21 January 2005

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Dear Simon,

NGC System Operator Incentives from April 2005 - Initial Proposals

Thank you for the opportunity to comment on the issues raised in the above consulation paper.

Key Points

- **There should be a single GB SO incentive scheme based on the established sliding scale approach, the scope of which should be consistent with the current E&W scheme.**

- **We agree with Ofgem that the introduction of a deadband on the scheme target value should be avoided.**

- **Whilst our preference is for symmetry within the scheme, we recognise that an asymmetric approach may be appropriate for the initial GB SO incentive arrangements.**

- **We welcome Ofgem's recognition that under previous schemes NGC has consistently overestimated its forecast of incentivised balancing costs. We therefore look to Ofgem to trim back NGC's forecast of GB balancing costs with a view to setting a realistic yet challenging target.**

- **Whilst in principle we support a move to a net transmission losses scheme, this should only be progressed if it can be demonstrated that the costs involved are small and after consideration of the impact on the systems of users for processing BSUoS data.**

- **We remain concerned about the number and impact of Income Adjusting Events on the operation of the SO incentive schemes. We are particularly concerned about the potential impact of CAP047 and CAP048 on the initial GB incentive scheme to be implemented from 1 April 2005.**

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Detailed Comments

Scope of the GB SO Incentive Scheme from 1 April 2005

For the initial GB SO incentive scheme to apply from 1 April 2005, we continue to support the introduction of a single GB scheme based on a sliding scale approach, the scope of which should be consistent with the current E&W scheme. However, for future GB schemes consideration should be given to including within the incentive arrangements the internal costs that NGC incurs in carrying out its SO activities, particularly since these are also recovered via BSUoS charges.

Under the current arrangements, NGC's internal SO costs are incentivised via the regulated price control (with calculations in the BSUoS charging methodology). It seems inconsistent, however, that some components of NGC's SO costs should be incentivised via the licence/price control and others by the explicit SO incentive arrangements. In setting future schemes, consideration should therefore be given to the merits of including within the SO incentive arrangements NGC's internal SO costs, particularly if future schemes reflect Ofgem's preference for schemes of longer duration.

Form of the GB SO Incentive Scheme from 1 April 2005

We agree with Ofgem that the introduction of a deadband on the scheme target value should be avoided. Whilst there is some uncertainty surrounding the GB SO costs to which NGC will be exposed in the first year of operation of BETTA, this uncertainty is significantly less than that surrounding NGC's SO costs at the start of NETA (when the deadband approach was first used). In particular, NGC now has four years experience of balancing the E&W NETA market and hence should have a good appreciation and understanding of the likely costs of operation of a GB market. Therefore, the introduction of a deadband mechanism to reflect the addition of the smaller Scottish market to the incentive arrangements is not justified. In any event, and as Ofgem point out, the use of a deadband creates a range of costs within which NGC has reduced incentives to manage costs on behalf of system users and ultimately customers.

Like Ofgem our preference is for symmetrical sharing factors and caps and collars. However, we recognise that the uncertainty surrounding the overall level of GB costs could result in a somewhat asymmetric risk profile. As a consequence, and noting that a deadband will not be included, we recognise that the inclusion of asymmetric sharing factors and caps and collars within the *initial* GB scheme may be an appropriate way of dealing with any cost uncertainty. However, it will be important to return to a symmetrical approach in respect of any future, similar schemes.

Incentive Scheme Parameters

Without access to the data or models it is difficult for BE to comment on NGC's projections of IBC. Nonetheless, we welcome Ofgem's recognition that NGC has consistently overestimated its forecast of IBC under previous schemes and share Ofgem's scepticism regarding NGC's forecast of GB IBC. In these circumstances we expect Ofgem to trim back NGC's forecast of GB balancing costs with a view to setting an appropriate and realistic yet challenging incentive target. In this regard, and as we noted in our response to the initial consultation, the current Scottish Administered Pricing arrangements are predicated on lower balancing costs than in E&W. A legitimate expectation therefore is that the GB IBC target should imply lower average balancing costs across GB than would be the case without BETTA. Actual values aside, we agree that the adoption of a menu approach for the initial GB scheme will allow a reasonable balance to be struck between risk and reward for NGC.

We continue to support the inclusion of transmission losses within the SO incentive arrangements, with a single GB volume target and TLRP. In principle we also support a move to a net losses scheme given that system users are not exposed to the full cost of losses through BSUoS charges. However, Ofgem will need to consider the impact of moving to a net losses scheme on the systems of NGC and of users for processing BSUoS data. In particular, and given that the materiality of a change to a net losses scheme is neutral in terms of the level of BSUoS charges and on the incentives on NGC to manage the volume of transmission losses, the costs to NGC (and hence users) of making the change would need to be minimal.

On a point of accuracy, we note that Ofgem provides conflicting estimates for the target volume of losses within the document (e.g. in paragraph 6.30 Ofgem suggests a target of 5.8 TWh whilst at paragraph 6.45 the target is stated as 4.6 TWh). We assume that the correct figure is that stated at paragraph 6.30 given that this is better aligned with NGC's forecast.

BSC Modification & CUSC Amendment Proposals

British Energy remains concerned regarding the number of income adjusting events that have occurred under NETA and their impact on the operation of the SO incentive arrangements. This concern is heightened by the uncertainty surrounding the treatment of CAP048 and the wide disparity between the views of NGC and Ofgem regarding the impact of CAP047. These issues need to be resolved before the final target is agreed and reflected appropriately in the final scheme arrangements.

Yours sincerely,

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