# Cash Flow Timing for Customised Price-quality Paths

10 September 2012

# 1 Introduction

This note responds to the Commerce Commission's consultation paper on cash flow timing for customised price-quality paths (CPPs) (the consultation paper). We address three issues that arise from the Commission's proposals to amend the input methodologies on cash flow timing assumptions for CPPs:

- **The relationship between the DPP and CPPs.** While incorporating default timing assumptions into CPPs is appropriate, suppliers should have the flexibility to propose different timing assumptions that better reflect their circumstances. This preserves the option value of CPPs.
- **Proposed cash flow timing assumptions.** In general, we support the proposed cash flow timing assumptions. We propose some improvements for the treatment of small-scale capital expenditure and disposals, and we recommend that depreciation on newly-commissioned assets applies from the assumed date of commissioning (either the forecast or mid-year).
- **Providing working capital under CPPs.** The Commission's cash flow timing assumptions implicitly provide an allowance for working capital. This is appropriate because working capital is a legitimate cost of doing business. Explicitly acknowledging that the 20-day revenue lag provides working capital would allow suppliers to test this assumption against their own business information when preparing an application for a CPP.

# 2 The Relationship between the DPP and CPPs

Customised price-quality paths provide an option for suppliers to remove themselves from the default price-quality path (DPP). This means that CPPs need to be distinct from the DPP, and need to be sufficiently flexible for suppliers to propose a price-quality path that suits their particular circumstances better than the DPP.

### Preserving the option value of a CPP

The Commission has stated that audit, verification, and approval processes are the biggest contributor to the costs of setting price-quality paths, and plans to reset the DPP in a way that does not require audit, verification, and approval.[1] The Commission sees CPPs as providing suppliers with an option to change their price-quality paths through a

[1] See Revised Draft Reset of the 2010-15 Default Price-quality Paths at paragraph 109.

process that involves greater audit, verification, and approval of the information they submit.[2]

The value of the option to apply for a CPP can be thought of as a cap on the costs of the inaccuracy in the DPP that arise from the absence of supplier-specific information that is audited, verified, and approved. The Commission's analysis in Appendix J of the draft decisions paper suggests that this option may have considerable value, with a margin of error between the draft DPP reset and supplier forecasts of between -3% and +5%. CPPs will be particularly valuable when there are unique factors that apply to the company that do not apply across the industry, such as experienced by Orion after the Canterbury earthquakes or for other suppliers due to a "step change" in capex or opex requirements.

Cash flow timing assumptions (either by themselves or in combination with other factors) may be one legitimate reason for suppliers to apply for a CPP. In the consultation paper (at paragraphs 17-19), the Commission discusses whether a company applying for a CPP would likely want a more specific treatment of cash flows. In our view, the issue is not whether suppliers require more specificity or accuracy in the forecasts, but rather whether the cash flow timing of a particular supplier may be different from the industry norms used in the DPP. There are a number of reasons why actual cash flow items might differ from industry-wide assumptions—for example, if the debt raising activities of the company follow a particular intra-year pattern, or if the business has unique requirements for working capital.

The Commission appears to recognise the possibility that cash flow timing may itself be a reason to apply for a CPP in footnote 9 of the consultation paper, where it states "It is possible that a supplier may want to adopt more specific timings than those proposed (or less specific, if there are information constraints)". The Commission then goes on to suggest that if this is the case "The supplier is able to apply for the input methodology to be varied by agreement with the Commission under s 53V(2)".

In our view, the ability to vary the cash flow timing assumptions is essential to preserve the value of CPPs. To ensure that this ability to change the assumptions is effective, we think the Commission's cash flow timing assumptions should be treated as default assumptions that will be used unless the regulated supplier proposes an alternative cash flow timing assumption in its CPP application. The regulated supplier would need to provide evidence showing that the proposed variation better reflects the supplier's circumstances (and that actual cash flow timing would be better reflected using an alternative timing assumption). This approach would better ensure that the Commission achieves "An appropriate balance between the benefits of increased accuracy for CPPs and administrative costs of compliance".

**Recognising the limits of regulatory precision**

In the consultation paper (at paragraphs 17-19), the Commission concludes that efforts to make cash flow timing assumptions "even more accurate" are likely impose administrative costs that would outweigh their benefits. The Commission proposes not to pursue a further level of detail in the cash flow timing assumptions because regulated suppliers are unlikely to generate more detailed information for their own purposes, and further detail is likely to have forecast errors (paragraphs 18.1 and 18.2 of the consultation paper).

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[2] See Revised Draft Reset of the 2010-15 Default Price-quality Paths at paragraph 112.

As discussed above, we believe that the Commission's focus on the accuracy of timing assumptions is misplaced. The more important point is that some suppliers may have idiosyncratic cash flows, and should be able to be address these unique features of their business as part of a CPP application.

Instead of assessing whether any piece of analysis or detail provides greater accuracy, we believe that the Commission should first ask what level of specificity or accuracy is required to achieve outcomes that are consistent with workably competitive markets (section 52A of the Commerce Act). This approach does not try to overcome the information asymmetry that the Commission inevitably faces—but rather recognises that its decisions are being made for a purpose that is fundamentally different than management or investment, and that regulation by its nature requires less precision.

Having re-oriented itself towards the more appropriate goal of achieving the statutory objectives (rather than accuracy for its own sake), the Commission should then identify what components of a price-quality path matter most for outcomes under Part 4. Clearly some components and assumptions in a decision to reset price-quality paths matter more than others—all else being equal, getting the size of cost and revenue forecasts right will have a greater impact on the accuracy of the decision than timing assumptions. Knowing which elements of a decision are the most important will help to focus the Commission's efforts on the areas where accuracy has the greatest value.

# 3 Proposed Cash Flow Timing Assumptions

In this section we comment on the Commerce Commission's intra-year cash flow timing assumptions proposed for CPPs. In our view, the proposed timings generally reflect commercial reality and are consistent for the most part with regulatory practice overseas (except in the areas noted below). There are two areas where we believe changes would better achieve the Commission's statutory objectives—improving the way capital expenditure and disposals treatment works in practice (Section 3.2), and ensuring that the timing of depreciation aligns with the proposed timing of capital expenditure (Section 3.3).

## 3.1 Comments on Cash Flow Timing for CPPs

Our comments are summarised in Table 3.1. The areas where we recommend changes are discussed further in the remainder of this section.

**Table 3.1: Comments on Proposed Timing Assumptions**

| Building Block Item | Commission's Proposed Timing | Comments | Suggested Timing |
|---|---|---|---|
| Revenue | 20 days after mid-year | Appropriate approximation of the actual receipt of revenue | No change, but we suggest that the Commission explicitly acknowledge that these assumptions (together) provide an allowance for working capital (discussed further in Section 4 below) |
| Operating expenditure | Mid-year | Appropriate approximation of the actual pattern of payments | |

| Building Block Item | Commission's Proposed Timing | Comments | Suggested Timing |
|---|---|---|---|
| Capital Expenditure | Forecast commissioning date | Only significant capital expenditure projects are likely to have formal commissioning dates. The cost of forecasting commissioning dates for all projects would be onerous | No change, commissioning date for significant capital works projects<br>**Change**, mid-year for general capital expenditure (to align with operating expenditure) |
| Disposed assets | Forecast disposal date | Only significant asset disposals are likely to have an expected disposal date. The cost of forecasting disposal dates would be onerous | **Change**, assume mid-year for disposals |
| Tax | Mid-year | Appropriate approximation of the actual pattern of tax payments | No change |
| Other regulatory income | Mid-year | Appropriate approximation of the actual pattern of receipts | **Change**, align with other revenue. There is no obvious reason for assuming revenue and other regulatory revenue would have different timing |
| Term credit spread differential allowance | Mid-year | Appropriate approximation of the actual pattern of payments | No change |
| Return of capital (depreciation) | Year end (default position in the CPP IM) | Needs to be aligned with commissioning of capital expenditure—that is depreciation commences after commissioning | **Change**, align with capital expenditure |
| Return on capital | Year end (default position in the CPP IM) | Interest and dividend payments occur throughout the year | Should be consistent with approach to modelling other cash flows |

## 3.2 Capital Expenditure and Disposals

The consultation paper proposes no change to the assumption that capital expenditure is recognised at the forecast commissioning date, and that the cost accounted for at that

time recognises interest during construction. While we agree this is a conceptually correct treatment of capital expenditure, we are concerned with how it will be implemented in practice.

A material part of the capital expenditure incurred by suppliers consists of small scale projects, such as pole replacements. These projects are on-going and will not have specific "commissioning" dates. Internally, this type of capital expenditure is usually recognised for accounting purposes based on total expenditure over the period (month, quarter, or year). This expenditure does not typically qualify for interest during construction.

We consider that a reasonable assumption for small scale capital expenditure is that it is incurred evenly throughout the year—i.e. a mid-year assumption. This treatment generally reflects how such capital projects are carried out, and is the same as the timing assumption for operating expenditure (and therefore does not create incentives to shift costs between expenditure categories). Under this approach, the Commission could retain the existing timing assumption for commissioned assets that are significant (either above some threshold level or in accordance with the proposal made by the company applying for a CPP).

The same issue also applies to asset disposals. A material component of the revenue from asset disposals will arise from the regular disposal of a large volume of small scale assets that are sold periodically. It would be more practical to recognise this revenue as occurring evenly throughout the year, rather than expecting regulated businesses to forecast expected disposals five years in advance.

## 3.3 Depreciation and Return on Capital

In the consultation paper, the Commission proposes to retain the current year-end timing assumptions for return of capital (depreciation) and return on capital.

The Commission's year-end assumption for depreciation creates an anomaly. Capital expenditure is recognised from the date of asset commissioning, and regulated suppliers should receive depreciation on assets and return on capital from that date. However, the current year-end timing assumption for depreciation in the Input Methodologies does not achieve this outcome. The 2010-2015 Default Price Path draft determination (currently out for consultation) illustrates the inconsistency that arises with these different timing assumptions. The financial model for the DPP shows that assets commissioned in one year (e.g. 2012/2013) receive no depreciation until the end of the following year (2013/2014).

Regulators overseas have recognised this issue, and adopt a mid-year assumption for capital expenditure with consistent timing for depreciation. For example, the Independent Pricing and Regulatory Tribunal of New South Wales (IPART) depreciates commissioned assets at half the normal rate in the year of commissioning.[3] Although suppliers will be put in the same financial position over time (because depreciation reduces the regulatory asset base and therefore lowers return on capital), depreciation returns the capital to the supplier within the current regulatory period (and is therefore preferable).

The year-end timing assumption for return on capital also seems inconsistent with the Commission's general philosophy of attempting to represent actual cash flows as accurately as possible. As discussed above, we disagree with this philosophy (preferring

[3] See "Comparison of financial models—IPART and the Australian Energy Regulator", July 2012, Section 3.2.2

instead to accept a level of accuracy that provides confidence in regulatory outcomes), however we also note that this approach has not been faithfully applied for return on capital. Given that suppliers pay finance charges and dividends throughout the year, a mid-year assumption would be more consistent with the reality facing most suppliers. While adopting a mid-year assumption for return on capital would also require changing the WACC input methodology, this would have the advantage of achieving consistency across all components of the CPP.

# 4 Providing Working Capital under the CPP

In its submission on Additional Input Methodologies for Default Price-quality Paths, the Electricity Networks Association (ENA) recommended that the Commission explicitly recognise a lag between when revenue cash flows are received relative to expenditure cash flows—a working capital allowance. We agree that an explicit allowance for working capital is important. Working capital is a legitimate cost for any regulated business.

The Commission has implicitly provided an allowance for working capital through the 20-day lag assumed for the timing of revenue (relative to expenditure). In our view, this is likely to provide a reasonable estimate of working capital costs because the difference between debtor days and creditor days is likely to be in the order of 20 days. However, we encourage the Commission to acknowledge that the difference in timing recognition is designed to allow regulated businesses to recover working capital.

In our experience in other regulatory regimes, an allowance for the costs of financing working capital takes into account:

- Debtor days—the average length of time between revenue recognition (invoices sent out) and the receipt of cash
- Creditor days—the average length of time between recognition of expenditure (invoices received) and the payment of cash
- The quantum of debtors
- The quantum of creditors usually for operating expenditure, capital expenditure (excluding major projects where working capital is included as interest during construction) and inventories.

A typical formula used by regulators in Australia (such as IPART, the Essential Services Commission of South Australia and the Queensland Competition Authority) to calculate working capital is:[4]

*Working capital = ((Annual accounts receivable * average debtor days/365)-(Annual accounts payable * average creditor days/365)) * WACC*

While the Commission's 20-day revenue lag assumption may produce similar results to the standard working capital allowance formula, we suggest that this be treated as a default under the CPP. Regulated suppliers would then have the option of proposing an explicit working capital allowance, based on the above formula (or some variant), for a CPP. This approach is preferred it provides the opportunity to:

[4] For a summary of approaches to working capital in Australia see Deloitte "Queensland Competition Authority: SunWater – Working Capital Allowance" http://www.qca.org.au/files/W-Deloitte-Report-WorkingCapitalAllowance-0911.pdf. For an example of an explicit allowance for working capital in a regulatory decision see ESCOSA 2005-2010 Electricity Distribution Price Determination at pages 122-124, http://www.escosa.sa.gov.au/library/050405-EDPD_Part_A_StatementofReasons_Final.pdf.

- Improve the transparency of the working capital allowance by incorporating an explicit calculation (where the issue of working capital is material); and
- Improve the accuracy of a CPP process by using supplier-specific debtor and creditor days, which can easily be ascertained and verified.