



Consultation Response

By email to yourbritain@labour.org.uk

Ref: **Energy Green Paper**

3 March 2014

ELEXON's response to Labour's Energy Green Paper

We welcome the opportunity to respond to this consultation. ELEXON is the not for profit body established to manage the GB electricity Settlement arrangements as set out in the Balancing and Settlement Code (BSC). In addition we will be the Settlement Agent for the EMR, Contracts for Difference and Capacity Mechanism arrangements. We hope you are familiar with aspects of our role (two of Caroline's special advisors attended our Introduction session in June 2013; our Chairman, Michael Gibbons, recently met Tom Greatrex and our Chief Executive, Peter Haigh, met with Jonathan Reynolds at the Climate Change Forum) and our unique place as an independent, not for profit, trusted advisor. We are however happy to discuss our role in more detail at your request.

We have restricted our observations to questions which relate to Settlement activities, namely the introduction of a pool (questions 5 and 7) and central market regulation (question 11) as these are areas where ELEXON can share its substantial expertise and independent voice. In addition we have included our observations regarding the processes managed by Ofgem E-Serve (question 15) as we are both a provider of independent data that E-serve uses in validating its renewables schemes and a provider of industry wide central services on a non-profit basis. We would be happy to discuss our thoughts on other questions relating to the GB energy market in person, in particular we track developments on energy policy from Europe as these will have a significant bearing on the GB market.

I would be grateful if you would indicate a convenient time and venue to discuss our response. Please contact me on 020 7380 4213, or by email at david.jones@elexon.co.uk.

Yours sincerely

David Jones
Senior Regulatory and Market Advisor



A consultation on Labour's Energy Green Paper

Question 5: Do you believe that the objectives for the introduction of a pool – increased access to energy for all suppliers and increased transparency, including on price formation – could be met by requiring all market participants to trade 100% of their output via a day-ahead exchange?

Because of our unique position in undertaking imbalance (BSC) settlement for the electricity market, ELEXON does not take a view on policy. However we do endeavour to help the industry and policy makers by suggesting ways in which policies that impact BSC settlement can be best implemented. As such we have no view on the objectives for introducing a pool. We note that the proposals seem distinctly different from the pool regime that existed prior to 2001 and therefore should avoid the issues associated with the old pool arrangements.

Importantly, at a high level, the proposed pool arrangements can be introduced alongside the existing settlement arrangements. When further detail is developed ELEXON will carry out an impact assessment and identify if any changes are required. Settlement rules and processes have been (and will be) successfully flexed to meet any revised market arrangements when policy is decided by the government or regulatory authority.

We would note that any national energy policies will need to take account of the developments from Europe and the increasingly co-ordinated nature of European energy infrastructure, market rules and agreements.

Question 7: Do you believe that additional interventions to address (a) imbalance risk and (b) collateral requirements of market participants will be needed alongside the introduction of a pool type arrangement?

Wider market arrangements and Imbalance Risk

ELEXON believes that any new policy needs to be assessed in the context of the existing market rules and incentives to properly assess the potential impacts. Consideration needs to be given to the interaction with the Electricity Market Reform (EMR) solution and other energy industry mechanisms (e.g. system operator balancing services and contracts, European legislation and GB renewables incentives) to understand the potential impacts on behaviour and market prices. Only then can



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Imbalance Risk be fully assessed and any appropriate changes made to market rules to ensure an efficient, effective and economic package is implemented. We expect there to be fruitful discussions in the coming year through the Future Trading arrangements work.

We note that there have been numerous changes to the BSC imbalance pricing rules since their introduction in 2001 as industry has sought to refine the rules, manage emerging risks and issues and create the right incentives for participants to balance their energy positions (most recently ELEXON provided analytical support to Ofgem and industry with a Significant Code Review of the imbalance pricing arrangements). We would expect a new set of arrangements to require consequential amendments over time as the processes are tested. Design of the governance in support of a new pooling arrangement will need to balance the need for the flexibility for industry sponsored changes to amend market rules against the need to ensure the core objectives of the new regime's design continue to be met.

ELEXON is confident we can deliver systems and processes that will support any final designs to ensure settlement is an efficient and effective component of the new arrangements. We would be happy to discuss the potential impacts on existing arrangements as policy is developed further.

Trading up to 30 minutes before real-time

We note in the comparisons to the Nord Pool that the Nord Pool allows trades up to 30 minutes before real time. We are unsure whether this would form part of any Labour proposal for GB but we would urge you to consider the detailed work undertaken through Ofgem's [Electricity Balancing Significant Code Review](#). Within the draft decision document Ofgem concluded the following with regards to changing the timing (referred to as 'Gate Closure') for GB trading from the current one hour to 30 minutes:

'whilst we can see the potential for some improvements in forecasting, we consider them to be small, and the risks and potential costs for the System Operator of balancing the system over a shorter timeframe to be more material'.

Collateral requirements

The requirement to post collateral is critical to protecting industry participants from the exposure of other participants whilst also ensuring participants can meet their liabilities. However we know that this may be a challenge for participants (and small participants in particular) who may not have ready access to the necessary collateral or ties up collateral which could be utilised elsewhere.

The energy industry posts collateral in the order of hundreds of millions of pounds across the various industry codes, schemes and agreements. At any one time the industry does not need that amount of



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collateral.

Over the years ELEXON has sought to improve the settlement collateral requirements for BSC Parties and sought amendments to the methodology to ensure participants are subject to appropriate collateral arrangements based on the most accurate reflection of their potential liabilities. We have also discussed with the Gas settlement body (Xoserve) what can be learned from the way collateral is managed under the different market rules applied to the separate fuels (gas and electricity). However radical change in the way the industry manages its various collateral arrangements is hampered by the fragmented governance (see question 11 below).

We remain of the view that further work could be undertaken to identify improvements to the way collateral is managed but this requires a co-ordinated approach across fuels and the plethora of industry codes. We are aware that DECC have recently commissioned work on understanding the various cash and collateral arrangements across the industry.

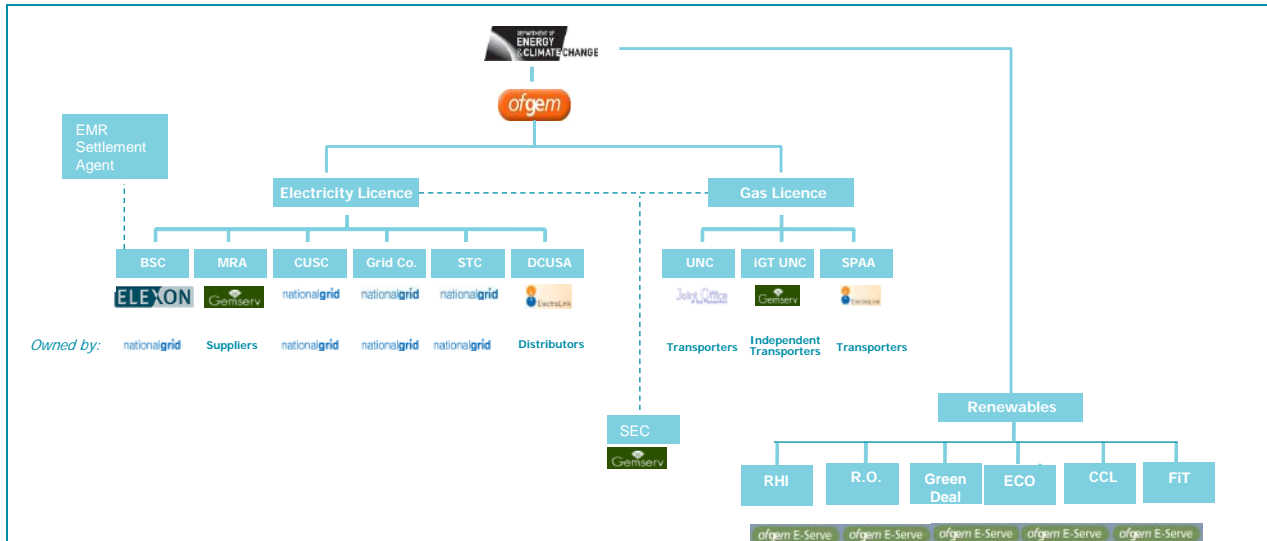
We expect that putting all trades through the power exchange(s) would place a significant counterparty risk on the power exchange that will need to be secured with collateral. In the long term the power exchange becomes the counterparty to all trades and will potentially result in monopoly power for a small number of power exchanges or single power exchange. Any policy review should consider the impacts of this happening

Question 11: Are there any additional powers you believe are needed to regulate effectively the retail and wholesale energy markets.

The complexity and plethora of industry 'Codes and Agreements'

The GB energy industry operates with the support of a number of industry codes and agreements delivered by central service providers. These codes and agreements set out the rules and obligations on (mainly licensed) organisations that participate in the transmission, distribution, generation and supply of gas and electricity. The diagram below shows a selection of the main industry codes and agreements:

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We believe there is an opportunity to merge and rationalise delivery of these codes and services. This will remove potential barriers to competition and create efficiencies in the operation of the market which will ultimately benefit consumers.

Most of these industry codes and agreements do not (but may) directly impact the end customer (i.e. the consumer is not required to engage with the code). However as they form the basis of the industry rules for competing in the wholesale and retail markets their efficient operation and the ability of industry players to understand them does directly impact on the efficiency of the arrangements and the end cost to consumers. The creation of a new regulatory structure to manage the market will not resolve the complexity of the underlying industry codes and agreements (although any regulator could be charged with simplifying this).

We believe that new participants face a significant challenge to entering the energy market as they have to accede to, pay charges in support of and post collateral for a large number of separate codes and agreements. Once a participant has been through the process there is arguably no need for them to seek to simplify the processes as this would only provide a competitive advantage to others in their initial investment and start up efforts.

The industry codes and agreements were all developed at different times across the last fifteen years. They were developed for a specific purpose and in isolation. We believe that a review of how these code and agreements could be rationalised is a critical factor in enabling the efficient operation of the retail and wholesale energy markets and therefore allow for more effective regulation.



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Question 15: Do you believe Ofgem's functions under E-Serve should be separated from its core regulatory functions and performed by an administrative body or by private company under contract?

It would appear that E-serve was created to allow for certain administrative functions to be delivered by Ofgem (as nominated by government) but for those functions to be distinguished from its role as a regulator. We have no view on whether this is the optimal approach to administering certain policies. Certain policies clearly contain aspects that are part regulatory (e.g. compliance enforcement) that sit with a regulatory body and part non-regulatory (e.g. settlement) that could be performed by others. We would note that over the years some new functions that are required have been ceded to Ofgem E-serve whilst others have been allocated to other existing central bodies (EMR settlement agent to ELEXON) or tendered for; the approach has not always been consistent.

In considering whether the E-serve services could be delivered elsewhere we believe the pertinent questions are:

- Does the function sit comfortably with Ofgem's role as a regulator?
- Can the service be delivered by another body more efficiently?
- Does the whole function best sit within a single body, such as E-Serve, or would it be best split between one or more bodies (for example under the BSC, those parts that are deemed to be competitive are required to be competitively procured by ELEXON, but still managed by ELEXON)

The answer to the second question can be easily tested by tendering services. We note that the types of services provided by E-serve are already provided by others in the energy industry (including the providers of central codes and agreements services (like ELEXON), as shown in the diagram in our response to question 11). In addition ELEXON provides settlement data to E-serve to assist it in validating energy consumption submissions made by energy companies.

The answer to the first and third question will depend on how a revised regulatory function is defined and then apply that test to the differing functions delivered under E-serve. For example E-serve fulfils a number of functions that you could categorise as:

- Regulating offshore transmission;
- Administering renewables/energy efficiency schemes.

You would presume that there would remain a need for a regulator to oversee the regulatory aspects of



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offshore transmission and granting of licences. It may be possible to outsource the procurement activity to another body, working with the regulator. It appears less clear that the regulator needs to be a provider of administration services for renewables or energy efficiency schemes, other than to ensure licensees are meeting their obligations. The information required is often self-submission by participants and validated using other industry data sources. If new functions are required to deliver policy it may be more efficient to ask existing central bodies, who have the systems, governance and data readily available to deliver the function swiftly and efficiently. Such administrative services could be provided on a not for profit basis, like ELEXON.

It is entirely possible for a number of the E-serve functions to be delivered by a different body. In part answer to our third question, we would suggest that any functions that would no longer be delivered by a regulator be packaged together under a single service provider, otherwise there is a risk of creating greater complexity to the structures that support the energy industry (see our response to question 11).

For more information on our response, please contact:

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