

12 November 2018

WHAT

This fact sheet outlines IPART's method for calculating the working capital allowance that we include in a regulated business' notional revenue requirement (NRR) for price setting purposes. It reflects the final decisions of our 2018 review of this method.



WHY

We include this allowance in the NRR to ensure businesses can recover the costs they incur due to delays between them delivering regulated goods or services and receiving payment for those goods or services (net of any benefits they receive due to delays between them receiving goods or services and paying for those goods or services). It typically represents around 1% of their NRR.



WHO

We will use our method to calculate the working capital allowance in setting prices for any regulated business:

- ▼ with a Regulatory Asset Base (RAB), and
- ▼ where we use a 'building block' approach to set the NRR.

This includes price regulated businesses in the water and transport sectors, as well as other price regulated entities such as the Valuer General.



HOW

Our method for calculating the allowance involves two main steps. For each year of the determination period, we will:

- ▼ calculate the net amount of working capital the business requires, then
- ▼ calculate the return on this amount by multiplying it by the nominal post-tax WACC.

To calculate the net amount of working capital the business requires, we will use the following formula:

Net working capital = receivables – payables + inventory + prepayments

- ▼ Receivables means payments not yet received for goods and services already delivered.
- ▼ Payables means payments not yet made for goods and services already received.
- ▼ Inventory means goods held in stock by the business that are inputs into the production process and are necessary for it to meet its service obligations.
- ▼ Prepayments means payments made by the business in advance of receiving goods or services.

Our method for calculating each component of net working capital for water businesses is summarised in Figure 1. For non-water businesses, our method is the same as for water businesses with the possible exception of receivables.



WHAT NEXT

The Working Capital Allowance Policy Paper is available on our [website](#).

1 Method for calculating the working capital allowance

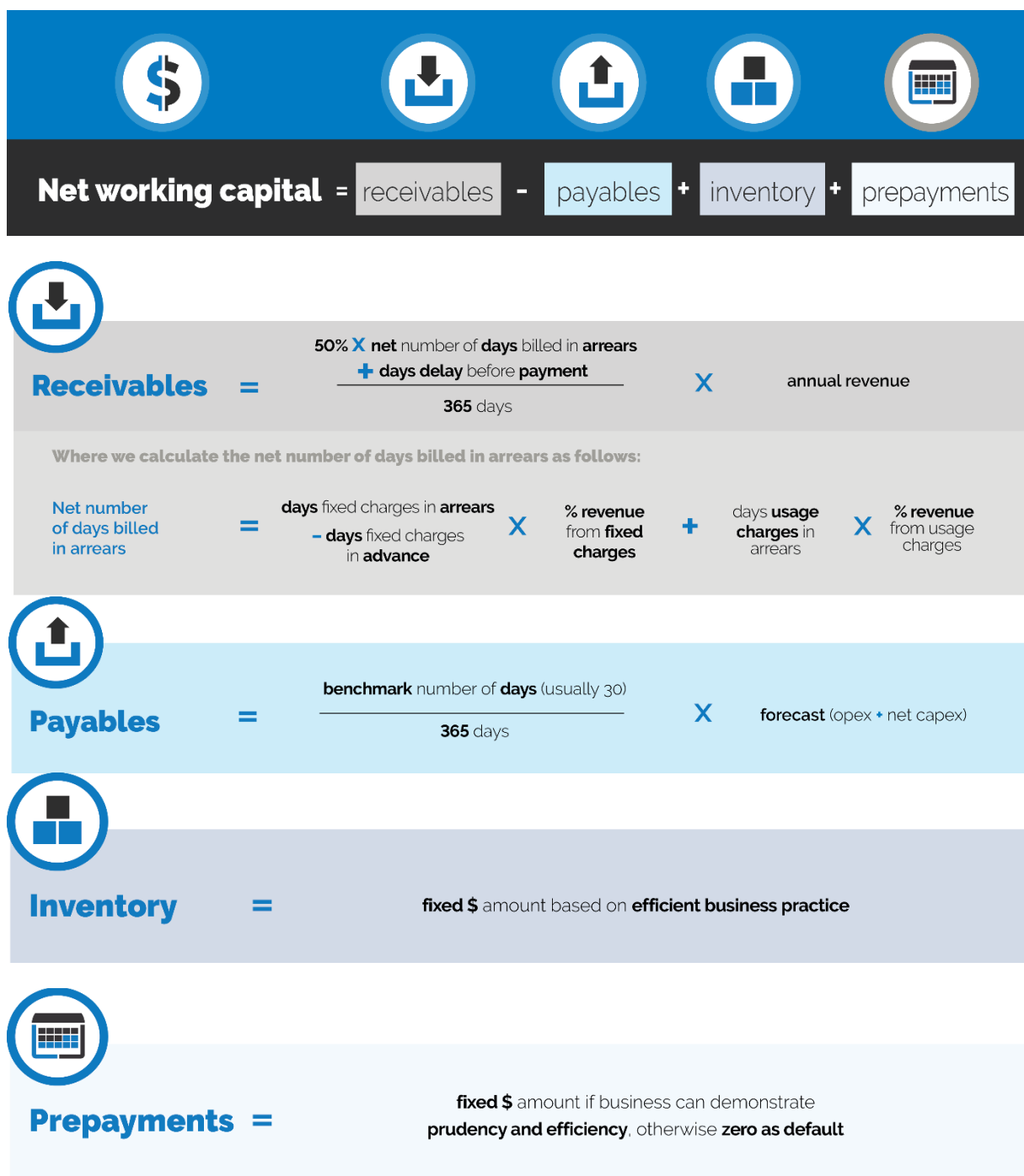
For water businesses, our method for calculating each component of net working capital for water businesses is summarised in Figure 1.1. Where a business bills fixed charges in arrears only, the net number of days billed in arrears is equal to the number of days in the billing cycle. Therefore, the formula for calculating receivables can be simplified to the one shown in Figure 1.2.

For non-water businesses, our method for the payables, inventory and prepayments components of net working capital is the same as for water businesses. However, because these businesses have a variety of billing and payment arrangements, we cannot establish a set of rules for calculating receivables for them. Instead, we will make this decision on a case-by-case basis in the context of a review, and with reference to:

- ▼ our method for calculating receivables for water businesses, and
- ▼ the business' actual historical receivables where suitable information is available for the regulated part of the business.

Our method for calculating the working capital allowance is summarised in Figure 1.3.

Figure 1.1 How we will calculate net working capital for a water business, for example^a



^a We will use the same method for a non-water business, with the possible exception of how we will calculate receivables.


Note: Net capital expenditure, which we will use to calculate payables, means capital expenditure net of cash capital contributions.

Figure 1.2 Simplified formula for calculating receivables for a water business, for example, that bills all charges in arrears



$$\text{Receivables} = \frac{50\% \times \text{billing cycle number of days} + \text{days delay before payment}}{365 \text{ days}} \times \text{annual revenue}$$

Figure 1.3 How we will calculate the working capital allowance



$$\text{Return on net working capital} = \frac{\text{net working capital} \times \text{nominal post tax WACC}}{(1 + \text{nominal post tax WACC})^{0.5}}$$

Note: The denominator discounts the return on working capital to its mid-year value, consistent with our timing assumptions.