CDSP MARGIN, SURPLUSES AND DEFICITS

DISCUSSION PAPER FOR UNC FGO WORKGROUP (CHARGING) 29TH JULY 2016

This is a draft paper that is subject to further review and development. It is being published for the purposes of sharing initial thinking with the Workgroup and seeking feedback to help inform the further development of the CDSP funding model.

1. Introduction

1.1 The UNC FGO Workgroup (Charging) has requested information from Xoserve on the level of CDSP margin that would be included in CDSP Charges to users, and on the treatment of surpluses and deficits where actual Charges vary from the CDSP Budget position.

1.2 This paper sets out Xoserve's initial thinking on these topics. It is subject to further review and development, taking account of feedback from the Workgroup.

2. CDSP Margin

2.1 The purpose of the inclusion of a margin in the setting of CDSP Charges is to provide the CDSP with the ability to maintain an adequate level of working capital that is necessary and sufficient for the operation of the business, for meeting financial commitments to employees, vendors and other third parties, but is not intended to cover the risk of exposure to liabilities. It also provides protection in the event of short term unanticipated changes in costs that can avoid the need for a short notice call on users of CDSP Services for additional funding.

2.2 In order to avoid the unnecessary accumulation of cash reserves in the CDSP, the level of CDSP margin should be reviewed annually, and the outcome of this review factored into the setting of CDSP Charges for the following CDSP Budget Year.

2.3 Initial thinking is that the level of CDSP margin would not exceed 6%, and could be set at 0% if there is adequate working capital available.

2.4 The level of CDSP margin for the first CDSP Budget Year will be informed by an assessment of the working capital in the business at the end of the preceding Financial Year. This will be the subject of a separate paper.

3. Surpluses and Deficits

3.1 <u>Principles</u>

- An over recovery (or surplus) occurs when total actual CDSP Charges are less than (or are forecast to be less than) the total budgeted CDSP Charges for the year
- An under recovery (or deficit) occurs when total actual CDSP Charges exceed (or are forecast to exceed) the total budgeted CDSP Charges for the year
- Action taken in response to an over or under recovery needs to consider the impact on the financial liquidity of both the CDSP and the users of CDSP Services

- A materiality threshold should be established for such action, and the CDSP should perform tests (and share results with users) on the case for either a rebate of Charges or the levying of additional Charges, e.g.:
  - The maintenance of adequate working capital
  - The potential for management action to contain a deficit (whilst having due regard for service requirements and service quality)
  - Consideration of future investment requirements
- It is possible to assess over and under recovery for "Run the Business" (RTB) Charges separately from those for Investment
- Variances between budgeted and actual (or forecast) investment expenditure can be assessed both at the end of a CDSP Budget Year and on completion of a project, and can be attributed to one or more of the following:
  - Timing – project is running earlier or later than assumed in CDSP Budget, resulting in accelerated or delayed expenditure
  - Scope – increase or reduction in scope compared to that assumed in CDSP Budget, resulting in greater or lesser expenditure
  - Additional projects – investment requirement not in scope of CDSP Budget, resulting in additional expenditure
  - Cancellation – investment no longer required, resulting in expenditure reduction

3.2 Process

- In year forecasts of total CDSP Charges can be used to assess within year the likelihood of deficit or surplus and the extent of variance from total budgeted CDSP Charges by end of year.
- In year forecasts are currently carried out quarterly (May, August, November, February)
- The CDSP would not normally expect to make any return of CDSP Charges within the first six months of the CDSP Budget Year
- The apportionment of a surplus or deficit for return to or recovery from individual users of CDSP Services will require the application of the CDSP Cost Allocation Model and the CDSP Charging Methodology rules to total forecast or actual CDSP Charges and the comparison of outputs to budgeted CDSP Charges

3.3 Scenarios

Scenario 1 – RTB Under Recovery

Options:

a) If the CDSP has access to adequate working capital, include recovery in Charges for the following CDSP Budget Year (noting that where access to adequate working capital includes making use of borrowing facilities, Charges for the following CDSP Budget Year should include the recovery of borrowing costs); or

b) If the CDSP is unable to access adequate working capital, increase within year CDSP Charges, either as a 'one off' or over the remainder of the Budget Year (noting that, in accordance with the terms of the (draft) GT Licence Condition, this increase would be required to be notified to Ofgem)

Scenario 2 – RTB Over Recovery

Options:

a) Retain actual surplus until end of CDSP Budget Year, then return to users of CDSP Services by way of a reduction in CDSP Charges in the following CDSP Budget Year. Return may be either a 'one off' transaction, or over a number of months; or

b) Return forecast surplus to users of CDSP Services within the CDSP Budget Year. Return may be either a ‘one off’ transaction, or over a number of months.

Scenario 3 – Investment Under Recovery

a) Where actual investment expenditure timing is ahead (or is forecast to be ahead) of that assumed in the CDSP Budget, increase CDSP Charges within the CDSP Budget Year, but only to the extent that there is insufficient working capital for the remainder of the CDSP Budget Year (noting that, in accordance with the terms of the (draft) GT Licence Condition, this increase would be required to be notified to Ofgem); and
b) Where actual investment expenditure exceeds (or is forecast to exceed) that assumed in the CDSP Budget due to an increase in the scope of a project or a requirement for a new project, increase CDSP Charges within the CDSP Budget Year, but only to the extent that there is insufficient working capital for the remainder of the CDSP Budget Year (noting that, in accordance with the terms of the (draft) GT Licence Condition, this increase would be required to be notified to Ofgem)

Scenario 4 – Investment Over Recovery

a) Where actual investment expenditure is less than (or is forecast to be less than) that assumed in the CDSP Budget because of a deferral (but not cancellation) of a project, retain previously collected CDSP Charges to fund future expenditure on that project; and
b) Where actual investment expenditure is less than (or is forecast to be less than) that assumed in the CDSP Budget because of the cancellation or reduction in scope of a project, return funds to users of CDSP Services