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18th January, 2005

Dear Simon,

NGC System Operator Scheme from April 2005

I am responding to the above consultation on behalf of E.ON UK plc. Whilst we generally support many of the proposals set out in the above consultation paper, there are some areas where we disagree with what has been proposed.

The scope of the scheme and number of options

As we stated in our previous response, we believe that a scheme similar in scope and structure to that which has historically operated in England and Wales (E&W), should be implemented for Great Britain under BETTA. We are therefore supportive of a number of proposals outlined in the consultation document, namely that:

- The scheme should have the same scope as present E&W schemes
- It should be set for the period of one year.
- A single scheme should be developed to cover the whole of GB.
- A dead band should not be considered.
- The transmission losses element of the scheme would apply uniformly across the whole of GB.

However, we do not support the proposal to provide NGC with a choice of schemes, although we appreciate that this approach was followed for NETA Go Live. It is not clear what benefit is created from giving NGC such a choice. We can see that NGC stands to benefit. As the party in the position of greatest knowledge in this process, it will be able to choose the scheme which is most likely to maximise its income. However, what isn't clear is how users and customers stand to gain. Without such a demonstrable benefit we believe that NGC should be presented with a single scheme.

Sharing factors

As we have mentioned in previous responses on this issue, it is clear that NGC has been able to make a great deal of money from past schemes. This has in the main been due to it being able to retain too high a proportion of any savings made. We have suggested that more modest sharing factors could be considered, which we feel would be sufficient to provide NGC with an incentive to minimise balancing costs. We note that the factors proposed are still extremely generous and therefore continue to believe that they could be reduced.

We note that Options 1 and 2 have asymmetric sharing factors. We do not believe that there is justification for the scheme to have asymmetric sharing factors if it is set against the central view of the level at which balancing costs are expected to outturn at. This is because, assuming a normal symmetric expected distribution of uncertainty, this view has just as high a likelihood of being high as it has of being low. This is illustrated in Figure 1 below.

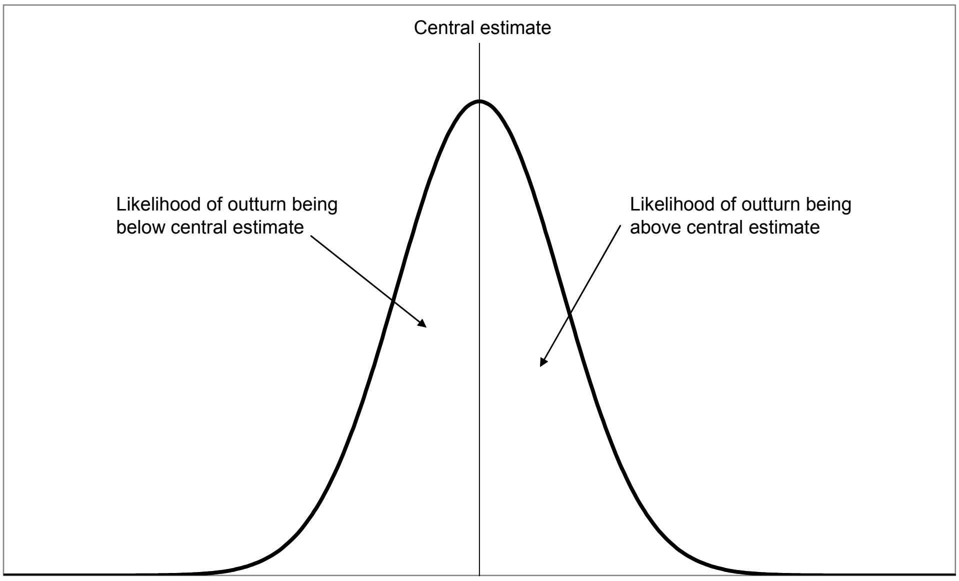

Figure 1 – Illustrating normal distribution of uncertainty around the central estimate

This shows a normal distribution of possible outcomes, to show the uncertainty around the central estimate. The areas to the left and right of the central estimate illustrate the likelihood that the actual outturn will be lower or higher respectively. The diagram illustrates that it is just as likely that the uncertainty will result in a target that is too high as it is too low, as the areas either side of the target are equal.

This doesn't mean however that there are no situations for which asymmetric factors would be appropriate. Figure 2 illustrates the uncertainty around a target which is set below the central estimate, which is therefore more challenging to meet.

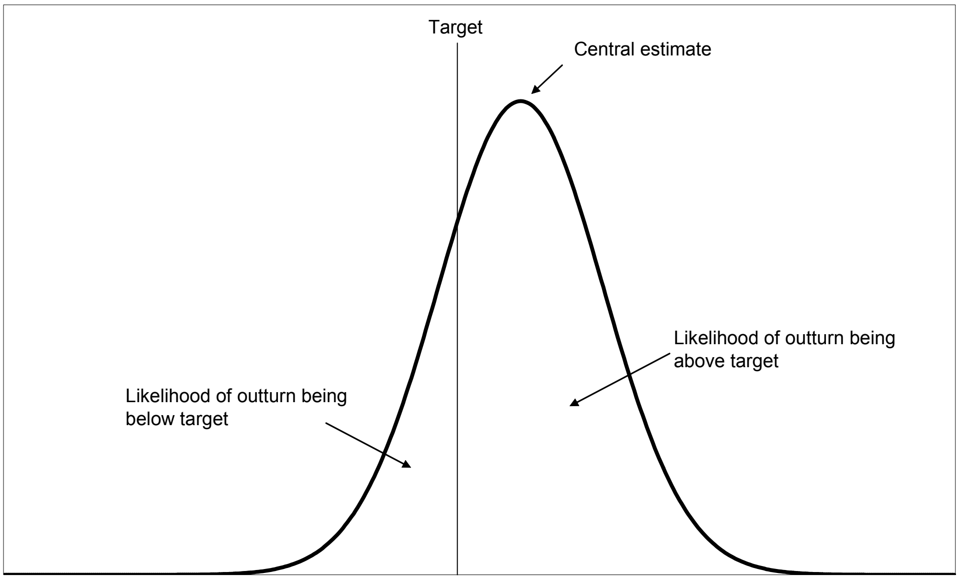

Figure 2 – The effect of setting a lower target

This illustrates that the uncertainty around the central view implies that it is more likely that the outturn level of cost will be above the target than below it. Therefore, it may be reasonable to set a lower sharing factor for outcomes above the target and a higher sharing factor for outcomes below the target, to reflect the asymmetric nature of the uncertainty either side.

With the above in mind, there appears to be some ambiguity in how the asymmetric factors in Options 1 and 2 of the scheme have been derived. Paragraph 6.33 of the consultation appears to suggest that Ofgem's central estimate of next year's likely balancing costs is £480m. However, the accompanying sharing factors, in Option 1 of the scheme, are asymmetric which would appear to contradict this. The option which does have symmetric sharing factors is Option 3 which has a target value of £515m. This would imply that this is actually Ofgem's central view. Figure 3 illustrates this below.

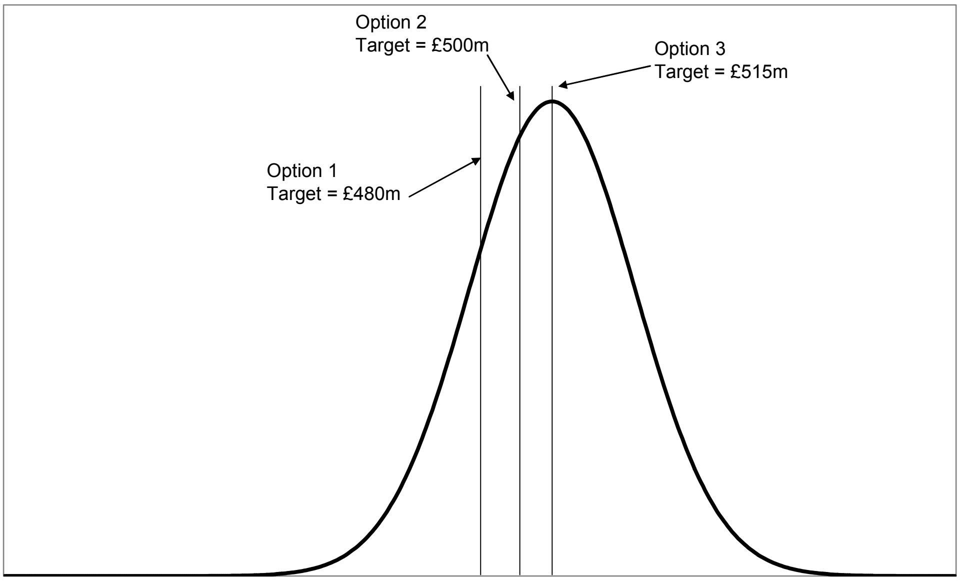

Figure 3 – Illustration of how the uncertainty appears to interact with the three proposed options

It is not clear why £515m should be set as the central estimate. If it is not, and £480m is still the central view, then the sharing factors for Option 1 should be symmetric. If other options are to be set with target values above the central estimate, then these should actually have higher downside sharing factors and lower upside sharing factors if the purpose is purely to reflect the uncertainty. Of course, it could be that the distribution is not symmetric. However, without evidence from NGC as to why this would be the case, we have to assume that the estimate is just as likely to be high as low.

That said, as we have mentioned above we do not believe that there are any benefits, except for NGC, from creating a number of options. Therefore, we believe that single option should be set, with a target reflecting Ofgem’s central estimate and with symmetric sharing factors.

Treatment of transmission losses

As stated above, we support the proposal to have a GB wide incentive for transmission losses. However, the proposal to change the incentive to a net basis does not appear to have much merit. We note that the incentive properties of both the gross and net schemes are identical. The reasoning set out in the consultation for changing the treatment of losses is to give a clearer indication of the cost to customers. Whilst the effects on customers through BSUoS may be limited, the total effect on customers is not. Any increase in losses will mean that the cost to customers increases proportionately as more generation is required per kWh of consumption. We believe that this is why the original target was set as it was.

Another problem with setting the transmission losses element on a net basis is that it will make it very difficult to compare schemes and outturn costs after the change with those which occurred prior to the change. Whilst this will be an issue to some extent anyway with the widening of the scheme to GB, it does not appear sensible to reduce transparency further for no improvement in incentive. Therefore, we believe that retaining the present gross treatment would both better reflect the total effect of transmission losses on customers and would maximise transparency in respect of trends in total balancing costs levels.

Provisions to cope with a delay to BETTA implementation

We are generally supportive of the proposal to roll over the existing E&W scheme should BETTA implementation be delayed. Whilst we suggested an alternative approach in our response to the initial consultation in September, it no longer seems worthwhile at this stage to create a specific E&W scheme for 2005/06, in light of our expectation that these provisions will be unnecessary anyway.

In respect of the choice of profiling factor to use, if the profile of balancing costs changes by time of year this should be reflected in the methodology used. If this is not the case, then a simple methodology which apportions the scheme purely in proportion to the number of days in the period would appear to be sufficient.

Conclusions

Whilst we support much of that which has been proposed, we feel that NGC should be presented with a single scheme, with symmetric sharing factors of a modest level to avoid the creation of windfall gains or losses. We believe that transmission losses incentive should be consistent across GB and should be included on a gross basis to reflect the wider impact on customers and to allow year on year comparisons of schemes and outturn costs. Finally, we agree with the proposals for coping with a delay to BETTA.

I hope the above proves helpful.

Yours sincerely

Paul Jones
Trading Arrangements