

NGC GB System Operator from April 2005 Initial Proposals Document.

NGT Response.

1. Executive Summary.

We welcome the opportunity to respond to Ofgem's initial proposals on NGC's GB System Operator Incentive Scheme. Our main comment is that Ofgem have made a number of unreasonable assumptions in their initial proposals document. Consequently, we believe that the targets proposed do not offer an appropriate level of risk and reward for NGC as GB system operator.

There are 3 main areas where we are very concerned. Firstly, we believe that Ofgem have significantly underestimated constraint costs and their decision to reduce parts of our constraint forecasts by 50% appears completely arbitrary. It is also clear that Ofgem's view of the effect of the implementation of CAP047 is significantly different from our own, and we are keen to ensure that the incentive arrangements cover this risk appropriately. Also, we believe that the starting point for Ofgem's construction of 2005/06 costs, namely the forecast of costs for England and Wales in 2004/05, significantly underestimates the likely outturn.

We will seek to engage with Ofgem in order to find a way forward and deliver appropriate incentive arrangements to apply from 1st April 2005.

2. Introduction.

In general, we support Ofgem's desire to incentivise NGC on a similar basis to the current SO Incentive Scheme arrangements in England and Wales, and to implement a sliding scale incentive scheme for one year. We are keen to ensure that incentive arrangements for 2005/06 provide NGC with an appropriate incentive to manage costs and outperform against the target, whilst adequately reflecting the risks that NGC is exposed to. We do not believe that Ofgem's initial proposals adequately reflect the level of uncertainty involved.

In section 3 of this response, we briefly discuss performance under previous incentive schemes and then respond to Ofgem's view of our forecast of IBC for 2005/06. In section 4 we respond to Ofgem's initial proposals and the specific issues on which Ofgem have requested a response.

3. NGC's Forecast.

3.1 NGC's external SO incentive schemes since the implementation of NETA.

We welcome Ofgem's statement that we have made good progress in reducing the overall level of SO costs since NETA go-live, which has benefited both NGC and the industry alike. Indeed, in Appendix 5 of Ofgem's initial proposals, we discussed the areas where our innovative actions alone, which are driven by the incentive scheme, have led to a reduction in costs in 2003/4, conservatively estimated at around £34m. Under the sharing factor of this scheme, half of these benefits within year were passed

directly through to customers. These savings were then fully passed through to customers in 2004/05, as their effect is reflected in subsequent incentive scheme targets.

3.2 Ofgem's view of NGT's forecast.

2005/06 is the first year for which we have forecast balancing costs on a GB basis, and as Ofgem mention, there are considerable uncertainties associated with forecasting these costs, as for a number of elements of GB balancing costs there are no historic costs available on which to base the forecast. We welcome the fact that Ofgem have recognised the level of uncertainty in developing options which contain asymmetric sharing factors – we believe this appropriate given the asymmetry of risk faced by NGC, certainly in the first year, and possibly the first few years, of the GB market.

Ofgem have also suggested that NGT's forecast of £395m is overstated and use a linear extrapolation method to arrive at a suggested outturn figure of £373m for 2004/05. We continue to believe, supported by the latest information available, that the outturn figure will be much closer to our forecast than the straight-line extrapolation figure of £373m used by Ofgem. Further evidence to support our forecast is provided in section 3.2.1 below, where alternative options to the linear extrapolation method are provided for consideration.

We welcome Ofgem's statement that the deviation between our pre-scheme forecast and actual outturn is reducing. We are continually refining and improving our forecast, and as we have gained more experience of the market, we have become more adept at forecasting balancing costs. We believe our cost forecast is a reasonable representation of the potential balancing costs and risks.

Ofgem have suggested that a number of elements of our forecast are overstated. We will discuss each of these areas in turn.

3.2.1 Starting Point

Ofgem have suggested that our forecast outturn for 2004/05 of £395m is too high, and should be in the region between £361m and £371m. We strongly believe that Ofgem's range of £361m to £371m is substantially below the likely outturn costs. Based on actual outturn data up to December 2004 three updated scenarios are considered:

- i. Linear Extrapolation method – updated using the outturn costs up to December 2004 gives a projected outturn of **£396.1m**;
- ii. Actual outturn data up to December 2004 plus average historical costs for the remaining three months (adjusted to reflect 2004/05 TLRP) gives a projected outturn of **£391.3m**
- iii. Actual outturn data up to December 2004 plus lowest historical costs for the remaining three months (adjusted to reflect 2004/05 TLRP) gives a projected outturn of **£384.5m**

It can be seen that all the figures above are above the range assumed by Ofgem and even assuming the lowest historic outturn for each of the remaining months (Scenario (iii)), the outturn would be about £18.5m above the mid-point of Ofgem's projected range for outturn in 2004/05. Based on the average of the 3 projections we believe that the

midpoint of Ofgem's range is approximately £25m too low and that it would be appropriate to increase the targets by £25m to reflect this.

One final option is put forward for consideration which would remove the subjective views on the current year forecast. This solution would be for Ofgem to include an adjusting mechanism, dependant on actual outturn in 2004/05. Ofgem consider a range of £361m to £371m for the starting point of their forecast, and so one can reasonably assume the mid-point of £366m as the basis for the targets that Ofgem have set. We believe therefore, that the target should be adjusted dependant on actual outturn for 2004/05. Therefore, should costs outturn above £366m, then the target should be increased accordingly, whilst if costs outturn below £366m, then the target should be decreased accordingly. We believe this would be an alternative practical way in which to deal the difference between our view and Ofgem's view of 2004/05 outturn.

3.2.2 Overall forecast

Ofgem point out that our forecast for 2005/06 is 38% higher compared to our outturn forecast for 2004/05, despite the GB market being just 11% larger in energy terms and 15% larger in generation terms, than the England and Wales. This assumption that increases in costs are directly proportional to increases in system size is overly simplistic, and Ofgem make this statement despite having already acknowledged in the Initial Consultation that there are likely to be significant constraint costs. Furthermore, they do not recognise the indisputable fact that cost elements like constraints and transmission losses, do not scale with the size of the Scottish system, as they are locational in nature and specific to individual transmission systems. As is pointed out in Appendix 6 to Ofgem's initial proposals it is possible to separate the cost increases into those resulting from the move to a GB market, and those resulting from other cost pressures. For the majority of cost elements, the move to a GB market does equate to a 12% increase on the projected 2004/05 outturn, broadly in line with the overall metrics outlined above. However, the fact that constraints and losses do not scale with the size of market, and that additional cost pressures on existing activities also need to be acknowledged, means that it should be expected that the overall forecast is significantly higher than the increase in the size of the market alone would suggest. We respond to Ofgem's views on individual cost elements below.

3.2.3 Constraints.

In response to Ofgem's views on constraints, we split the constraint costs between a) England and Wales, b) Within Scotland and c) across the so-called "Cheviot" boundary¹ basis, and discuss these in turn.

- **a) England and Wales Constraints** – Ofgem point out that our forecast for constraints in 2004/05 was £40.7m when accounting for TS Capex benefits. Our current estimate for 2004/05 is now £18m. The reason for this difference, as outlined in Appendix 6 to Ofgem's proposals, is a significant unforeseen increase in forward prices in England and Wales, resulting in a step change in the flow across the Anglo-French interconnector. This, coupled with new NGT constraint management initiatives and within year optimisation of constraints, resulted in a large reduction in constraints. It should be noted that the avoidance of constraint costs is most often

¹ The boundary made up of the existing interconnector circuits between England and Scotland

achieved by the rescheduling of transmission system outages so that they are aligned with more favourable generation patterns. During 2005/06 the forecast system investment is such that many of the outages will be for construction reinforcement and as such cannot be rescheduled at short notice to avoid constraint costs. Therefore, our forecast of £20m for 2005/06 represents a realistic view of the constraints in England and Wales in 2005/06.

- **b) Within-Scotland Constraints** – We welcome Ofgem's acknowledgement that there are significant uncertainties over constraints in Scotland in 2005/06, such as the level and timing of windfarm generation operating in Scotland, and the lack of operational experience of managing constraints in Scotland. Indeed, no one has any experience of managing constraints in Scotland under market arrangements, as such arrangements will not exist until BETTA go-live.

However, it should be equally recognised that our forecast is based on actual data and information provided by Scottish TOs, and our extensive studies of the Scottish transmission system, assuming reasonable generation behaviours. Therefore, we do not believe that Ofgem's 50% reduction from our forecast is reasonable, with Ofgem's justification appearing to be that the projected outturn constraint cost in England and Wales in 2004/05 is 50% of the forecast. This 50% reduction is unreasonable and appears to be completely arbitrary and we seek further clarification from Ofgem on how they have calculated this figure for within Scotland constraints.

As mentioned in Appendix 6 to Ofgem's initial proposals, constraint costs are currently internalised within SP and SSE, and these costs will be revealed under market arrangements. In general, constraints are locational in nature and are dependent upon the characteristics of transmission system. We do not believe that it is valid to compare constraint costs in Scotland with current constraint costs in E&W, where we have had many years of experience in managing constraints, and have invested in the network to relieve constrained parts of the system. As mentioned above, the new SO-TO interface in Scotland means that it is currently unclear the extent to which we will be able to employ many of the tools that we have used to manage constraints in England and Wales into Scotland under BETTA. Thus, we do not believe that comparing the England and Wales constraint costs with Scottish constraint costs is a valid comparison.

A more relevant comparison would be with the CEGB system before 1990, which like the Scottish system today, had not been subject to market based constraint costs and incentivisation on the network utility to manage those costs. Following vesting, constraint costs rose to over £250m in E&W in 1993/94. The costs have subsequently been managed down to the level of around £20m today through incentivisation, investment and the innovative actions of NGC. It should not be expected, therefore, that constraint costs within Scotland in 2005/06 should be in proportion to current England and Wales constraint costs, but should be more comparable with the unmanaged constraint costs seen in England and Wales in the early 1990's. Our forecast of £17m less than 10% of the constraint costs seen on the England and Wales system in the early 1990s.

- **c) Cheviot Boundary** - We welcome Ofgem's acknowledgement that it is likely that there will be significant constraint costs across the former Anglo-Scottish

interconnector (Cheviot boundary), related to the fact that all parties are to be granted GB transmission access if they applied before 1st January 2005. Furthermore, as mentioned in our response to Ofgem's initial consultation, constraint costs across the Cheviot boundary will be very dependent on the development and operation of the new GB market, and the strategies of the participants in this new market. It should be recognised, as with the within Scotland constraints, we believe that we have taken a conservative approach to our forecast of constraint volume and price, assuming reasonable market behaviours. For example, our forecast constraint volume is lower than other similar studies, such as RETS and SKM², and our forecast Scottish bid price is comparable with historical actual submitted Scottish bid price.

Therefore, we are disappointed that Ofgem consider it reasonable to reduce our forecast by an arbitrary 50%. We believe that the risk of very high constraint costs within Scotland and across the Cheviot boundary is the single most significant issue in the development of the BSIS scheme for 2005/06. As mentioned, we have no experience of managing constraints in Scotland, and there are a number of constraint management tools that we use in England and Wales that may be unavailable to us in Scotland in the early years under BETTA and therefore our control over the costs is reduced.

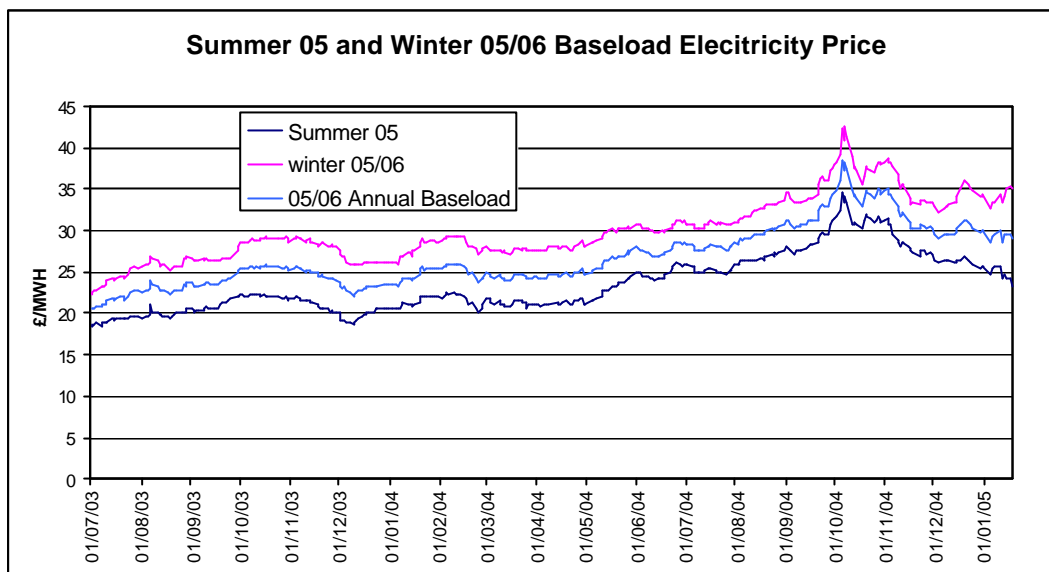
Appendix 6 of Ofgem's initial proposals outlines our approach to forecasting GB constraints, which involves analysis of the operation and pricing of Scottish generation, and for within Scotland constraints, a boundary by boundary analysis of the Scottish network and generation background. In summary, we believe this to be a robust method, which results in a realistic forecast, and do not believe that there is any basis for Ofgem's arbitrary reduction in our constraint forecasts. We will seek further clarification from Ofgem on this matter and will seek to establish methods of mitigating our risk.

3.2.4 Forward Prices

In their consultation, Ofgem argued that the forward prices assumed in the scenarios may be significantly higher than current trends for 2005/06 indicate. We do not agree that there is any reliable evidence seen in forward prices that would indicate an ongoing future downward trend. The forward baseload price for 2005/06 has risen significantly since the start of 2004/05 and reached a peak of £39/MWh in October 2004. Although since then it has fallen sharply and was last reported as £29.8/MWh on 17th January 2005, reflecting a mild winter and falling gas prices, we believe it premature to declare this as a "current downward trend" into 2005/06. The forward price went through a similar mid winter correction in winter 2003/04, and subsequently rose in the following months.

The diagram overleaf illustrates the recent movements in forward prices, and we believe that this supports our forward price assumptions in our scenarios.

² The RETS studies were carried out by the three transmission companies to develop plans for network reinforcement to accommodate the connection of new renewable generation in Scotland. The SKM study was carried out by SKM on behalf of Ofgem as part of Ofgem's consideration of the plans of the three transmission companies.



As stated above, the forward price for electricity is fluctuating at a level above that of the mean forward price assumed in our scenarios of £29/MWh. The purpose of the scenario approach we use is to represent a range of potential outcomes, and we believe that our range of values for forward prices is vindicated by the fact that the mean level is still consistent with forward prices observed in the market. Furthermore, it should be noted that all of our scenarios have a forward price lower than the 2004 peak of £39/MWh. Thus the evidence suggests that this range is a credible one. Given the evidence from the past year, further increases in forward prices cannot be ruled out, and it would be imprudent to forecast that prices could only fall from the current level. Whilst Ofgem choose to portray our scenarios as giving a 60% chance of the price being £30/MWh or higher, it is also equally correct to describe them as assuming a 70% chance of the forward price being £30/MWh or lower. We do not understand, therefore, how Ofgem have arrived at the view that the forward prices assumed in the scenarios are considerably higher than current trends indicate, and we believe that the forward price assumptions in our scenarios are entirely reasonable.

3.2.5 CAP047 – Introduction of a Competitive Process for the Provision of Mandatory Frequency Response.

Ofgem have acknowledged that there are likely to be cost pressures as a result of the introduction of CAP047, though it considers that our forecast of 50% increase in frequency response costs will not materialise, and that an increase of 10% to 25% is more likely. We have argued consistently during the development of CAP047 that these costs will rise by approximately 50% as a result of CAP047. This equates to an additional cost of £14.7m in 2005/06 following its introduction in October 2005. Our analysis in the Appendix 6 of Ofgem's initial proposals examined the development of the bid market following the implementation of NETA, a market comparable to the introduction of a market in response provision. Our analysis showed that this market contains a similar level of competition to, if not more than, the response market, and that cost premiums of over 100% above cost reflective levels were observed once a competitive market was introduced. If the implementation of CAP047 results in similar

trends, a 50% increase in the cost of response provision following the introduction of CAP047 would occur.

We believe, therefore, that our forecast is a reasonable expression of the risks faced by NGC following the implementation of CAP047. We are concerned that Ofgem's current view of the cost pressures resulting from the implementation of CAP047 differs significantly from our forecast. There are uncertainties inherent when moving to new market arrangements, and we believe that incentive arrangements should reflect this. Consequently, we are keen to ensure that this risk faced by NGC is reflected in the prevailing incentive arrangements. We suggest that this could be best achieved through the use of the income adjusting event provisions contained within the transmission licence.

3.2.6 Supplementary Standing Reserve.

We note that Ofgem consider that the effect of Scottish competition when procuring a similar level of SSR from a larger pool of available plant would put downward pressure on prices. However, tenders for standing reserve for 2005/06 shows that there has been limited competition from Scotland. Indeed of over 2900MW of standing reserve tendered, only around 5% came from Scottish generation plant. Average prices have risen by more than 25% to almost £22/kW, more than that assumed in the forecast for Standing Reserve. This implies that we have under-forecast margin costs, comprising Standing reserve, SSR, warming and margin actions in the BM, by around £5m in total.

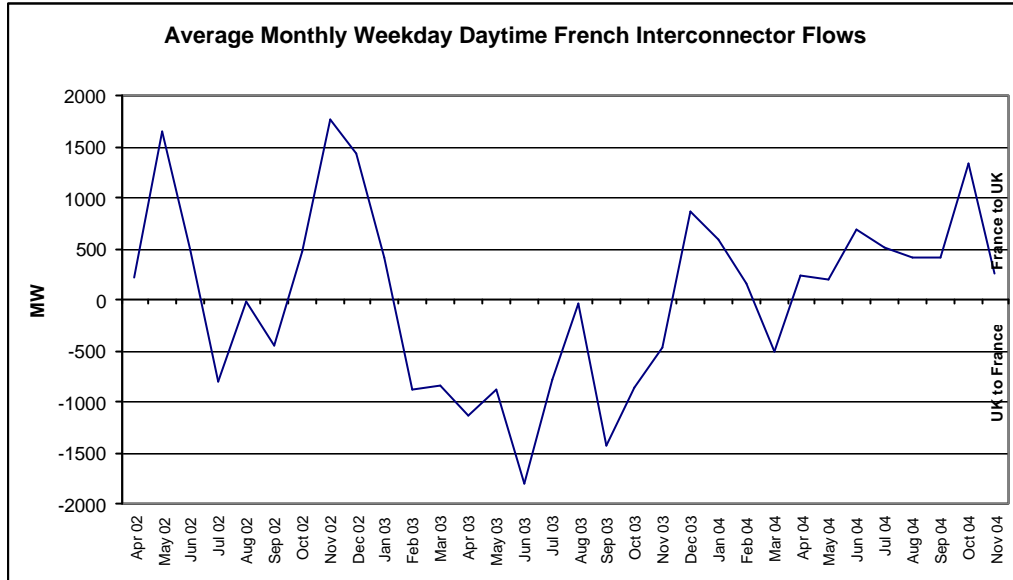
Therefore, we believe that our forecast price for any supplemental standing reserve contracts of £17.6/kW for 2005/06, the same as the current year, is extremely conservative. Indeed, based on the evidence seen in Standing Reserve tenders for 2005/06, the competitive pressures that Ofgem believe will push prices down will need to take place in order to push prices back down to the level assumed in the forecast. We believe, therefore, that it is extremely unlikely that competition will push prices all the way back down to the £14/kW assumed by Ofgem, and that our assumption that prices will be the same as in 2004/05 is itself very conservative, even assuming additional competition from Scottish plant.

3.2.7. Interconnector Flows.

Ofgem make the point in its consultation that under scenario 5, with a forward price of £36/MWh, that it would expect there to be greater import across the French interconnector, and therefore a higher plant margin. However, plant margin is calculated on total capacity, not forecast imports. The French interconnector is included in the calculation of plant margin at its full capacity; thus the French interconnector's contribution to plant margin remains unchanged by scenario, irrespective of the actual flow assumed.

Ofgem state that they would expect much greater imports on the French interconnector in the scenarios, which have forward prices over £30/MWh. As presented in Appendix 6 of Ofgem's consultation, even where high price differentials between the UK and France have existed historically, diurnal variations in flow mean that average flows over the period of a month have never equalled the maximum export. Indeed the highest monthly import over the last 2½ years was equivalent to an average import of just over 1500MW and the average monthly flow from France to the UK has only exceeded 1000MW for 3 months since April 2003. The scenario assumptions are based on average flow over a

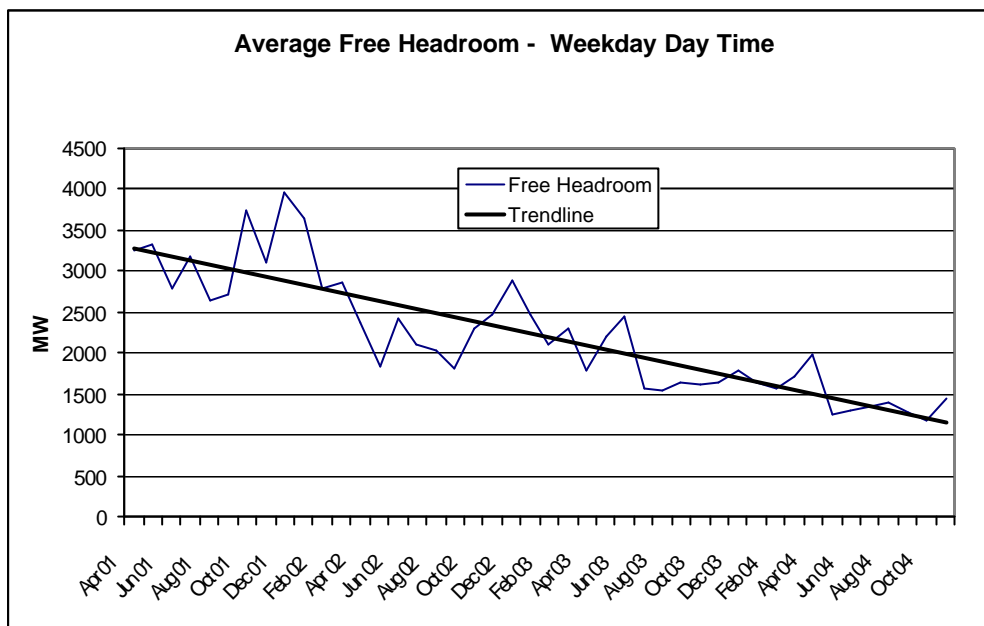
season (summer, winter and equinox). It can be seen from the data presented in Appendix 6, and the diagram below, the assumptions on average seasonal flows are consistent with historic flows. Therefore, we continue to believe that the forecast interconnector flows in our scenarios are both representative and reasonable.



3.2.8 Headroom.

Since NETA “Go-Live” free headroom has displayed a year-on-year reduction of approximately 25% as a result of market changes, and as market participants have become more efficient, with less part-loaded plant on the system. The diagram overleaf illustrates this clear trend. We expect this trend to continue until it reaches its minimum as determined by generation and demand characteristics. Our scenario assumptions include the impact of additional plant in Scotland, and that generators will maintain the efficiencies in the operation of their plant that have led to the reduction in free headroom to date.

Ofgem state that it sees little evidence to suggest that this trend will continue in a GB environment – however, there is no evidence to suggest that the implementation of BETTA will result in any reverse of this trend. We see no reason why generators would seek to operate their plant less efficiently following the implementation of BETTA. Moreover, one of the drivers of loss of free headroom has been consolidation of generation ownership in the market, and there is still evidence of continuing consolidation.



4. Ofgem's Initial Proposals.

4.1. Scope and Form of Incentive Scheme.

We agree with Ofgem's proposal that the scope of the existing E&W incentive scheme provides an appropriate basis on which to develop GB SO incentive arrangements provided that this does not introduce disproportionate risk upon NGC. As Ofgem mention in their consultation, we have performed well under these incentive arrangements since NETA, and have reduced balancing costs significantly, to the benefit of the industry as a whole. This shows that the incentive properties of the current arrangements are appropriate. The move to a GB market extends the geographical boundary of our balancing activities; hence we believe that there is no reason to change the current scope of the incentive scheme as long as the new risks can be accommodated appropriately.

We welcome the proposal to use an incentive scheme with a sliding scale with asymmetric caps, floors and sharing factors. As Ofgem point out, there are a number of uncertainties associated with the transition to BETTA, and we are keen to ensure that this uncertainty is reflected in the incentive arrangements. We discuss the options posed by Ofgem below.

The option to use separate schemes for Scotland and England and Wales would be difficult to implement, as we pointed out in our response to the initial consultation. This is because it is not possible to uniquely allocate costs to individual balancing services, as some balancing actions are taken to solve a number of issues in a GB wide market. Furthermore, it could create perverse incentives between the different incentive arrangements, as Ofgem have highlighted. Finally, we do not believe that operating two separate schemes is consistent with the overall goal of BETTA.

As stated in our response to Ofgem's initial consultation, we believe that there are a number of issues covered by the incentive arrangements where there is significant asymmetry of risk. Consequently, we believe that an asymmetric cap, floor and sharing factors or the use of deadbands may be appropriate in the initial period following the implementation of BETTA, as was the case following the implementation of NETA. We welcome Ofgem's view that asymmetric caps, floors and sharing factors are an appropriate way in which to accommodate uncertainty, and welcome the fact that Ofgem have included two options that contain asymmetric sharing factors.

4.2. Duration of the Scheme.

We continue to support the development of longer-term incentive arrangements in principle. However, given the lack of experience under BETTA and the considerable uncertainty over how the market will operate, we agree with Ofgem that a two-year scheme would be difficult to implement at the current time. We will work with Ofgem going forward to try and develop longer term SO incentive arrangements.

4.3 Incentive Scheme Parameters.

3.3.1 NIA

We welcome Ofgem's proposal to revise the licence drafting in light of the merger of UKPX and APX. Furthermore, we agree with Ofgem's proposal not to change the price adjuster components of NIA to avoid creating additional uncertainty in the transition to BETTA. We recognise Ofgem's desire to review these in the context of future incentive schemes and we will work with Ofgem in this area going forward.

3.3.1 Transmission Losses Adjustment.

We agree with Ofgem that we should be given a single GB-wide transmission losses incentive. We also recognise that Ofgem wish to align the Transmission Losses Reference Price (TLRP) with the current forward price of electricity, which will be significantly above the existing £21/MWh and will significantly overall level of the target, without altering costs borne out by customers. We acknowledge Ofgem's proposal to use a net value of losses in the TLA component. We agree that the incentive properties of the gross and net targets are identical and that the net scheme may mean that the overall IBC target will be a more accurate reflection of the costs borne by customers through BSUoS charges.

4.4 Target.

We believe that Ofgem have made a number of unreasonable assumptions in their initial proposals, and that this is reflected in the fact that the targets proposed are too low, and do not appropriately reflect the risks and uncertainties involved in operating the GB transmission system. Our comments are summarised below.

- As discussed above we believe that Ofgem's starting point, their view for the outturn in the current year is around £25m below the likely outturn level. We believe, therefore that the targets should be adjusted to reflect a more reasonable forecast of 2004/05 outturn as a starting point.
- In addition, we believe that Ofgem's reduction of our constraint forecast across the Cheviot boundary and within Scotland by 50% is excessive and arbitrary and we are

concerned that Ofgem have offered no justification for this reduction. Ofgem have acknowledged previously the considerable risks and uncertainties involved with constraints in Scotland, but have failed to reflect this when considering costs. We believe that Ofgem should provide more information on their calculation of constraint costs in order to facilitate ongoing discussions.

- We believe that constraints represent an area of significant risk, and this risk is not addressed appropriately in any of the options presented by Ofgem. In order to make any of these options acceptable in their current form; the constraint risk may need to be managed separately.
- We also believe that the implementation of CAP047 will result in cost pressure, with the cost of providing response likely to rise by approximately 50%. Ofgem have stated that they believe that cost pressures will be lower than this. However, we are concerned that no provision has been made for the risk that costs will be higher than Ofgem's view.
- As we have mentioned previously, we strongly support the use of asymmetric caps, floors and sharing factors as a way of mitigating risk, and we believe that none of the options presented should be symmetrical unless the target is adjusted upwards to take account of the level of risk involved.
- We recognise Ofgem's desire to align internal and external sharing factors to ensure consistency and that our interests are aligned with those of customers.

4.5 Timing of BETTAgo-live.

We welcome Ofgem's proposal to choose option 1 (rollover of existing E&W scheme until the delayed BETTA go-live date) should the BETTA go-live date be delayed. This is for the same reasons as highlighted in our response to Ofgem's initial consultation, that we have forecast costs for 2005/06 on a GB basis. Following BETTA go-live, we believe that the second, more complex profiling factor suggested by Ofgem is more appropriate, as this reflects the fact that balancing costs are generally higher in the winter than summer.

4.6 BSC Modification Proposals and CUSC Amendment Proposals.

We support Ofgem's position that IAE provisions should not be available if they have been accepted and we have included the cost of them in our forecasts. However, given uncertainty surrounding CAP047, we believe that the IAE provision should be retained for CAP047 should Ofgem's view continue to be significantly different from ours. Our current view of IBC costs for 2005/06 takes no account of having to accept bids and offers at prevailing prices following the issuing of emergency instructions or the operation of intertrips. Indeed, we believe that IAE provisions should be retained for low probability, high impact events, as it is difficult to take these into account in the incentive arrangements.

5. Conclusion.

In conclusion, we believe that there are a number of issues where Ofgem have significantly underestimated the costs for 2005/06 IBC without adequate justification. We believe that Ofgem have based their proposals on a number of unreasonable assumptions, and we seek further clarification from Ofgem on a number of issues in relation to their proposals.

In particular, we are concerned at Ofgem's proposals regarding constraint costs in Scotland and across the Cheviot boundary. We believe that the risk of very high constraint costs within Scotland and across the Cheviot boundary, is the single most significant issue in the development of the BSIS scheme for 2005/06. We see no justification for an arbitrary 50% reduction from our forecasts for within Scotland and Cheviot boundary constraint costs. This is particularly disappointing, as Ofgem have already acknowledged that there is considerable uncertainty surrounding these costs.

The costs associated with the implementation of CAP047 is another area of concern, as we believe that there are significant cost pressures associated with this, and our analysis above indicates that our assumption that costs will rise by approximately 50% is entirely reasonable. We are concerned that our view differs significantly from Ofgem's view, and are keen to ensure that the risk faced by NGC as a result of the implementation of CAP047 is addressed, possibly through the use of the income adjusting event provisions in the Transmission Licence.

Ofgem's starting point for construction of 2005/06 costs, the forecast of costs for England and Wales in 2004/05 is also too low, and we have provided evidence to support this. We believe that our suggested solution of including an adjusting mechanism to move the target in light of actual 2004/05 outturn would be a practical solution to this issue.

In summary, Ofgem have acknowledged there are significant uncertainties in relation to the extension of the England and Wales market into Scotland, and our role as GBSO. However, we do not believe that the options presented by Ofgem in their initial proposals sufficiently address the risks involved sufficiently and are based on a number of unreasonable assumptions.

We are extremely keen to work with Ofgem over the coming weeks to agree a suitable way forward on the items raised in this response and thereby deliver appropriate incentive arrangements to apply from 1st April 2005 covering NGC's role as GBSO.