

LONDON ELECTRICITY PLC
and
THE BALANCING AND SETTLEMENT CODE

OPINION

INTRODUCTION

1. I have been instructed to advise London Electricity plc (“London”). London generates and supplies electricity.

2. London is required to accede to the Balancing and Settlement Code (“the BSC”). It is in connection with the proposed modification of the BSC that I am asked to advise.

THE PROVENANCE OF THE BSC

3. The licence issued to National Grid Company plc (“NGC” or “the Licensee”), under Section 6 of the Electricity Act 1989 (“EA 1989”), as amended, authorising NGC to transmit electricity, imposes on NGC a condition, Condition 7A, adopted pursuant to Section 15A of EA 1989, introduced by Section 68 of the

Utilities Act 2000 (“UA 2000”), under which NGC is required to adopt and have in force a BSC meeting the requirements and designed to achieve the objectives specified in Condition 7A. NGC adopted the BSC, on 7 August 2000. The Secretary of State designated it, for the purposes of Condition 7A.1, on 8 August 2000.

4. The Gas and Electricity Markets Authority (“the Authority” or “Ofgem”), established by Section 1(1) of UA 2000, and successor to the Director General of Electricity Supply, directed NGC to modify the BSC on 15 March 2001, in a respect not material for present purposes. In making a modification decision, the Authority is exercising a function conferred on it by Section 7(3) of EA 1989. It is required to discharge its functions in accordance with its statutory duties. These are set out in Section 3A of EA 1989, introduced by Section 13 of UA 2000.

THE LICENCE CONDITIONS

5. Condition 7A.1 of NGC’s licence provides:-

“The Licensee shall at all times have in force a BSC, being a document

- (a) setting out the terms of the balancing and settlement arrangements described in paragraph 2:
- (b) designed so that the balancing and settlement arrangements facilitate achievement of the objectives set out in paragraph 3:
and
- (c) including the modification procedures required by paragraph 4 and the matters required by paragraphs 6 and (where applicable) 10.

and the Licensee shall be taken to comply with this paragraph by adopting as the BSC in force with effect from the date this Condition comes into effect the document designated by the Secretary of State for the purpose of this Condition and by modifying such document from time to time in accordance with the provisions of paragraphs 4 and 5.”

6. Condition 7A.2 sets out the “balancing and settlement arrangements” (by reference to the BSC Parties” as defined in Condition 15). They are (emphasis supplied):-

- “(a) arrangements pursuant to which BSC parties may make, and the Licensee may accept, offers or bids to increase or decrease the quantities of electricity to be delivered to or taken off the Total System at any time or during any period so as to assist the Licensee in operating and balancing the Licensee’s Transmission System; and for the settlement of financial obligations (between BSC Parties, or between BSC Parties and the Licensee) arising from the acceptance of such offers or bids; and
- (b) arrangements:
- (i) for the determination and allocation to BSC Parties of the quantities of electricity delivered to and taken off the Total System, and
 - (ii) which set, and provide for the determination and financial settlement of, obligations between BSC Parties, or (in relation to the operation of the Licensee’s Transmission System) between BSC Parties and the Licensee arising by reference to the quantities referred to in sub-paragraph (i), including the imbalances (after taking account of the arrangements referred to in sub-paragraph (a)) between such quantities and the

quantities of electricity contracted for sale and purchase between BSC Parties.”

7. Condition 7A.3 stipulates that the “objectives” referred to in Condition 7A.1(b) are:-

“(a) the efficient discharge by the Licensee of the obligations imposed upon it by this licence;

(b) the efficient, economic and co-ordinated operation by the Licensee of the Licensee’s Transmission System;

(c) promoting effective competition in the generation and supply of electricity, and (so far as consistent therewith) promoting such competition in the sale and purchase of electricity;

(d) without prejudice to paragraph 10, promoting efficiency in the implementation and administration of the balancing and settlement arrangements described in paragraph 2.”

8. Condition 7A.4 states that the BSC shall include procedures for its own modification, which procedures shall provide for proposals for modification of the

BSC to be made, and, where such a proposal is made, for, inter alia, properly evaluating whether the proposed modification would “better facilitate achieving” the “Applicable BSC Objective(s)”, as defined by Condition 7A.15.

9. Section F of the BSC sets out Modification Procedures. These involve a role for a Panel (“the Panel”), established by Section B.

THE BSC IN PRACTICE

10. Under the BSC:-

(1) Generators agree to notify to a central operator (operating under the auspices of NGC, or its subsidiary, Elexon Limited (“Elexon”)):-

(a) The volumes of electricity which the generator has contracted to sell in a given half hour period; and

(b) The volumes of electricity which it expects to generate in a given half hour period; and

(2) Similarly, suppliers agree to notify:-

- (a) the volumes of electricity which they have contracted to purchase; and
- (b) the volumes of electricity which they expect to take (to meet their customers' demand) in a given half hour period.

11. The notifications described in 1(a) and 2(a) are described as "contract notifications". The notifications described in 1(b) and 2(b) are described as "physical notifications".

12. Based on the information provided by generators and suppliers as to their physical position, NGC¹ will balance the system in a given half hour period by contracting with generators and suppliers for them to increase or decrease the amount of electricity which they will deliver onto the system, or take off the system in the relevant half hour period, so that deliveries are constantly in balance with supplies. NGC contracts on its own account with generators and suppliers to make such balancing trades.

Footnote ¹ : For the purposes of the following description, reference is made to the functions of the central BSC parties as if they were all to be undertaken by NGC, albeit that, in some cases, they are undertaken by other entities controlled or engaged by NGC or Elexon.

13. The BSC also provides for NGC to recover the amounts expended under such balancing trades in respect of a given half hour period. NGC will, after a half hour period has been completed, compare each generator's physical position (as adjusted by its balancing trades) with its contract position to establish to what extent the generator has (in effect) exported onto the system more or less electricity than it had contracted to sell. Similarly, NGC will compare the volume of electricity which a supplier has actually taken from the system in a given half hour period (that is, the total consumption accounted for by its customers) with the volume of electricity which the supplier had contracted to purchase. Any "imbalance" is then settled by having generators and suppliers who are "out of balance" pay "cash out" prices calculated by reference to the cost of balancing bids accepted by NGC in respect of the relevant half hour period.

14. The BSC therefore serves two purposes:-

- (1) It provides a mechanism for NGC to achieve "total system balance" in any given half hour period (and, indeed, from minute to minute within a half hour period); and
- (2) it provides a mechanism for individual suppliers and generators to settle their own imbalances in any given half hour period (that is, the discrepancy between the amount which a particular trading party had

contracted to sell/purchase and the amount which it actually delivered to/took from the system).

15. NGC is required to perform these functions in accordance with the BSC. The BSC seeks to attain its objective (see paragraph 6 above) of providing for the efficient, economic and co-ordinated operation by NGC of its transmission system by requiring NGC (in effect) to buy and sell electricity for the purposes of balancing trades at the cheapest available price.

16. It is to be noted that, in deciding what balancing trades to make in a given half hour period, NGC has regard only to parties' physical notifications (and not to their contract notifications). The data as to parties' contract notifications is used only after the completion of the half hour trading period to determine parties' individual imbalance positions and, hence, how much each individual party should contribute to discharging the costs of the relevant balancing trades.

17. An initial settlement is effected a number of days after completion of a trading period. Settlement payments are subsequently adjusted, as more complete information becomes available. For example, the initial settlement run is based on estimates of each supplier's offtake from the system, and the actual offtake figures are substituted for the estimates at a later date, as supply customers' meter readings become available.

18. This means that final settlement in respect of a given trading period is not completed until some 14 months after the end of the trading period. Reasonably “firm” figures are, however, available at much earlier interim settlement dates.

THE PROBLEM

19. Until recently, generators and suppliers traded electricity in a single wholesale market known as the “Pool”. The Pool was established by and operated on the terms of the Pooling and Settlement Agreement, a multi-partite agreement between (inter alia) generators and suppliers which required generators to sell all the electricity which they generated via the Pool, and required suppliers to purchase all their electricity requirements for supply to customers from generators via the Pool. Licensed suppliers and licensed generators were all subject to a licence obligation to accede to the Pooling and Settlement Agreement.

20. For some time Ofgem had considered that the Pooling and Settlement Agreement was not calculated to produce an efficient market outcome. Accordingly, in March 2001, the Pooling and Settlement Agreement was effectively brought to an end (subject to settlement of outstanding obligations) and New Electricity Trading Arrangements (“NETA”) were brought into operation.

21. In practice, there have been “teething troubles” since the introduction of NETA. Many participants, including NGC, have experienced some problems with their IT systems.

22. On 2 April 2001 notification data put back by NGC to London for verification contained numerous errors. London failed to notice before “Gate Closure” (which occurs 3.5 hours before the commencement of a given half hour trading period) that the amounts which it had notified as being the volumes which London’s Supply Business had contracted to purchase for trading periods during 3 April were entered as nil, whereas in fact they should have reflected a quite different trading position.

23. In consequence, London failed to rectify the contract notifications applicable to its Supply Business. After the completion of the relevant trading periods, London’s Supply Business was found to be liable for substantial imbalance charges, reflecting the fact that its supply customers had taken substantial volumes of electricity off the system, but London had (according to its notifications) contracted to purchase zero volume.

24. In total, London was required to pay net imbalance charges of approximately £7.5 million. Its error also resulted in a substantial windfall to other trading parties. London’s erroneous notification of its contract position had

no effect on the balancing trades undertaken by NGC (as they are based on physical notifications, not contract notifications), but the imbalance charges to London significantly exceeded the total cost of all such balancing trades, resulting in a return of windfall gains to other trading parties.

25. During the early period of NETA trading, other trading parties (including Scottish Power) also made, and failed to correct, erroneous notifications of their trading positions. They too were, in consequence, rendered liable to substantial imbalance charges.

MODIFICATION

26. In May 2001 Scottish Power proposed, under the formal modification procedures of the BSC, a modification to the BSC to enable (in effect) erroneous notifications arising from technical errors to be corrected after Gate Closure, and for imbalance charges to be calculated by reference to the corrected notifications, rather than the notifications in place at Gate Closure. Scottish Power's proposed modification was designated as modification proposal 9 ("P9").

27. It was evaluated under the relevant modification procedures as an urgent modification proposal. The Panel prepared a modification report. It

recommended that the proposed modification be rejected. On 8 June 2001, Ofgem decided to reject the proposed modification. It gave short reasons.

28. London Electricity decided, in the light of the rejection of modification P9, that it would be worthwhile to propose a different, more fully developed, and more fully justified, modification. Accordingly, on 11 June 2001 London formally proposed a different modification to the BSC, which has been designated as P19.

29. In short, P19 proposed that trading parties should be permitted to correct erroneous contract notifications, even after Gate Closure, but subject to certain limits, in order to ensure that settlement of imbalances is effected by reference to the difference between parties' trading (ie contract) positions and their final physical positions, rather than by reference to an erroneous notified contract amount. P19 would, if adopted, have provided for its retrospective application - that is, trading parties could correct erroneous contract notifications in respect of periods prior to the adoption of P19, and have the correct contract volumes taken into account in final settlement (by way of adjustment to any interim settlement already effected for such trading periods).

30. London's proposal also was subject to the urgent modification evaluation procedures. An initial Panel meeting to discuss the modification was held on 2nd July. Voting Panel members were evenly divided as to whether the modification

should be recommended for adoption or rejection. The Chairman indicated that since, in the event of a tied vote, the BSC provided for him to have a casting vote, he would exercise his casting vote in favour of rejecting the modification and preserving the status quo.

31. It was subsequently ascertained that the Panel meeting had been inquorate. A new meeting was convened, on 4th July. Once again there was a tied vote, and the Chairman cast his vote in favour of the status quo.

32. By a decision letter dated 1st August 2000 Ofgem decided to reject modification proposal P19. The decision letter contains Ofgem's stated reasons for its decision.

33. In essence, Ofgem considered that P19 did not satisfy the applicable test for the making of modifications to the BSC (that the modification would better facilitate achieving the BSC objectives) since it did not provide sufficient incentives on parties to submit accurate notifications in the first place. However, Ofgem holds out the possibility that a suitably drafted modification dealing with the correction of notification errors would be capable of satisfying that test.

34. Paragraph 25 of the decision letter sets out the features which Ofgem indicates should form part of such a modification which "would not necessarily be

incompatible with the BSC objectives or [Ofgem's] statutory duties". Those features include:-

- (1) An appropriate and material charge for any party seeking to correct a notification error:
- (2) A fixed percentage limit on recovery of a claim;
- (3) A short claim period;
- (4) The responsibility for establishing the nature of the error resting on the claimant;
- (5) The claimant having to show that it had acted prudently in checking its notifications; and
- (6) The claimant having promptly to put in place steps to avoid repetition of the error.

35. The retrospective effect of P19 is the subject of a separate section of the decision letter (paragraphs 27 to 38). This states that Ofgem is, in general, against approving modifications which will have retrospective effects. However, it

recognises that there may be a small number of “particular circumstances” that could give rise to the need for a modification which would have a retrospective effect. A non-exhaustive list of three such “particular circumstances” is given at paragraph 36. In identifying these categories of circumstances, Ofgem indicates that it has one eye to the fact that it (and its predecessor, Ofgas) has in the past approved modifications with retrospective effect to the Gas Network Code, a document that fulfils a very similar role in the gas market as does the BSC in the electricity market but which has been in operation since 1996.

36. In addition, the decision letter indicates that any future modification dealing with the correction of notification errors and having retrospective effect should provide for “a more stringent cap” on the recovery of monies lost through notification errors that benefit from the retrospective effect of the modification.

37. On 11 September 2001 London formally proposed a further modification to the BSC. It has been designated as P37.

38. The proposed modification provides for the remedy of past notification errors only (that is, notification errors that have occurred prior to the coming into effect of the modification), although it contemplates that a further modification addressing future notification errors will follow in due course. P37 attempts to incorporate all of the features that Ofgem indicated in its decision on P19 should

be included in any future modification dealing with past notification errors including, in particular, those features that apply to a modification with retrospective effect.

39. On 13th September 2001, Ofgem agreed that P37 should be subject to the urgent modification evaluation procedure. In accordance with this procedure, a consultation document was sent to the BSC Parties on 21st September 2001.

LEGAL ISSUES

40. London has submitted that, in its present form, the BSC effectively provides for settlement to be made by reference to the difference between physical delivery/take on the one hand, and notified volumes, on the other, without regard to the fact that notified volumes may (through simple error) differ from the parties' true contract positions, and notwithstanding that Condition 7A.2 contemplates that, for any trading party, it will be possible (subject to any evidential difficulties) to ascertain its contracted trading position, independently of any figures it might notify for settlement purposes. London contended that, compared with the existing BSC provisions, P19 would better provide for imbalance settlements to be effected by reference to the difference between a party's delivery/take to or from the system, on the one hand, and the quantities of electricity which it has contracted to sell or purchase on the other (since it would

provide for corrections to be made where inaccurate figures had been submitted for settlement). London argued that P19 would thereby better facilitate the achieving of the BSC objective in Condition 7A.3(a): the efficient discharge by [NGC] of the obligations imposed upon it by [its] licence.

41. During the Panel's consideration of P19, NGC/Elexon took legal advice as to the merits of London's argument and was advised that Elexon should effectively disregard London's submissions to the effect that its modification proposal would render the BSC better calculated to achieve the requirements of Condition 7A.2. The Urgent Modification Report in respect of P19 records (at page 15) that Elexon received the following advice:-

"Some of the arguments in the Proposal rely on their assertion that the BSC does not fulfil the 'objects' described in Condition 7A.2 of the Transmission Licence. Condition 7A.2 defines the scope or boundary of the BSC. It does not establish the objectives of the BSC (which are set out in Condition 7A.3).

"Moreover, since the document designated by the Secretary of State at go-active is taken, for the purposes of NGC's licence, to be consistent with the scope defined in Condition 7A.2, we think there is a strong argument that 'contracted' would be interpreted to give effect to the Secretary of State's

intentions. Indeed, if one applied a literal interpretation to the word 'contracted' in Condition 7A.2, it would exclude ECVNs between the two energy accounts of a single Party, which is expressly permitted by the Code."

42. Elexon's legal advisers are thereby saying that the notified contract volumes under Section P (Energy Contract Volumes and Metered Volume Reallocations) of the BSC (including, therefore, all volumes notified in error) are to be deemed to be "the quantities of electricity contracted for sale and purchase" for the purposes of Condition 7A.2.

43. Ofgem did not address these issues in its decision in relation to P19. Paragraphs 12 to 14 of the decision letter refer to NGC's transmission licence conditions, but there is no consideration of whether Ofgem is effectively bound to approve the modification by virtue of the fact that it better facilitates the achievement of the efficient discharge of NGC's licence obligations. Ofgem appears to have concluded that its only legal duty was to ensure, before directing the adoption of P19, that, if P19 were adopted, the amended BSC would meet the requirements of Condition 7A.2.

44. These same issues arise in respect of P37 as they arose for P19.

ADVICE

45. In my opinion, Elexon, and, consequently, the Panel, has received, and Ofgem may be acting upon, erroneous advice.

46. To my mind, the correct interpretation of Condition 7A.1 and Condition 7A.2 is that:-

- (1) The effect of the Secretary of State's designation of the present version of the BSC has the effect only of protecting NGC from being subject to enforcement action on the grounds that it has infringed Condition 7A.2;
- (2) The designation does not mean that the present version of the BSC is to be conclusively regarded as compliant with the requirements of Condition 7A.2, so as to be incapable of being modified for the better attainment of those requirements;
- (3) indeed, Condition 7A.1 specifically contemplates that the BSC, as originally designated, may be subject to later modification;
- (4) Condition 7A.2(b)(ii) contemplates that there will be, quite independently of amounts notified under the BSC, an ascertainable contracted trading

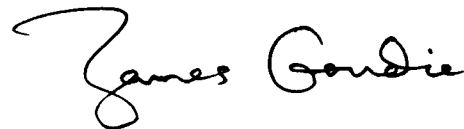
position, by reference to which the imbalance settlements should be effected.

47. It is true that, in London's case, the particular relevant trade is not a "contract" between London and another trading entity, but is an "internal trade" between two different accounts maintained by London (its Energy Production Account and its Energy Consumption Account). The BSC expressly, however, requires trading parties to maintain two such Accounts. Moreover, where a single trading party carries on business both as a generator and a supplier, the NETA arrangements, as reflected in the BSC, clearly contemplate that such a party should be permitted to effect internal trades, as between its generating arm and its supply arm and to treat those as "contracts" for the purposes of the BSC. Further, paragraph P1.4 of the BSC clearly demonstrates that such internal trades are to be treated as "contracts".

48. I do not consider that the adoption of the features that Ofgem indicated in its P19 decision letter should be incorporated into a notification error correction modification detracts materially from the argument that P37 better facilitates the efficient discharge of the requirements of Condition 7A.2. The incorporation of such features is, in my view, no more than a pragmatic means of implementing those requirements. based on the view that, as the parties themselves are best placed to provide information as to their contract position, it is appropriate that

they should be incentivised to provide accurate information, and that there must be some means of securing finality of settlement within a reasonable timescale.

49. I do consider that, in order to act lawfully, the Panel and Ofgem must address the modification proposal unfettered by the Secretary of State's initial designation and by reference to what will best facilitate the achievement of the efficient discharge of NGC's licence obligations.

A handwritten signature in black ink that reads "James Goudie". The signature is written in a cursive style with a large, sweeping initial 'J'.

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JAMES GOUDIE QC

September 2001

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OPINION

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