

Competition killer?

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When the UK launched its wholesale electricity trading market in March this year, the power generating industry braced itself for the impact of such a far-reaching change to the way power is traded in the country. And true to form, the new system, known as New Electricity Trading Arrangements (NETA), immediately played into the hands of its detractors with several delays to launch followed by substantial teething problems with the new software (see Project Finance May 2001). But it is now six months since the new arrangements were put in place and the dust has settled to reveal a system that seems to have achieved its goal of reducing the price of electricity to the consumer but at a clear cost to certain sectors of the generating marketplace.

What NETA has done is to replace the old electricity pool system (whereby generators bid into the electricity pool in half-hourly segments) with a series of bilateral contracts between generators and purchasers. The pool had been introduced in 1990 when the UK electricity industry was privatised. The aim of NETA was to address three fundamental concerns with the pool: firstly that wholesale electricity prices had not fallen in line with reductions in generators' input costs; secondly that there was a lack of supply side pressure and demand side participation and thirdly that inflexible governance arrangements had prevented reform of the arrangements.

NETA is designed to work like any other commodity market while having the provision for the electricity system to be kept in physical balance. A balancing mechanism is in place, which opens at Gate Closure (three-and-a-half hours before real time). The National Grid then accepts offers and bids for capacity and has a settlement process for charging participants whose contracted positions do not meet their metered volumes of electricity. Under this process NETA produces a financial reconciliation of each player's imbalances (the difference between its net contractual position and its net metered position in each half hour) and generates an 'imbalance settlement' – the price at which the surplus or deficit is settled. The system is designed to encourage generators and suppliers to contract ahead for most of their requirements in the forward, futures and short-term markets.

So six months in – has NETA achieved its goals? According to OFGEM, the answer is, not surprisingly, yes. The electricity regulator published a report in August this year examining how NETA had performed in its first three months. It found that forward prices have fallen substantially in the UK Over The Counter (OTC) market and the three new power exchanges that have been set up under NETA: the UKPX, the UK APX and the IPE. The average price for all UK OTC peak trades in the first three months of NETA was £24.81 MWh, compared to £31.24 MWh for the same period last year – a fall of 21%. OFGEM makes the point that this fall in costs has taken place against the backdrop of a rising wholesale gas cost that has increased by around 12% in the last year. There has also been a substantial drop in volatility in the day-ahead markets. 'OFGEM recognises that this will not necessarily be typical of the longer-term situation when the market settles down and the rules are modified as necessary in the light of operational experience,' says the report.

OFGEM may like it – but what about those in the industry? The reaction to NETA varies starkly across the board – depending on the type of player involved and the ease with which the new arrangements have been adopted. But there is certainly some criticism of the OFGEM review. 'It is very frustrating,' complains Nigel Knee, market development manager at British Energy. 'They have produced a glossy report but have not pointed out any of the problems in the

industry. They should have been more honest and then people would treat the report with more respect.?

The first problems that NETA faced were technical. Problems with default pricing (which kicks in if no bids or offers have been accepted over a certain period or when accepted bids are arbitrage tagged out of the system) caused wildly erratic price spikes during the first few days of trading and attracted much criticism from generators. The balancing system website is run by quasi-independent operator Elexon, which was forced to post correct prices on its website to correct the wildly erratic numbers that the system was generating. In the face of this criticism Elexon stressed that it was aware of the problem before the system launched and that it implemented an 'enduring solution' to the software glitch on April 26 - a month after the system went live on March 27. But during this period market participants suffered huge penalties if they were out of balance past the three-hour Gate Closure deadline - being forced to buy capacity at whatever MWh price was in place.

But it is not only Elexon's software that has proved to be a headache for NETA participants - several companies have encountered huge software problems of their own. Industry estimates reckon that total losses to electricity companies from bungled trades during the introduction of NETA run to around £20 million.

Two companies that were particularly hard hit were Scottish Power and London Electricity. In its first quarter results Scottish Power states that 'In the initial period of operation of NETA a systems software error led to incorrect contract notifications being made at a cost of £10 million. The error was rectified as soon as identified and we are seeking recovery of the cost through a number of routes.' One industry insider reckons that the losses were as a result of allocation between internal accounts and thus were an internal transfer issue. A London Electricity spokesman has also confirmed that the company lost £7.5 million on a single deal in the immediate aftermath of NETA's introduction.

When losses of this magnitude have been recorded, it is not surprising that the electricity companies are seeking to shift blame from their own systems and have therefore proposed modifications to NETA to address the causes of their software glitches. The core of their complaint is the time that companies are given to undo, or cancel, transactions once they have been entered on the system. Companies like Scottish Power have complained that they incurred such heavy losses as a result of not being able to adequately cancel deals on which errors had been made.

The crux of the dispute is so-called 'Technical Error Mod 9', the function through which NETA participants can undo deals once they have been done. The electricity companies argue that they should be given more time to cancel than is currently the case. OFGEM held a hearing on the issue on May 11 but rejected the industry's proposals, saying that the existing system is adequate for mistakes to be rectified and that companies will have to accept responsibility for any losses they have made through their own errors. The chances of Scottish Power and London Electricity being able to recoup some of their losses from the regulator are, therefore, extremely slim. Each participant is responsible for its own risks under NETA.

While the initial software problems associated with NETA seem to have been ironed out, there is still criticism that system buy prices (SBPs) and system sell prices (SSP) can be very volatile. But this is not a technical problem, it is simply a by-product of one of the biggest criticisms of NETA so far: liquidity. 'We would definitely like to see more liquidity in the market,' says Knee at British Energy. Price volatility is a factor of the number of SBPs and SSPs that have been posted for any one time period before Gate Closure. If there are only a small number of bids, and those bids are extremely diverse, the result is inevitable price volatility.

OFGEM has identified the lack of liquidity in short-term contracts as an area that 'needs further development'. It attributes the problem to the length of Gate Closure, portfolio generators part-loading to self-insure against plant failure within the day, a lack of reporting from central systems which makes participants unwilling to notify contracts and the ever-present risks associated with potential exposure to imbalance prices. The regulator has two proposed solutions to the problem. Firstly, it is considering shortening Gate Closure to one hour. It hopes that this would persuade generators who are presently 'self-insuring' against plant failure to offer plant to the market. Secondly it is looking at increasing the

amount of data available from central systems about aggregate contract positions close to real time.

While these moves might increase liquidity to a certain extent, clearly the number of bids received is a factor of the number of participants in the market ? which is something that many observers feel will reduce under the new trading arrangements. Electricity generators most at risk under NETA are the smaller operators, which cannot guarantee their output. This is hitting the smaller IPPs, those with perhaps only one plant, very hard. ?If you lose power overnight you are very unlikely to be able to find capacity the next day,? explains Knee. ?This severely impacts the single site generators and is very bad for the smaller, CHP generators.? One such operator, Slough Estates, which runs a small power plant in one of its business parks announced in early September that NETA had cost the company £4.6 million in the first half of this year and that it was considering writing down the value of its plant as a result.

This is no surprise, as one of the criticisms of NETA before it was implemented was the adverse effect it would have on smaller operators. In its review of NETA, OFGEM stated that smaller renewable and CHP generators had seen smaller price cuts (17%) than the wholesale generators (20% to 25%) but admitted that output from the smaller generators has slumped 44%. The original plan under NETA was for the smaller generators to pool output and sell it as one block but OFGEM has admitted that this is not happening as hoped. The regulator identified seven smaller power generating companies as potential consolidators but so far only one, Innogy subsidiary Concert Energy, has been very active in doing so. A spokesman for the Combined Heat and Power Association (CHPA) says that the reason for this is that the facilities put in place under NETA are far too complicated for consolidation to work.

Given this situation, the inevitable consequence will be a falling away of smaller power generators and industry will become dominated by fewer, larger players. ?I think the government really needs to look at what it is trying to achieve here,? says Nigel Knee at British Energy. ?To what extent do they want to maintain diversity in the industry?? The UK government does seem to be acutely aware of the problem and has been making lots of noises about protecting smaller generators under NETA. ?There is a real problem with NETA for small companies. We have got to persuade OFGEM that they have to be safeguarded,? says UK environment minister Michael Meacher.

The problems for the small generators stem from their inability to guarantee supply, due to their exposure to the risk of plant failure, or in the case of wind-powered plants simply not having capacity at the period for which they have contracted. In addition to looking to the regulator for protection, the industry is looking to the insurance sector to try to offer mitigation of some of these risks. ?The insurance industry needs to be able to offer power generators insurance against the cost of contracts they have had to buy in the market [in the case of not being able to meet those commitments],? says Knee. He says that some of the larger insurers to the power sector are looking at developing such a product.

There is no doubt that NETA has achieved its aim of reducing wholesale electricity prices in the UK and that the system does seem to have recovered from its earlier hiccups. But it does suffer from a lack of short-term liquidity and the impact of the new trading arrangements are likely to mean a reduction in diversity and number of UK power generators and the inevitable vertical integration of the industry. And there are clear contradictions between the government's stated energy policy of trying to promote ?greener? generation and NETA. ?If you are going to have a market, have a market,? says Nigel Knee. ?If you want to have a centrally planned policy, have a centrally planned policy. Just don't try to mix the two.?

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