Sydney Water's response to IPART's Review of Working Capital Allowance

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1 Executive summary

Sydney Water Corporation (Sydney Water) welcomes the opportunity to respond to the Independent Pricing and Regulatory Tribunal's (IPART's) *Review of working capital allowance – Information Paper, July 2018* (the Issues Paper). This submission outlines Sydney Water's views in relation to IPART's Issues Paper.

We support IPART's continued commitment to providing an explicit working capital allowance and method, and commend IPART for updating its 2005 method to an approach which will better reflect the circumstances of each business and provide an appropriate level of compensation for the legitimate costs associated with working capital. We consider that overall proposed revisions to the method will ensure that working capital allowances reflect efficient costs, so long as:

a) The calculation of receivables is adjusted to better reflect differences in timing between consumption of services and receipt of payment, for all customer groups;

b) Definitions applied to elements within the method are robust and clear; and

c) There is adequate opportunity during our pricing submission process to propose for IPART's consideration our working capital requirements.

To that end and where valuable, we have proposed improvements to IPART's views, which we believe will help us manage our cashflow better and continue to provide high quality services to our customers.

2 Introduction

2.1 Overview

In this submission, we comment on each of IPART's views for each component of the working capital method proposed. Where possible we have made our best effort to assess IPART's preliminary views from a practical perspective and suggest solutions to address practical challenges. Sydney Water's position on each view is outlined in Table 1. Throughout the table, we have used the following terms to mean:

- **Supported**: Sydney Water agrees with IPART's view.
- **Not supported**: Sydney Water has reservations regarding IPART's view.
- **Accepted**: Sydney Water is not challenging or contesting IPART's view or proposal.
- **Other**: Sydney Water highlights new issue to be considered.

Table 1 Summary of Sydney Water views on working capital method

Working capital allowance component	Sydney Water position
Exclusion of prepayments	**Not supported —** IPART proposed the exclusion of prepayments. We do not support this approach as it does not consider a legitimate cause of working capital requirements. We propose IPART retains the inclusion of prepayments. This will retain the option of providing an allowance if the business is able to reasonably demonstrate that prepayments are an efficient and legitimate cause of working capital.
Receivables	**Accepted —** in principle we support the proposed approach *but* consider that the revised method for accounting for receivables is likely to substantially underestimate the extent of any delay between service provision and receipt of payment. There are two reasons for this: • The net number of days billed in arrears fails to take into account unbilled usage charges on unread meters. • Delay days before payment may fail to consider the impact of customers on payment plans or similar arrangements. On average, customers on payment plans take 88 days (or about 3 months) to clear their payment obligations with Sydney Water. To address this, Sydney Water proposes: • the net number of days in arrears calculation takes into account unbilled usage charges on unread meters; and

	• the calculation of receivables includes an additional component to account for the extended delays in payment for those customers who will seek payment assistance due to their financial circumstances. It is important that IPART's approach to determining receivables is not based on an external benchmark but appropriately recognises the unique demographics, policies and customer preferences of water utility customers. Further, it is inaccurate to consider that all customers payments are made on or before the due date based on the assumption that late payment fees compensate the business for payments made after the due date. This is inconsistent with the obligations under Sydney Water's Operating Licence and Price Determination regarding the application of late payment fees, which cannot be levied in certain circumstances.
Other receivables	**Other —** we propose to include the working capital requirement for net GST receivable, i.e., the net of GST on payable to suppliers less the GST that we receive from customers. Water utilities are net GST payers, thus will always have a GST receivable debtor balance due from the ATO; the services provided or chargeable to customers by utilities are generally exempted from GST.
Payables	**Supported —** we support maintaining the current approach.
Inventory	**Accepted —** we accept the proposed revision of a fixed dollar allowance for inventory. However, we note that it is important that IPART considers the practices of relevant businesses in determining the efficient level of inventory, as this could reasonably be expected to differ between businesses.
Nominal weighted average cost of capital (WACC)	**Supported —** we support the change to a nominal WACC.

2.2 Structure of this submission

The following sections of this submission provides detailed comments on IPART's proposed views.

- Section 3.1 – Retain prepayments in the net working capital requirement calculation
- Section 3.2 – Improve how we measure receivables
- Section 3.3 – Improve how we measure inventory
- Section 3.4 – Use a nominal WACC to calculate the return on working capital.

3 Sydney Water's positions on IPART's proposed changes

3.1 Retain prepayments in the net working capital requirement calculation

Prepayments reflect the difference between supplier prepayments (expenses paid prior to receipt of input) and customer prepayments (revenue received prior to provision of service). In this context, our position relates to supplier prepayments as customer prepayments do not generally occur.[1]

1. Calculate a business' net working capital requirement as receivables minus payables plus inventory.

IPART has proposed to exclude prepayments from net working capital. The basis for this proposal is:

- a lack of supporting information to justify the quantum;
- amounts are commonly small or zero; and
- their exclusion will not have a material impact on the notional revenue requirement in future reviews.

Whilst Sydney Water recognises that historically prepayments have not been a significant portion of the overall calculation of the working capital allowance, we do not consider this in principle justifies removal. Business circumstances have, can, and are expected to continue changing as businesses evolve. For example, contemporary businesses outsource more of their essential input services, with suppliers commonly requiring modern payment terms that include some level of prepayments. It would be sensible and administratively efficient for prepayments to remain part of working capital calculations, allowing businesses, should the need arise, flexibility to meet supplier demands.

Further, we agree with IPART's consultant Deloitte Access Economics assessment that an efficient business will not seek to voluntarily make prepayments to suppliers under benchmark contract terms, and that generally prepayments ought not to be included in working capital allowances unless a business can reasonably demonstrate the need.[2] To this end, we have identified at least two instances where prepayments are efficient and required, falling outside of broad surveyed benchmark contract terms. These include:

[1] This excludes the advanced billing of customers for fixed charges, which IPART has addressed in its proposed revision to the calculation of receivables.
[2] Deloitte, Return on Working Capital in the Notional Revenue Requirement. Final Report for the Independent Pricing and Revenue Tribunal, July 19, pg 15.

- IT licences and maintenance prior to the start of the provision of the software/hardware services[3]; and,
- Insurance, rent and land tax.

Recent history shows that our prepayments for these items have ranged between $10m to $30m. As we are always seeking appropriate and efficient terms for payment to better manage cashflows and capital requirements, we believe that the working capital allowance methodology should not disincentivise such efficient practices.

We believe that if these trends continue, prepayments may become material to the overall outcome of the working capital allowance. Thus, it would seem administratively efficient for IPART to continue to allow for these costs in working capital allowance calculations.

For simplicity, we propose for the inclusion of prepayments to be treated similar to IPART's approach to measure inventory as a fixed dollar amount in the working capital calculation. This amount can be determined on a case-by-case basis with reference to the business's actual measure of prepayment in recent years (if available) and/or other relevant information. The fixed dollar amount could then remain unchanged in real terms over the determination period.

3.2 Improve how we measure receivables

2. Measure receivables:
   a. in days of total revenue based on half the net number of days in the billing cycle for which services are billed in arrears, plus a benchmark number of days of delay between the last day of the billing cycle and the receipt of payment, and
   b. determine the benchmark number of days of delay on a case-by-case basis in the context of the review, on the principle that this number should:
      i. represent the average number of days of delay for an efficient business providing the same service, and
      ii. assume that all customers pay their bills on or before the due date, because late payment fees compensate the business for payments made after the due date.

IPART has proposed changes to the method for determining receivables, by accounting for:

- the practice by some water businesses of billing a proportion of fixed charge in advance, which means that customers provide a proportion of the business' working capital requirements (referred to as "net number of days billed in arrears"); and,
- a delay between the last day of the billing cycle and when the business receives payment (referred to as "days delay before payment").

[3] These are expected to significantly increase for Sydney Water with the imminent changes to its key billing and financial technology platforms.

Our response to the proposed changes are detailed below, along with other relevant receivables we believe IPART ought to have regard to in determining its final methodology.

Net number of days billed in arrears

To provide for the practice of billing a proportion of fixed charges in advance, IPART proposes to measure receivables based on the net number of days for which charges are billed in arrears rather than the total number of days in the billing cycle. The intention of this change is to better align the allowance with how a water business recovers its charges.

Whilst we agree in principle with the change, in practice we believe the change is incomplete as it does not consider unbilled usage charges on unread meters (i.e. meters which have yet to be read due to the timing cycle).

A common issue that all water businesses face is estimating the revenue associated with unread meters, referred to as the unread meter accrual. The accrual estimation is inherently uncertain as water consumption is continuous, while meter readings are discrete events, producing a lag between meter reading and billing to the customer (generally one quarter in arrears of consumption). Consumption patterns also vary significantly between customers and seasons, adding estimation complexity.

These estimated charges constitute a significant value of unbilled debtors for our business at any point in time. This is detailed below.

Table 2 Accrued unbilled usage charges on unread meters

Accrued unbilled usage charges on unread meters	As at 30 June 2018 ($ million)	As at 30 June 2017 ($ million)
Water	169.6	149.5
Sewer	11.5	5.7
Other	6.0	5.8
TOTAL	**187.1**	**161.0**

Source: Sydney Water's Financial Statements

We therefore propose that the net number of days in arrears calculation is amended to consider unbilled usage charges on unread meters. Noting the difficulty with a "one size fits all" solution, we propose that each water business proposes a methodology for considering its unbilled usage charges on unread meters and submit to IPART for consideration as part of its pricing submission.

Days delay before payment

IPART propose to include a 'benchmark number of days of delay' in the total number of days on a case-by-case basis. IPART noted that it would apply the principle that the benchmark should represent the average number of days for an efficient business providing the same service, having regard to current business practice, which reflect customers' preferences.

Broadly, we believe that internal consistency of the working capital method ought to apply, as such IPART should adopt an approach consistent with all other relevant components of the working capital allowance; each component should be based either on a business's actual historical costs (to determine receivables, payables and inventory), or benchmarks representing an efficient business providing the same service.

Determining appropriate benchmarks for delay days will be challenging, due to each businesses' customer demographics and practices, which will impact on the ratio of customers able to pay on time, and those that cannot (or do not). Regions where there are a higher proportion of vulnerable customers or those in hardship will generally experience higher delay days and a greater proportion of customers on payment plans.

We support the IPART's proposal to consider current business practices when determining the benchmark number of days' delays. We note that for a time difference between date of bill and date when we receive payment from customers can be up to 30 days. It is important that IPART recognises the range of factors which contribute to this timing difference, including delays out of most businesses control, such as delays in bank payments being transferred to our account.

Table 3 Typical days for payment after bill issue

	Delay days (no.)
Number of days' notice for bill payment	21
+ delay in bank payment being transferred to Sydney Water account	2
+ days (after notice days) before late payment fee is applied	7
Total average delay days	30

Further, basing the decision on a benchmark number of day delays for the typical customer will fail to capture financially distressed customers who sought help with their water bills and have entered into a payment plan or arrangement with us that delayed their payment (without penalty) past due dates.

To this end, we note IPART's statement that:

…we would assume that all customers pay their bills on or before the due date, because late payment fees compensate the business for payments made after the due date.[4]

We do not support this statement as being necessarily true nor consistent with our Operating Licence and IPART's Sydney Water 2016 Price Determination (the Determination). Specifically, the decision applying to late payment fees within the Determination and enforced via our Operating Licence provides that, at a minimum:

- we must not charge a late payment fee if we have already agreed with our customer a deferred payment date with respect to his or her overdue account balance; or,

[4] IPART, Review of Working Capital Allowance, Information Paper, 20 July 2018, page 6.

- an arrangement to pay by instalments with respect to their overdue account balance, or
- we have entered into a payment assistance arrangement with our customer.

In practice the implication is that in the majority of cases where a late payment fee and/or accumulated interest charges might apply, we waived the fees or overdue interests for our customers benefit. Importantly, we note that he Determination also sets out other instances in which we are unable to charge late payment fees to our customers.[5] For example, only seven days past due, can we levy late payment fees on customers' bills.

We note that IPART's proposed method hasn't considered the material number of customers that request to be placed onto payment plans, we believe consideration ought to be given to this. For example, in 2017-18 ~130,000 customers per quarter – 120,000 residential and 10,000 non-residential – sought payment assistance through our payment plans. The debtor value of customer under payment arrangement totaled ~$90 million per quarter; these numbers are expected to increase in the coming years.

Customers also remained in the arrangements for lengthy periods of time, with an average of 88 days (or about 3 months) [6]. More specifically:

- 70% of customers take on average 40 days to pay their bills;
- 15% of customers being in the program up to six months (on average 92 days);
- 9% between six to 12 months (on average 270 days); and
- 6% greater than 12 months (on average 360 days).

As a result, we believe that IPART's revised approach will under-estimate the true delay between service provision and payment.

As a practical way forward, we proposed the calculation of receivables to include an additional component in the "benchmark number of delay" calculation, to account for the extended delays in payment for those customers who will seek payment arrangement and assistance due to their financial circumstances.

Other receivables

Sydney Water also considers that IPART's proposed approach to calculating receivables fails to consider the working capital needed to fund the difference between GST on payables to suppliers less the GST that we receive from customers. We consider that this amount will be substantial given that water utilities are net GST payers; as the services provided or chargeable to customers by utilities are generally exempted from GST.

To address this, Sydney Water suggests that an additional component is included in the calculation of receivables to allow businesses to submit the appropriate cost to fund the net GST receivable and provide supporting evidence during the determination stage.

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[5] See Box 12.1, IPART Review of Prices for Sydney Water Corporation, From 1 July 2016 to 30 June 2020. Final Report, p.211.

[6] The calculated weighted average of days for customers on payment plans to clear their bills

3. Continue to measure payables:

    a. in days of operating expenditure plus capital expenditure (net of capital contributions), and

    b. use 30 days as the number of days unless there is a compelling reason to use a different number of days.

We support IPART retaining its current approach to determining payables.

IPART is not proposing changes to its current methodology of accounting for payables within working capital allowances. We understand this to involve measuring a benchmark number of days of delay in payments to suppliers, IPART applies a typical contract payment period of 30 days.

We support continued inclusions of opex plus net capex. Trade accounts payables and accrued expenses at Sydney Water (other than for interest on loans) are normally settled within 30 days.

3.3 Improve how we measure inventory

4. Calculate inventory as a fixed (real) dollar amount with reference to the business' actual inventory in the recent past and/or other relevant information.

IPART has proposed to measure inventory as a fixed dollar value that remains unchanged in real terms over the determination period. This proposed value will be determined on a case-by-case basis, which references the business's actual recent historical inventory and/or other relevant information.

We agree with and support this approach. It is simpler and more transparent than the current method.

Regarding the determination of an efficient level of inventory, we propose that IPART considers closely each business' practices and operating approaches, as circumstances and drivers for inventory can reasonably differ across time and businesses.

In June 2018 we improved our approach to measuring new and existing inventory. The result has been an increase in stock, spare parts and materials to ~$17m across various depots and warehouses. We expect our forward inventory level to approximate $10m at the end of each financial year.

3.4 Use a nominal WACC to calculate the return on working capital

5. Calculate the allowance for working capital as the return on the net working capital requirement using a nominal weighted average cost of capital (WACC).

IPART has recognised that its current approach of applying the WACC to working capital is inappropriate. The approach leads to an anomaly where net working capital and the WACC are the same in the base (Year 0) and Year 1 of any new determination period (in Year 0 dollars).

We support IPART's two proposed amendments in this regard:

- use of the nominal WACC to calculate the return on working capital.

- continued use of the WACC rather than the cost of debt, which would not reasonably reflect the costs incurred by businesses in financing their working capital.