

Market-based Power Reserves Acquirement

An approach implemented in the Norwegian power system, with participation from both generators and large consumers.

Gunnar Nilssen and Bjørn Walther, Statnett

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THE PRESIDENT AND CEO IS ODD HÅKON HOELSÆTER.

STATNETT SF HEAD OFFICE
LOCATION: HUSEBYBAKKEN 28 B, OSLO
POSTAL ADDRESS: P.O. BOX 5192 MAJ., N-0302 OSLO
TELEPHONE: +47 22 52 70 00
FAX: +47 22 52 70 01

Summary

A new power reserve market was established in Norway as of 1 November 2000. This market invites participation from both generators and consumers. So far large consumers in the paper and melting industry have participated in the market. The idea is that the suppliers must guarantee specific volumes of power reserves in the Regulating Power Market (RPM) for a given period of time. In the two tendering rounds so far, about 110 potential participants were asked to submit daytime power reserve offers. 25 of those participants responded with several offers, and 26 offers from 12 of the participants, totalling 1745 MW of power reserves, were accepted. The agreements between Statnett as the system operator and the bidders are valid for a period of three months or one year. This paper describes the methods and some of the results so far.

The balance between demand and consumption in Norway is planned day-to-day on an hourly basis through the physical power market Elspot. During the operating phase forecasting errors, transmission limitations in the grid and any operational interruptions are compensated for by regulating the power of the units that have registered with the RPM. The purpose of the new power reserve market is to secure a satisfactory volume of power reserves in the RPM. New is the fact that the power reserve option scheme has enticed consumers to register with the RPM. This is of particular importance during annual peak load periods, since the demand for power approaches the capacity limit of the power system then.

The total electricity consumption in Norway is increasing annually, and there will be no significant increase in the production capacity in the coming years. Norway's consumption is greater now than the average annual production of hydroelectric power. In addition, to this country-wide challenge regional deficits may occur due to grid limitations.

Several alternative solutions for obtaining power reserves were evaluated, before the market was established. The industry participated actively during this phase. The option price had to be high enough so that both consumers and generators would be interested in participating. Moreover, a high level of competition and liquidity in the market was regarded as important. Production and consumption as two different products was also considered. However, a decision was made to give equal status to both production and consumption in this connection due to reasons of a principle and liquidity related nature. The solution chosen was therefore a market where the generators and large consumers were asked to give Statnett the right to control the company's power within specific limits. The companies themselves were to stipulate what remuneration they desired for this right.

The minimum unit of power was set at 25 MW, and it was a requirement that the reserve power agreed on had to be registered with the RPM and thus physically be available to the day-to-day regulation of the power system. The companies could choose a time perspective of either three months or one year. The offers had to satisfy detailed requirements with regard to their regulating properties. With regard to the grid, the country was divided into three regions where the supply, power demand and selection of offers was evaluated separately for each region. Linking the individual offers to specific physical plants was not required, but specific predefined grid related regions had to be specified in the offers. This was done in order to allocate the power reserves to regions where they would not be blocked in the event they were activated due to the transmission limitations of the grid. The physical location of the regulating power does not have to be specified until the day it is registered with the RPM.

This market solution has been in use now for two three-month periods, and it has secured registration of an adequate volume of power to the RPM for Statnett. It was satisfactory to see that the volume of power offered was 3-4 times more than Statnett needed, and that there was significant participation by consumer units. Thus a market was established with competition between the companies. The offers with the lowest price were accepted until the desired volume of power was obtained. All offers that were accepted were remunerated based on the price of the last offer accepted, which means that the compensation was based on an analysis of the marginal price.

So far the total option cost of the two tendering rounds of this power reserves is 73 MNOK.

It is expected the market based acquisition of power reserves will go on. It is under evaluation, however, if adjustments of the approach are desirable. The companies have been consulted and given an opportunity to contribute in the evaluation. They are in general very satisfied with the scheme, but desire certain adjustments with regard to the regulating properties and risks associated with their individual facilities. Statnett itself is very satisfied with the solution chosen, and operational experience has confirmed that it functions as intended.

1 Background

In the event of forecast deviations, transmission limitations in the grid or operational interruptions, Statnett normally covers its need for immediately regulable power reserves through the Regulating Power Market (RPM). In some instances in recent years the reserve power has not been adequate. Clearing the Elspot market has also been close to failing on certain days due to the lack of flexibility in the bidding at high prices on both the supply and demand sides. In recent years the winter season has not been particularly cold, and there have not been any major operational interruptions during peak loads either. Thus the capacity problems that may be caused by such situations have not occurred. Figure 1 gives some illustration of this. The power that is available during winter peak loads in the Norwegian power system is around 24 000 MW. This figure illustrates that the registered maximum load is increasing, and that it is approaching the maximum available power. The coming years also show that the volume of capacity available is almost constant, and it is therefore obvious, especially in annual peak load situations, that it is necessary to secure power reserves from the RPM so that operational interruptions and forecast deviations can be handled properly.

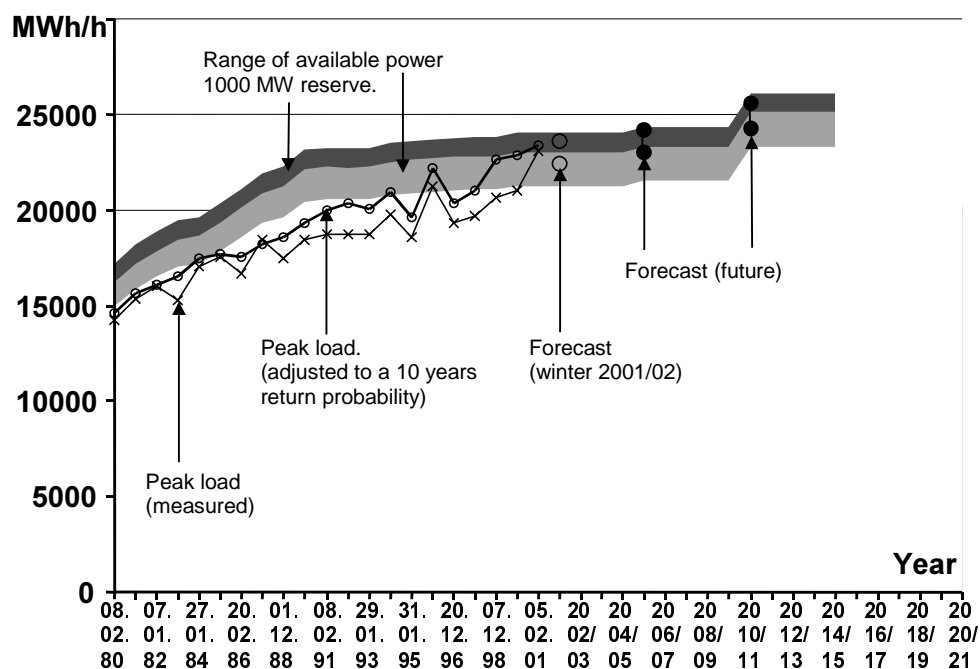


Figure 1. Maximum load in the Norwegian power system in relation to the available power.

In the long term, it is assumed that the capacity problem in Norway will also worsen due to the country's energy balance, since the duration of the power problem will increase. This is illustrated somewhat in Figure 2, where it is evident that the annual consumption in Norway is steadily increasing, while the average hydroelectric power production is flattening out. There was an abundance of water in the year 2000 and the actual production far exceeded the average annual production. In a year of normal production or less the difficult power situation will worsen based on these observations.

Figures 1 and 2 illustrate the overall power and energy situation in Norway. Climatic and grid-limitations may, however, make the problem worse in certain regions of the country.

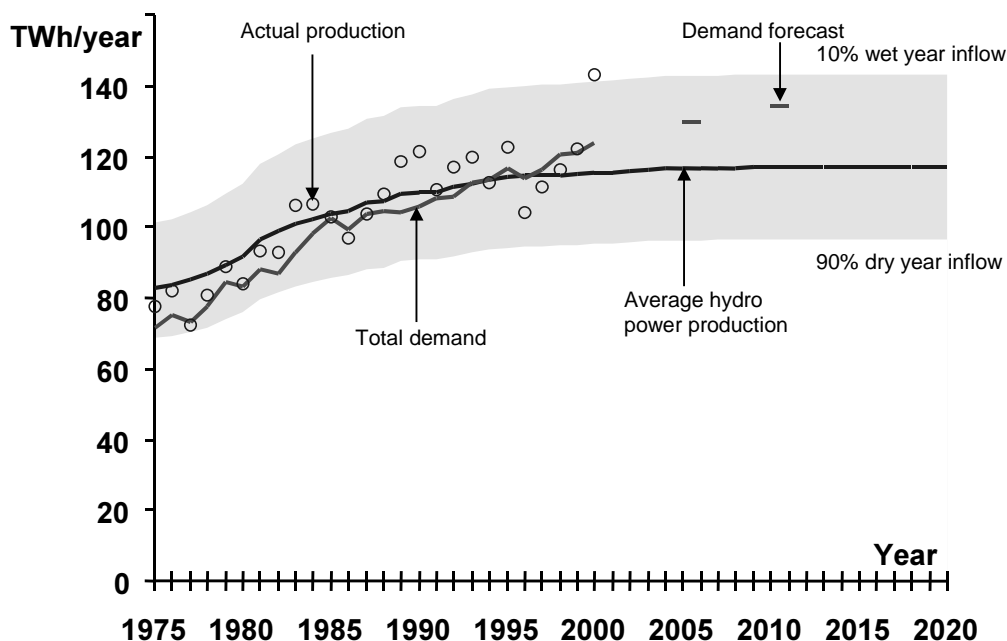


Figure 2. Annual consumption in Norway in relation to the average and actual production by the hydroelectric power plants.

The power reserves that Statnett had access to earlier through the RPM, were primarily the result of upward regulation bids from generators. Power reserves can, however, come from both production and consumption, and it is desirable at the same time to increase the level of predictability. Statnett decided accordingly to introduce an option market for power reserves. Offers have been requested from both generators and consumers of power and a more permanent supply of immediately regulable power reserves will be secured through bilateral contracts.

Agreements with generators may contribute to an increase in the available production capacity or at least maintenance of the current production capacity. If Statnett is to have access to power reserves from production in the operating phase, then this power must be kept outside of Elspot. However, the production resources in the Nordic power system are not sufficient to cover the forecasted maximum load for the entire region. This means that the consumption must be reduced in situations where the import of power is insufficient, primarily through measures that are agreed on in advance. Statnett seeks therefore to include a certain share of consumption objects in the overall power reserve contract portfolio. Power reserve contracts with consumers can contribute to the development of better solutions for the implementation of power regulation. It is assumed that such an improvement in the physical power regulation flexibility will in turn lead to greater price flexibility in the power market.

2 Elspot and RPM, the physical power markets

Nord Pool is the world's first multinational commodity exchange for electric power. Nord Pool is the marketplace for trading electric power in the Nordic countries, and Elspot is the market for trading power contracts for physical delivery. This is a contractual market where contracts are traded on a daily basis for delivery the next day, with a full obligation to pay. Prices are calculated based on the balance between the bids and offers from all the market participants. This is the point of departure for planning the balance between the power system's production

and consumption. During the operating phase, however, there will always be a large or small deviation in relation to the planned balance due to forecast deviations or transmission limitations in the grid, as well as operational interruptions that can upset the balance. The physical RPM is used during the operating phase to compensate for any deviations that arise.

The Regulating Power Market (RPM) is a collection of regulating objects to compensate for any imbalance between production and demand during the operating phase and a market for the subsequent settlement of the individual market participants' imbalance in relation to their overall obligations. The market participants submit bids for physical power regulation on an hourly basis for the following day. The size (MW) and price of the individual regulating objects are specified, and they are sorted by price. The objects are used in the order of their price in order to minimise the cost of any necessary power regulation during the operating phase. Traditionally, the power reserves in the market have been adequate on a voluntary basis. However, experience in recent years indicates that this is no longer the case during certain periods. This development towards growing power shortages is expected to continue in the coming years. The intention of the new power reserve market that is discussed in this document is to ensure an adequate supply of power reserves in the RPM.

3 Alternative solutions

Statnett has considered several alternative solutions to obtain power reserves and how these solutions should operate in relation to the physical power markets Elspot and the RPM. Initially agreements were made with selected generators to make such reserves available during specific predefined periods in return for a certain remuneration. The scheme was not well liked since the generators assumed too great a financial risk and the scheme did not provide an adequate incentive to invest in new power plants. The reservation of power was also unpredictable for the market participants.

Purchasing power reserves on Elspot was also considered, but Statnett was against such an approach due to reasons of principle as well as practical nature. The model with "uplift", where the bid and offer prices on Elspot are different, was not feasible. Interference like that would create an imbalance on Elspot and cause other problems. Moreover, Elspot is a Nordic market, and thus it is far more complicated and time consuming to change than to find an independent national solution. It has also been discussed whether a general capacity market should be established to price and provide capacity. No good solutions have been developed so far.

Long-term contracts with generators were considered, preferably with a view to giving the generators the economic foundation that was necessary for rehabilitation and thus maximum utilisation of their existing plants. Investing in gas turbines was also considered as a long-term solution. Our focus turned, however, more to disconnection of industrial consumption and the opportunities there for registration of some of this consumption with the RPM. Initially this was carried out through individual agreements with a couple of the major market participants. What was positive in this phase was the interest that the industry showed now to participate and find a solution to the power reserve problem. Agreements relating to reduced tariffs for disconnectable consumption had already been established. These apply to electric boilers that can be disconnected or switch to alternative sources of energy on 2 or 12 hours' notice.

The general consumption represents the largest and most complex consumption segment, and is thus the most complicated to use as a disconnectable power reserve. We are, however, currently working on systems for disconnecting certain segments of this consumption by remote control, but it will take time before this makes any significant contribution to the power reserves.

The power reserve market that is described in this document is a national solution for Norway. The other Nordic countries have chosen other solutions to secure power reserves due to historical reasons and differences in the structure of their power systems. We are now discussing how these solutions can be coordinated. An important result of this work is the fact that a contract has been signed by the transmission system operators, which outlines how capacity shortages shall be handled by the individual subsystems and in the interface with the power market.

4 Product description of the solution chosen

We have, based on a number of the alternatives outlined in the previous section, decided to establish an option market for power reserves. This market is in practice an instrument for attracting regulating objects to the physical Regulating Power Market and obtaining an adequate volume of both production and consumption with the desired regulating properties. A large number of companies were asked to make production or consumption available to Statnett as a system operator. Statnett pays remuneration to the companies in return for a commitment to register the agreed volume of power as available in the Regulating Power Market.

4.1 Contract types and characteristics

Statnett has up to now arranged two tendering rounds for this type of power reserve. In both cases, contracts with different time perspectives have been offered. The one type has a duration of three months and the other type has a duration of one year. In the two tendering rounds, both of these contract types were made effective as of 1 November 2000 and 1 February 2001, respectively.

The power reserve suppliers were asked to make an offer for a specific volume of power at a specific price for delivery within the relevant grid regions. The bids did not have to be linked to a specific consumption or production plant. The power volumes agreed on shall subsequently be registered as upward regulation bids during daytime in accordance with the Regulating Power Market regulations throughout the entire contract period from Monday through Friday on business days. This entails for example that the specific registration objects and points of contact for activation must be agreed on with Statnett. Suppliers who are not themselves operators responsible to Statnett, must clarify any matters that are relevant in this connection with their operators.

The following conditions apply:

- Power reserves shall be made available from 6 a.m. to 10 p.m. from Monday through Friday on business days.
- Minimum volume required to submit an offer: 25 MW
- Regulability of the power reserves:
 - Must be possible to activate the power reserves within 15 minutes.
 - Full activation of the power reserves for at least 1 hour without interruption must be possible.
 - Full activation of the power reserves for at least 10 hours per week must be possible. During weeks when public holidays fall between Monday and Friday, this requirement will be reduced correspondingly.

When trading in the other power markets, the power reserve suppliers must take into account their obligation to register with the RPM. However, for consumers who reduce their consumption in relation to the normal level due to the Elspot price during the period the power reserve shall be available, their obligation to maintain the power reserves is reduced correspondingly. Statnett shall in this event be notified as quickly as possible. The remuneration for maintaining power reserves will not be reduced in this case.

If a supplier of power reserves is not able to maintain the agreed power reserves during the contract period for other reasons, and this reason is related to the supplier's own plant or organisation, then the remuneration for the power reserves will be reduced proportional to the time that the power reserves were not available in relation to the total duration of the contract. Statnett shall in this event be notified as quickly as possible.

If a supplier of power reserves has neglected to notify Statnett that the power regulation cannot be carried out, then the power reserve remuneration will be reduced at a ratio proportionate to 25 times the time the reserves have not been available in relation to the total duration of the contract. The remuneration will not be reduced by more than the full remuneration stipulated in the contract.

4.2 Principles for the selection of reserves

Statnett determines the need for power reserve contracts. Statnett decides what suppliers the reserves will be taken from, and it will primarily use the offered price as the criterion for selection. Statnett will as mentioned make sure that the power reserves are taken both from production and consumption. This means that if an initial sorting of the offers by price does not give an adequate reserve volume in one of the categories, then the most expensive offers in the dominant category will be replaced by more expensive offers in the other category.

Due to possible bottlenecks in the transmission grid, the power reserves must have a certain geographic distribution. Statnett has decided to divide the country into three regions, A, B and C. These regions are denoted by letters to avoid confusion with the Elspot regions. There are other factors that also must be taken into account. Technical grid limitations may make it difficult to activate the power reserves offered and/or the size of the regulating object may be of significance on otherwise equal terms.

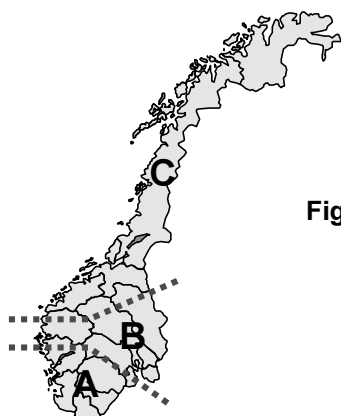


Figure 3. *Grid/geographic regions for the placement of power reserves.*

4.3 General terms and conditions

The suppliers' must make a binding offer to Statnett by the stipulated closing date. The suppliers must honour their offers for the stipulated period. Statnett will determine the overall power reserve needs for each geographic region for each contract period. The offers received will be evaluated based on these needs. It may be relevant to accept a part of the offer upon agreement with the supplier.

The suppliers who are accepted will receive a contract that has been filled in in accordance with the offer made and any corrections that the parties have agreed on. This contract shall be signed and returned to Statnett.

When Statnett has decided on what offers will be accepted, all the suppliers in each region with the same type of contract will receive the same contract price, which is determined by the highest accepted offer price for that particular type of contract in that particular region.

After the offers in a tendering round have been selected, information on the results will be published on Statnett's website at www.statnett.no. This information will show the contract type and region breakdown for the total volume offered and the agreed production and consumption volume, as well as the region's unit price (NOK/MW).

Statnett will continuously evaluate new tendering rounds for both types of contracts, as well as the contract volume required and the regional distribution for each time period. Gradually as experience is gained from this type of scheme and changes are possibly made in the regulatory framework, Statnett will adapt the products and/or the procedures for new tendering rounds as required.

4.4 Content and layout of the offer

The supplier shall price his offer in accordance with the requirements that are stipulated in the request for offers. We request that the offer is submitted by e-mail to the specified address and the layout is in accordance with the template that is available at Statnett's website. The price shall be stated exclusive of VAT. For each region that is relevant, the volume offered at the same price per MW shall be specified. The offer shall be confirmed by a signed fax or letter. Both the offer and the confirmation shall be in Statnett's hands by the stipulated closing date.

The prices shall include all the costs associated with the offer to maintain power reserves and be fixed for the entire contract period. The MW volume is the power reserves that the regulating objects represent if they are used in the RPM.

Any deviations and reservations of any type in relation to the commercial or technical requirements in the request for offers shall be clearly pointed out in the offer.

4.5 Special terms and conditions for consumption

Consumers who offer power reserves shall be fully activated as production units within 15 minutes after an order is given. As is illustrated in Figure 4 consumption units can determine themselves how much time will be used to return to normal operations. For pricing in the RPM, the regulation will, however, be regarded as terminated 15 minutes after Statnett has given notice that the regulation shall cease.

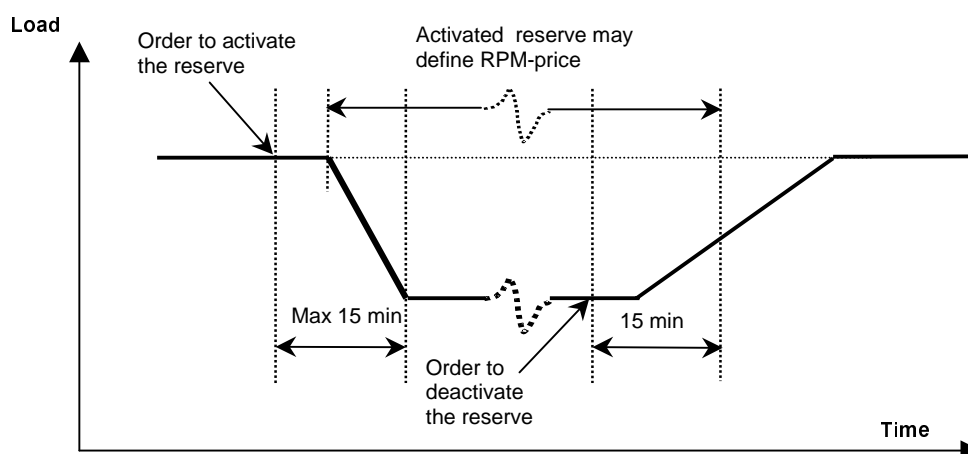


Figure 4. *Upwards regulation in the Regulating Power Market (RPM), consumption*

Suppliers of power reserves from consumption can specify a rest period that is required after activation of the power reserves before the next activation can take place. This rest period takes effect 15 minutes after notice to cease regulation is given and lasts until the next order to activate is given. The maximum rest period allowed is 8 hours.

4.6 Information on power shortages

If Statnett finds that there is a risk of a power shortage (less power reserves than the predefined requirements) in the power system, then Statnett will inform the power market about this through Nord Pool's website. It is the intention that such information shall be given in time so that the market participants can take this information into account when they report to the Elspot market. If an unforeseen power shortage occurs after Elspot has closed, then Statnett will seek to inform the market participants in an appropriate manner.

5 Main results

There have been two rounds where 110 companies have been requested to make power reserve offers, and both of these rounds have been based on the same product description described above. The offers had to be registered at the specified e-mail address and by letter or fax to confirm the offers by the specified closing date. Double registration has increased the level of confidence that the data received is correct, and the electronic registration has at the same time facilitated analysis of the data.

The white columns in figure 5 illustrate the results of the 1st tendering round for contracts that are effective as of 1 November 2000, mostly with a duration of three months. For the months from November to January, inclusive, contracts were entered into for power reserves of 1745 MW, 471 MW of which was attributed to one-year contracts. It was thus clear that we had to supplement the power reserves from 1 February 2001, since the first three-month contracts expired at the end of January.

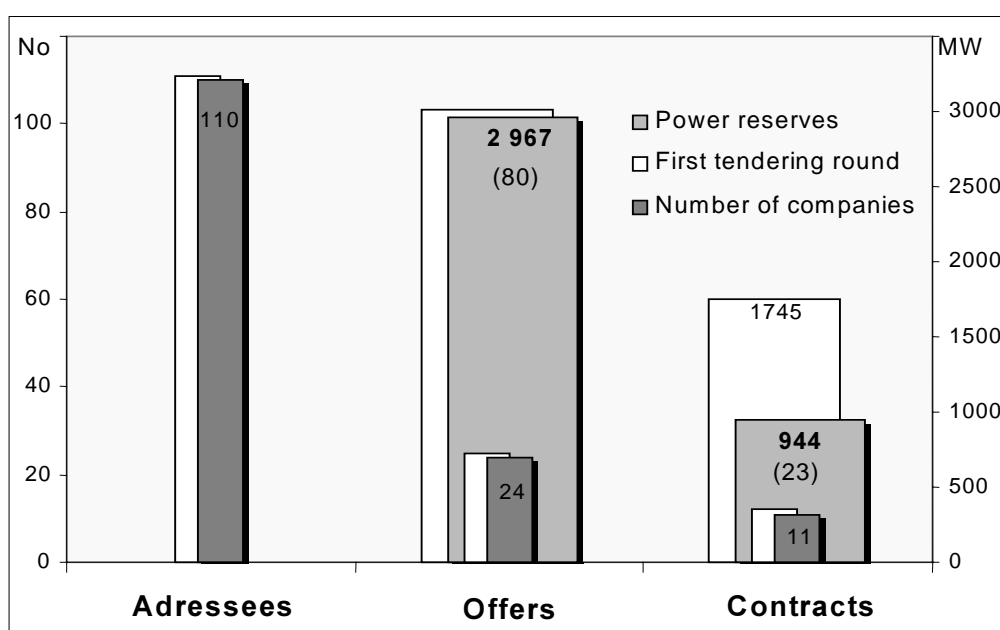


Figure 5. Number of companies in relation to the offered and contracted power reserves. The white columns illustrate the results from the first tendering round. In the second round 24 of the 100 companies contacted submitted offers for a total of 2967 MW on the basis of 80 offers. The 11 companies who were awarded contracts represented 944 MW, divided into a total of 23 accepted offers.

On the closing date for the second round, 80 offers had been received for a total of 2967 MW from 24 suppliers. Figure 5 illustrates that contracts were signed with 11 suppliers for a total of 944 MW, and 23 of the 80 offers received were accepted. The selection of suppliers was based solely on price in all three regions. In other words, no offers were hopped over due to reasons of a regional or grid-related nature.

Figure 6 shows all the contracts entered into from the two initial tendering rounds on a national basis. The figure illustrates the contracts for three months and one year as well as the distribution between production and consumption.

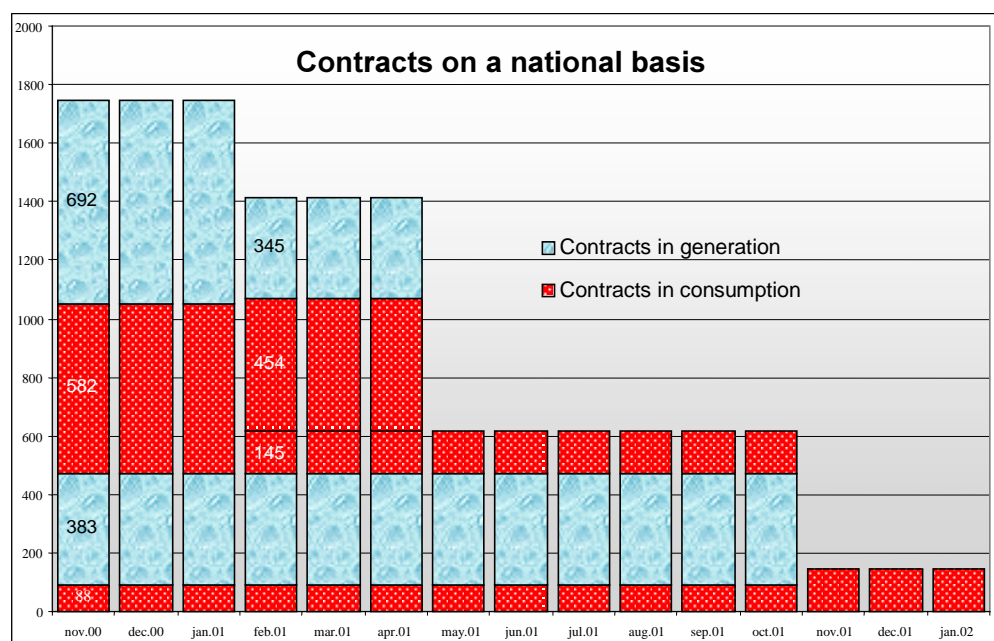


Figure 6.. Total number of contracts entered into from the two initial tendering rounds on a national basis from November 2000 to January 2002, inclusive.

So far the total option cost of this power reserves is 73 MNOK, initially paid by Statnett. The scheme is that this cost will be refunded later via the tariff system. There is an ongoing process on this topic, but Statnett do not want to give any forecast on the yearly option cost of this power reserves, because doing so could influence on the price-setting in this market.

5.1 Distribution of power reserves by the A, B and C regions

A description of regions A, B and C has already been given in Figure 3. Region A has major production units and is normally a surplus region. There is also a link to Denmark in this region with the capacity to import 1000 MW. The defined interface between the A and B regions is a section of power lines that will most likely limit the transport of power to the high-load B region in a difficult power situation.

The B region also has major production units, but it is also the region with the heaviest consumption, and there is normally a power deficit. In addition, there is the major link to Sweden, where the power flow is determined by the pricing on Elspot.

The C region is a long and narrow geographic region, and transmission limitations can easily arise in certain situations internally within the region. The C region also has major production units, but what is most notable in this connection is that it also has many large consumption units in energy-intensive industries. The C region has links to Sweden, where the power flow is

determined by the pricing on Elspot. The defined interface between the C and B regions is therefore, in addition to possible internal interfaces, the section of power lines that will most likely limit the transport of power to the high-load B region in a difficult power situation.

The power reserve contracts entered into for the period from February 2001 to April 2001, totalling 1415 MW, are illustrated in Figure 7 in such a manner that the location of power reserves between the regions and between production and consumption is shown. This also illustrates the transmission limitations that can arise between the defined A, B and C regions as a result of the fact that the B region is a high-load area.

The power reserve contracts for the period from May 2001 to October 2001, total 616 MW comprise 383 MW from production and 233 MW from consumption. Figure 7 illustrates this in addition to the location of power reserves between the A, B and C regions for this period. The 383 MW of power reserves from production in the A region is an annual contract that is in effect until 1 November 2000. It has been determined that the total volume and distribution between the regions and between production and consumption are satisfactory for this period. No requests will be made for additional power reserves for the period from May 2001 to October 2001.

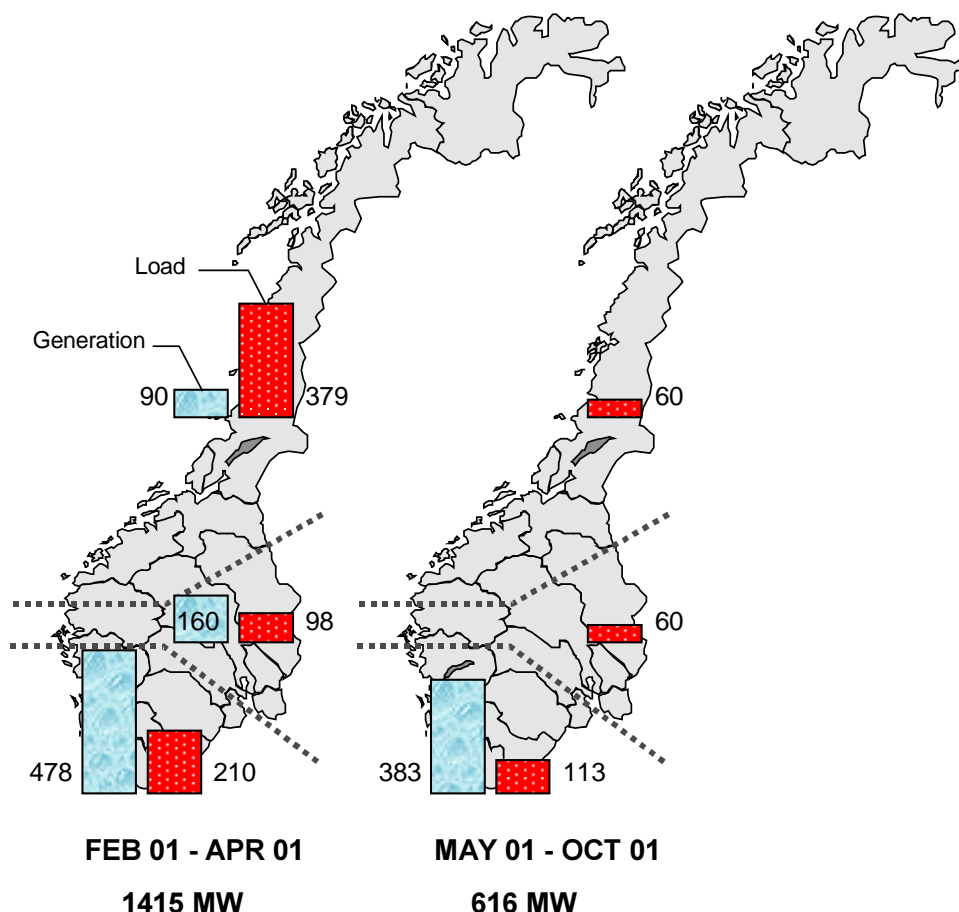


Figure 7. Contracted power reserves from production and consumption distributed geographically and over time.

5.2 System operator experience

Statnett is satisfied with the response shown by the companies in connection with this scheme. The working procedures have functioned satisfactorily, and both the number of offers and total volume of power reserves offered have given the desired and expected competition effect. All the companies that have entered into a contract have diligently registered the agreed power reserves with the RPM daily, and they have reported on a continuous basis in the event of temporary unavailabilities. Up to now there has not been any reason to reduce the remuneration that is paid for the contracted power reserves.

During the operating phase the RPM is used to compensate for operational interruptions and deviations from the power balance that has been established on Elspot. There is a continuous need for these power reserves. It is important that an adequate volume is available, especially during periods of strained operations, and that both production and consumption are included in the power reserves. On the background of the market-based procedures illustrated in this document, it was very reassuring from an operational perspective that the RPM had a satisfactory supply of power reserves, including reserves from consumption, during the peak load periods in the winter season.

On Monday, 5 February the highest demand ever was registered in Norway and the Nordic countries. The power balance in both the Norwegian and the Nordic countries' power system functioned satisfactorily then, but it must be pointed out that there were several favourable circumstances at precisely the time when this peak load occurred. During normal conditions the power situation would have been considerably worse, and the situation revealed that we should also consider whether this power reserve market should also include daytime during the weekends, and that we should consider requirements for the duration of disconnected consumption.

Even though there were no particular problems with the power balance on 5 February, there are several signs that the Norwegian power system is close to the limit of its capacity in such situations. The consumption is so high now that it exceeds what can be assumed as available from the winter production in Norway in combination with the need for power reserves. It is therefore important that Statnett continues to secure power reserves, especially through contracts that give the right to disconnect industry and possibly other consumption. Statnett's power reserve contracts have contributed to increasing the winter capacity available on the market by requiring industry loads and production to register. In addition, the electric boilers represent significant power reserves that can be disconnected by Statnett as the system operator on relatively short notice even though they are not registered with the RPM.

5.3 Customers views

Statnett requested the companies to give a written evaluation of the power reserves market in a letter of 8 March 2001.

The customers are in general satisfied with the solution chosen to provide power reserves from both production and consumption. They also expressed that this solution should be continued on a Nordic basis. The power balance in the long term is a somewhat more complex problem that is not necessarily solved by the option market that is described here.

The generators have expressed a desire for shorter contract periods of one month or shorter with a view to the management of established plants, but the three-month period that has been chosen now can be accepted by all. To increase interest in investing in more production capacity, contracts running over several years are required. Consumers desire contracts of a

longer duration, preferably on a seasonal or annual basis. In addition, there is also a desire to limit the number of tendering rounds.

The companies have raised the question of whether consumption and production are so different products that they should be priced separately based on their regulating properties as well as the standby costs. Treating them the same, however, gives the market a higher volume and competition between these two types of reserves. It is maintained that this will give an optimal utilization of the resources. The companies desire in addition strict rules and control to ensure that the agreed reserves are available during the contract period.

The companies express satisfaction with Statnett's information and practical management of the offers and contracts, but they would like to see that Statnett provide as much background information as possible as a basis for the companies' tendering process.

6 How to proceed

With regard to the question of whether the scheme should be continued and new power reserve offers should be requested as of 1 November 2001, the matter will be placed before the Board of Statnett in June this year. The experience with existing scheme for purchasing and contracting power reserves will be evaluated in advance.

It is expected that Statnett will continue with market based acquisition of power reserves. The present approach might be somewhat changed, however. One alternative could be to divide the market into two with production capacity and disconnection of consumption as two different products. The other alternative is to adapt the conditions for participation in the market so that production and consumption participate in the same market on terms that are more equal than is the case at present. Conclusions on board level are expected shortly after this conference.