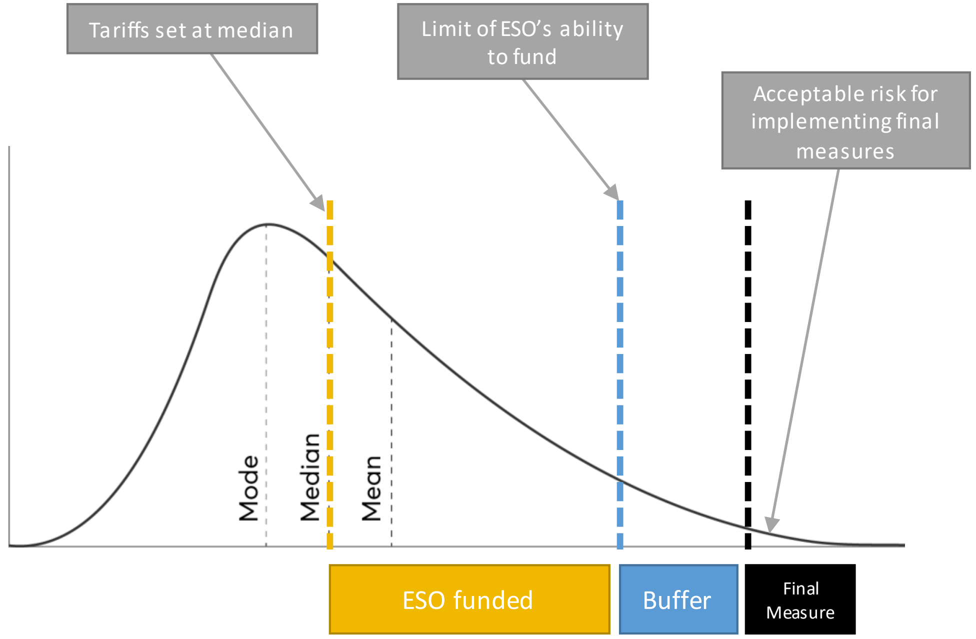
Principles for funding risk



We believe the distribution of possible outcomes will be positively skewed. So tariffs should not be set at the most likely out come (mode), but at the median outcome where there is an equal chance of over or under recovery.

ESO Funding Principles

- Limit on ESO funded risk must be set below the amount of ESO's current credit facilities and after taking into account any amounts of those facilities which are ringfenced to support other regulatory timing risks.
- The funded amount is on a cumulative basis at any point in time, it is not the amount per fixed period.
- Any over or under recovery should follow the established regulatory framework i.e. would be treated in the same way as 'k'. Any increased risk above that funded for RIIO2 to be discussed with Ofgem under RIIO2 uncertainty framework.

Buffer Principles

- Industry funded and proportionate to market share.
- Interest bearing and totally refundable.
- The structure of the fund should not benefit ESO e.g. could be ringfenced in the same way as cash securities.
- Buffer could be reviewed quarterly and topped up/refunded depending on use of ESO funds.
- Buffer should be sized to cover the gap between the ESO's capped liability and an acceptable probability weighted out turn commensurate with the nature of the backstop e.g. if buffer covers 98th percentile, is it acceptable to live with the chance of a final measure of e.g. tariffs being changed in the fixed period 1 year in 50?

Final Measure Principles

- Action in exceptional circumstances for covering the remote possibility of exceeding other actions.

Possible buffer fund solutions

Option	Description	Pros	Cons
Fixed supplier specific capital buffer	Utilise similar method as LCCC use for CfD to create agreed fixed amount of buffer for potential high BSUoS costs.	• Contribution proportionate to BSUoS payer's market share. • Cash ringfenced in Escrow account to attract interest and be returned if supplier exits.	• Requires suppliers to provide cash to support the scheme upfront. Introduces a new level of cost and complexity into BSUoS charging. • Supplier capital is tied up even if low usage of ESO credit facilities.
Flexible supplier specific capital buffer	Utilise similar method as LCCC use for CfD but suppliers only contribute as risk increases.	• As above but contributions reviewed quarterly and topped up/returned depending on overall level of over/under recovery. • Suppliers do not have capital tied up permanently, only when risk of exceeding ESO credit facilities.	• Could require additional contributions when suppliers are least able to pay. • Significant amount of additional complexity in BSUoS billing.
Over-recovery buffer	Set BSUoS price to over-recover from suppliers and create permanent buffer	• Easy to administer • Could be built up over more than one year	• May not be fair to suppliers entering/exiting the market at different times • Cash is not ringfenced and no interest received • No restrictions on how ESO could use the cash

Possible process for exceptional circumstances

Option	Description	Pros	Cons
Restate BSUoS tariffs in year	BSUoS tariffs are amended within fixed period (forward looking basis)	• Affects BSUoS payers only, doesn't create risk of further balancing cost increases	• Diminishes benefit of fixed BSUoS as risk remains to suppliers that fixed tariffs may change within fixed period • May lead to supplier default • May not generate cash quickly enough
Temporarily delay payment to Balancing Services Providers	Utilise principle used in Ireland whereby payments to balancing services providers temporarily delayed based on the principles that given balancing costs are exceeding expectations balancing service providers have commercially benefitted from this	• Shares the risk across industry and affects parties that may have benefitted from exceptional circumstances and increased balancing costs • Quick to take effect	• Risk of balancing service providers reducing service offerings • May require balancing contract changes