

Queensland Competition
Authority
SunWater – Working Capital
Allowance



Contents

1. Introduction	2
1.1 Context	2
1.2 Terms of reference	2
2. Working capital allowances	3
2.1 The need for working capital	3
2.2 QCA's previous decisions on working capital for regulated utilities	3
2.2.1 Final Report - Burdekin Haughton Water Supply Scheme – April 2003	3
2.2.2 Final Report - GAWB Investigation of Pricing Practices – June 2010	3
2.2.3 Manual for setting the 2011-12 SEQ Grid Service Charges – December 2010	4
2.2.4 Draft Report - SEQ Grid Service Charges 2011-12 – May 2011	4
2.3 Approaches to working capital allowances for regulated utilities in other jurisdictions	5
2.3.1 Essential Services Commission of Victoria	5
2.3.1 IPART	6
2.3.1 Essential Services Commission of South Australia	7
2.3.3 Australian Energy Regulator	7
3. SunWater's proposed allowance	9
3.1 Summary of SunWater's approach	9
3.2 Update – Ministerial direction – Return on existing irrigation assets	10
4. Deloitte analysis	11
4.1 Introduction: the need for a working capital allowance	11
4.2 SunWater's overall approach	11
4.3 Reviewing SunWater's calculations	12
4.3.1 Current Assets (Trade debtors)	13
4.3.2 Current Liabilities (Trade creditors)	14
4.3.3 Inventories	15
4.4 Conclusion: Recommended working capital requirement	15

1. Introduction

1.1 Context

SunWater is Queensland's largest bulk water service provider. SunWater owns and manages a regional network of water supply infrastructure throughout Queensland. SunWater manages 40% of all water used commercially in Queensland, via 22 water supply schemes.

The Queensland Competition Authority (QCA) is currently undertaking a regulatory review process to determine prices for SunWater's irrigation customers. The determined prices will apply to SunWater water supply schemes from 1 July 2012 to 30 June 2017.

1.2 Terms of reference

The QCA has engaged Deloitte to provide an independent assessment of whether SunWater's methodology for recovering an allowance for working capital is reasonable and in accordance with suitable industry benchmarks and acceptable industry practice.

Our approach to reviewing SunWater's methodology for calculating its proposed working capital allowance has involved:

- Reviewing SunWater's methodology in light of recent QCA decisions with respect to working capital allowances (including the QCA's Final Report on the Gladstone Area Water Board (GAWB) Investigation of Pricing Practices, Draft Report on the SEQ Grid Service Charges 2011/12)
- Reviewing the proposed methodology in light of recent decisions on working capital allowances made by regulators in other Australian jurisdictions
- Considering SunWater's proposed allowance for working capital in light of industry benchmark allowances in Queensland and other jurisdictions.

This report advises the QCA on our findings as to whether SunWater's approach and proposed allowance is reasonable.

2. Working capital allowances

2.1 The need for working capital

Working capital is commonly defined as the difference between a business' current assets and current liabilities, and is a measure of operating liquidity.

The need for working capital arises due to a timing difference between accounts receivables (payments received from customers from the sale of goods and services) and accounts payables (payments made to suppliers for the production and delivery of goods and services). This timing difference creates a financial liability for a business when the average collection days for accounts receivables are greater than the average payment days for accounts payables. Conversely, when the average payment days for accounts payables are greater than the average collection days for accounts receivables, businesses' cash flows are positively impacted.

For regulated utilities, regulators allow revenues based on economic cost, which includes a return on and return of capital. Working capital funding requirements are an economic cost of conducting business, and therefore should be included in regulatory revenue allowances.

In Australia, there are a variety of approaches taken to determining working capital allowances for regulated utilities. A summary discussion of approaches to determine working capital allowances by various Australian regulators is presented below.

2.2 QCA's previous decisions on working capital for regulated utilities

2.2.1 Final Report - Burdekin Haughton Water Supply Scheme – April 2003

In determining prices for the Burdekin Haughton Supply Scheme, the QCA sought advice from consultant SKM on the industry standards for working capital requirements. SKM advised the QCA that the industry average for working capital was equal to 5.08% of sales revenue. The QCA noted that this proportion was consistent with previous QCA decisions, and included an allowance of \$0.6 million.

2.2.2 Final Report - GAWB Investigation of Pricing Practices – June 2010

The QCA's recommended approach to calculating a working capital allowance for the GAWB price review was described as 'debtors less creditors plus inventories.'

This general approach was also adopted in the QCA's 2005 pricing investigation for the GAWB, in which consultant Snowy Mountains Engineering Corporation (SMEC) developed an approach to calculating the GAWB's working capital requirements, based on business growth and assumed collection and payment cycles. SMEC also recommended a different approach to calculating working capital, described by the QCA as:

"... pegging the working capital provision to a reasonable allowance, and indexing this allowance in line with other elements of the pricing framework."¹

¹ QCA, Final Report: Gladstone Area Water Board: Investigation of Pricing Practices, March 2005, p.110.

SMEC's estimate of a reasonable allowance for 2005-06 was \$18.07/ML, which was accepted by the QCA in its final decision for 2005.

In the 2010 price review, the QCA accepted the GAWB's proposed allowance for working capital, which was based on the average monthly working capital requirement for 2008-09, estimated at \$2.355 million. This was on the basis of advice from the QCA's consultant Davwil Designs and Management Services Pty Ltd (Davwil), who advised that the SMEC methodology remained appropriate, and that the GAWB's proposed allowance was reasonable.²

2.2.3 Manual for setting the 2011-12 SEQ Grid Service Charges – December 2010

In December 2010, the Queensland Water Commission released a manual for setting the 2011-12 SEQ Grid Service Charges, which forms part of the Minister's Direction Notice requiring the QCA to recommend grid service charges for the Grid Service Providers. This manual provides the QCA with guidelines on the methodology that is to be applied and the processes to be following in investigating and setting out the recommendations on Grid Service charges for 2011-12.³

The manual states that an allowance for working capital is to be included in the Grid Service Charges, to provide an allowance for the timing difference between receivables and payables. The manual states the following formula for the calculation of the working capital allowance:

$$\left[\text{Annual Accounts Receivable} \times \frac{\text{Average creditor days}}{365} - \text{Annual Accounts Payable} \times \frac{\text{Average debtor days}}{365} \right] \times WACC$$

2.2.4 Draft Report - SEQ Grid Service Charges 2011-12 – May 2011

Following the Queensland Water Commission's manual, the QCA's Draft Report on the SEQ Grid Service Charges for 2011-12 restates the above formula, and notes that the Queensland Water Commission estimated working capital on the basis of debtor and creditor days as per the following table.⁴

Table 2.1 Queensland Water Commission's basis for estimated working capital allowances

Grid Service Provider	Debtor days	Creditor days
Seqwater	60	25
LinkWater and WaterSecure	30	30

² QCA, Final Report: Gladstone Area Water Board: Investigation of Pricing Practices, June 2010, p. 115.

³ Queensland Water Commission, Interim Economic Regulation – Grid Service Providers: Manual for setting the 2011-12 Grid Service Charges pursuant to Chapter 8 of the SEQ Market Rules, December 2010.

⁴ QCA, Draft Report: SEQ Grid Service Charges 2011-12, May 2011, pp. 14-15.

The QCA carried out analysis of debtor and creditor days based on information provided by the Water Grid Manager on the transactional history of Grid Service Charge invoices over 2010-11. Table 2.2 outlines the QCA's conclusions on the assumed average number of debtor and creditor days, which it applied for all Grid Service Providers in its draft decision.

Table 2.2 QCA's conclusions for estimating working capital allowances for all Grid Service Providers

Debtor days	45 calendar days, based on 15 days from service delivery to month end, plus 30 days for invoice issuance and payment by the Water Grid Manager.
Creditor days	30 calendar days, consistent with the Queensland Water Commission's previous approach

The QCA noted that the working capital allowance may include critical spares, or inventory.

The allowances recommended in the QCA's draft decision are outlined in the following table.

Table 2.3 QCA's draft recommended working capital allowances (\$m)

Grid Service Provider	Average accounts Receivable	Average debtor days	Average accounts payable	Average creditor days	Critical spares and inventories	Total working capital requirement	Returns on working capital (Allowance)
Seqwater	49.1	45 days	14.0	30 days	0.9	36.1	3.4
WaterSecure	37.7	45 days	7.1	30 days	0	30.6	2.9
LinkWater	25.0	45 days	4.5	30 days	2.4	23.0	2.2

2.3 Approaches to working capital allowances for regulated utilities in other jurisdictions

2.3.1 Essential Services Commission of Victoria

In its September 2000 Electricity Distribution Price Determination for 2001-05, the Victorian Office of the Regulator General (now the Essential Services Commission of Victoria (ESCV)), rejected the Victorian electricity distributors' proposals for working capital allowances.

The basis for this decision is that, given the assumption regarding return on capital implicit in the building block formula that payments are received at year end, while in practice, utilities receive payments from customers throughout the year, there is already an excess net present value revenue for the return on assets component

that would more than compensate for working capital requirements.⁵ This decision was not challenged by the Victorian electricity distributors.

Since this 2000 decision, the ESCV has not provided an allowance for working capital in its pricing decisions for regulated businesses, although some utilities have made submissions arguing against this conclusion.⁶

2.3.1 IPART

The Independent Pricing and Regulatory Tribunal of NSW (IPART) previously provided regulated utilities with an allowance for working capital. We have reviewed two IPART decisions relating to working capital.

2.3.1.1 State Water Corporation 2010-14

In its Final Report on the Bulk Water Charges for the State Water Corporation 2010-14, IPART included an allowance for working capital in the return on capital.

In addition to this working capital allowance, IPART also acknowledged that State Water Corporation is exposed to annual variability in the availability of water, which creates a revenue volatility risk. IPART noted that this variability results in a cost to State Water Corporation, through a requirement for working capital, and that an allowance should be made for this in the revenue requirement.⁷ IPART decided that the best approach to addressing risks associated with revenue volatility was to include a volatility allowance in the notional revenue requirement.

“This allowance is designed to recover the costs State Water will face in managing the risk of revenue volatility – such as the holding costs it will incur if it needs to borrow funds to conduct its business in years when its revenue is low due to lower than forecast extractions.”⁸

IPART calculated the revenue volatility allowance based on the volatility of historical (previous 20 years) of water extractions around the mean.⁹

2.3.1.2 AGL Gas Networks Access Arrangement 2005

In its 2005 Final Decision on AGL Gas Networks' Access Arrangement, IPART provided an allowance for working capital. The final decision outlined the following assumptions used in determining AGL's working capital allowance:

- tariff and contract debtors at 29 days of distribution revenue (tariff and contract markets)
- unbilled gas (accrued revenue) at 41 days of tariff market revenue
- inventories at no real change from the previous (2003/04) level

⁵ Office of the Regulator General, Victoria, Electricity Distribution Price Determination 2001-05, Volume 1: Statement of Purpose and Reasons, September 2000, pp. 113-117

⁶ Envestra Limited - Albury & Victorian Access Arrangement - Working Capital and the Building Block Approach, 9 August 2002; TXU Networks, Response to the Draft Decision on the Review of Gas Access Arrangements: Attachment 6 – Working Capital and the Building Block Approach.

⁷ IPART, Review of bulk water charges for State Water Corporation From 1 July 2010 to 30 June 2014 – Final Report, June 2010, p. 55.

⁸ *ibid.*

⁹ *ibid.*, p. 57.

- operating cost creditors at 45 days of annual non-capital expenditure
- capital cost creditors at 27.7231 days of annual capital expenditure
- nominal pre-tax rate of return of 9.7%.¹⁰

2.3.1 Essential Services Commission of South Australia

The Essential Services Commission of South Australia (ESCOSA) provided some detailed discussion on the economic argument for working capital allowances for regulated utilities in its *2005-10 Electricity Distribution Price Determination Part A – Statement of Reasons*, April 2005.¹¹ Referring to the ESCV's 2001-05 electricity distribution price determination, discussed above, ESCOSA noted the reasons for the ESCV's decision not to include an allowance for working capital due to the overcompensation provided in the rate of return on capital.

ESCOSA separately considered the need for an allowance for working capital for capital related costs and operating related costs. ESCOSA noted that the building block formula it adopted compensates the utility for all capital financing costs, due to the assumption that a return on capital is provided on the average regulatory value of investment, assuming that all revenue is received on the last day of the year.

For operating expenditure financing, ESCOSA noted that the building block formula implicitly assumes that expenses are incurred and associated revenue received evenly over the regulatory period, which is not the case in practice.

Despite noting that capital expenditure made up a significantly greater portion of ETSA Utilities' revenue than operating expenditure, ESCOSA determined that an allowance for working capital funding on the operating expenditure is appropriate. It calculated the working capital to be included in ETSA Utilities' regulatory asset base according to the following formula:

$$\text{Working capital} = \left[\frac{\text{Lag (days)} - \text{Lead (days)}}{365} \right] \times \text{Operating expenditure}$$

Lag days (or debtor days) were assumed to be 73 days on average, while lead days (creditor days) were assumed to be 34 days on average.

2.3.3 Australian Energy Regulator

In determining the access arrangement for the Epic Energy Moomba – Adelaide Pipeline in 2002, the ACCC engaged the Allen Consulting Group (ACG) to advise whether an explicit allowance for working capital is appropriate given the cash flow assumptions in its revenue modelling. The ACG's report provides a detailed analysis of the implications of cash flow modelling for working capital, concluding that there is no rationale for including an additional allowance to provide a return on working capital.¹²

¹⁰ IPART, Revised Access Arrangement for AGL Gas Networks, April 2005, p. 119.

¹¹ ESCOSA, 2005-10 Electricity Distribution Price Determination Part A – Statement of Reasons, April 2005, p. 122-124.

¹² Allen Consulting Group, Working Capital – Relevance for the Assessment of Reference Tariffs, March 2002.

Accordingly, citing similar reasons as the ESCV, since 2002, the Australian Energy Regulatory (AER) (and the ACCC before it) have consistently held the view that under a building block framework, regulatory allowances for working capital funding are unnecessary. The AER's distribution Post Tax Revenue Model handbook states that:

*“ As a result of the PTRM's particular timing assumptions, i.e. all cash flows except capex are assumed to occur on the same (final) day of each regulatory year, there is no need to provide DNSPs an allowance for working capital in the modelling.”*¹³

¹³ AER, Electricity distribution network service providers Post-tax revenue model handbook, June 2008, p. 14.

3. SunWater's proposed allowance

3.1 Summary of SunWater's approach

SunWater's submission refers to the QCA's final decisions on the GAWB and Burdekin-Haughton price reviews, discussed above. It notes that the QCA accepted GAWB's proposed allowance based on historical average monthly working capital requirements, which represented 5.7% of GAWB's approved revenue for 2010-11, and applied an allowance of 5.08% of sales revenue for Burdekin Haughton.

Following these previous approaches, SunWater calculated its working capital requirements based on average trade debtors (net of provision for bad debt) less trade creditors plus inventory. The average trade debtors, creditors and inventory numbers used in the working capital calculations are based on the results for the entire business of SunWater and do not relate solely to the relevant 22 irrigation schemes.¹⁴

SunWater estimated its average working capital requirements for the period 2008-09 were \$6.543 million, or 3.3% of revenue from ordinary operations.

In a subsequent note provided to Deloitte¹⁵, SunWater acknowledged that its estimated annual working capital requirements vary significantly depending on annual historical accounting data. For example, SunWater's working capital requirements varied from 1.3% of revenue in 2006 to 6.2% of revenue in 2002. Over a nine year period to 2010, SunWater's average annual working capital requirement is 3.7% of revenue. SunWater has argued that as irrigation pricing is to be set for 5 years, taking a long term average is appropriate in setting forecast levels of working capital, noting that its estimated requirement of 3.3% of forecast revenue is consistent with long term average requirements.

SunWater has applied this percentage (3.3%) to revenue earned in 2008-09 for each of the 22 bulk water schemes in determining a working capital requirement for each scheme. Within SunWater's pricing proposal, the proposed working capital requirement is added to the Optimised Replacement Cost (ORC) estimate for the first year of the regulatory period for each respective bulk water scheme.¹⁶ Through the addition of a working capital requirement in the ORC, SunWater is proposing to earn a WACC on the working capital amount and therefore recover the economic cost of maintaining a working capital balance.

SunWater recognised that its proposed working capital requirement is based on average requirements, and that different schemes may have different working capital requirements based on different debtor and creditor days. However, SunWater has submitted that this average represents a good estimate for working capital requirements and notes that its proposed requirement is lower than working capital estimates determined by QCA for GAWB and Burdekin-Haughton.

¹⁴ SunWater Annual Report 2009-10, p. 57.

¹⁵ SunWater, *QCA Review – SunWater Analysis of Working Capital*, August 2011.

¹⁶ For example refer, *SunWater Barker Barambah Water Supply Scheme, Network Service Plan*, p. 38. All other bulk water scheme proposals incorporate working capital amounts in the ORC estimates.

3.2 Update – Ministerial direction – Return on existing irrigation assets

Subsequent to the submission of SunWater’s pricing proposal, the Minister directed the QCA under Section 24 of the *Queensland Competition Authority Act 1997* (the Act) to not allow SunWater a return on its regulated asset base for existing irrigation assets (being those commissioned prior to 1 October 2011)¹⁷ This provides that SunWater is only able to recover a return on and return of prudent capital expenditure for augmentation of assets commissioned after 30 September 2011. For existing assets, SunWater is able to recover prudent and efficient capital expenditure on renewals and rehabilitation via a real annuity method.

This directive implies that SunWater will not be permitted to recover a return on its working capital requirements as originally proposed, given its method of adding the proposed working capital allowance to its ORC asset base values (which will no longer earn a return).

In order to enable SunWater to recover an allowance for the economic costs of its working capital requirements (as also directed by the Government), an allowance can be calculated ($WACC \times \text{working capital requirements}$) and included as part of SunWater’s efficient operating costs.

¹⁷ Queensland Government Gazette No. 117, issued on 17 December 2010.

4. Deloitte analysis

4.1 Introduction: the need for a working capital allowance

The QCA has adopted a building block model to set revenue requirements that is similar to that used by the AER in determining revenue requirements for regulated electricity network assets. The QCA and AER building block models have an implicit underlying assumption of end of year cash flows. One key difference between the QCA building block model and the AER model is the use of a renewal annuity method to set revenue estimates for existing assets (commissioned before 1 September 2011) instead of a return on and return of assets based on sunk asset values. Nevertheless, in our view, the assumption of end of year cash flows in the NPV model may provide sufficient uplift to cater for any working capital requirements.

However, we note that unlike electricity and gas distribution businesses which have many thousand customers, SunWater has only a few customers and as such, its revenues may not be recovered on a daily basis throughout the year. SunWater's 22 bulk water schemes are all billed monthly. Accordingly, the different customer types and billing frequency for SunWater may result in a different outcome than that arrived by the AER for the electricity networks.

We also note that the QCA has set a strong precedent in setting working capital allowances for Queensland water companies, with the pricing framework methodology paper explicitly providing for working capital allowances based on a set formula. The Queensland Government has also indicated that a working capital allowance should be provided to SunWater.¹⁸

Given the regulatory precedent in Queensland and the stated position of the Queensland Government, it is appropriate that SunWater be permitted to recover the economic cost of working capital, where working capital is defined as accounts receivables minus accounts payable plus inventory.

4.2 SunWater's overall approach

Rather than projecting working capital requirements based on forecasts of revenue and cash flows over the 2012-17 regulatory period, SunWater has relied on historical averages to project its future working capital requirements. Forecasting working capital requirements based on projections of efficient revenue and cash flows is a preferred methodology, however, in our view, in the absence of forecast information, relying on historical data is acceptable as a second best approach.

While SunWater has used the long term historical average data to calculate working capital requirements, we consider it is more appropriate to restrict the historical analysis to the last three years only. This is because working capital estimates are extremely sensitive to debtor and creditor days, which may have varied historically,¹⁹ and therefore it is our view that recent historical data will better reflect the current terms of trade.

¹⁸ Email from Queensland Department of Environment and Resource Management to the QCA, 28 March 2011.

¹⁹ We note that our analysis, consistent with SunWater's proposal is based on historical data. Should the future profile of cash flows be significantly different from historical data due to either a change in billing, collection or payment terms, working capital requirements could be different from recent historical trends.

In addition, the use of average debtor and creditor amounts could distort the true working capital requirements for the irrigation schemes (based on trade debtors, creditors and inventories) if the terms of trade vary significantly between the irrigation schemes and other business of SunWater. We note that SunWater's irrigation schemes represented just 25% of its total revenue in 2009-10.

We consider that for future revenue and price determinations, the QCA should review the need for additional funding for working capital requirements given the assumptions of the building block model and the timing of all cash flows (including billing and collection cycles). Furthermore, all working capital calculations should be based on efficient forecasts of revenue and cash flows of SunWater's irrigation schemes rather than relying solely on historical data and whole of business averages.

In the rest of this section, we review SunWater's calculation of working capital based on historical data and provide our recommendations.

4.3 Reviewing SunWater's calculations

In accordance with the QCA's approach in previous price reviews, SunWater has used the following formula to calculate its working capital requirements:

$$\text{Total working capital} = \text{average trade debtors (net of provision of bad debts)} - \text{trade creditors} + \text{inventory}$$

SunWater's detailed calculation, based on 3 years of historical data, is presented below.

Table 4.1 SunWater working capital calculations

	2008	2009	2010	
Trade Debtors	12,367	9,697	9,138	
Plus Term Trade Debtors	27	49	38	
Less Impairment	1,100	1,100	1,100	
Total Adjusted Debtors	11,294	8,646	8,076	(a)
Trade Creditors	4,495	7,365	4,118	(b)
Inventories	2,444	2,639	2,572	(c)
EOY Working Capital	9,243	3,920	6,530	– (b)+ (c)
Revenue	190,575	198,568	196,442	
EOY WC as % of Revenue	4.9%	2.0%	3.3%	
Average WC Balance	9,436	6,582	5,225	Average of current and prior year
Average EOY WC Balance as % of Revenue	5.0%	3.3%	2.7%	

We outline our review of the calculations for each of the key parameters of trade debtors, trade creditors and inventories in the following sections.

4.3.1 Current Assets (Trade debtors)

In its annual financial accounting statements, SunWater categorises its current assets into two broad categories: receivables and other current assets.

Receivables represent invoices outstanding (net of bad debt provisions), while other current assets comprise of accrued revenue, GST receivables and prepayments.

In calculating its proposed working capital requirements, SunWater has correctly taken into account its receivables, however it has failed to account for other current assets, particularly accrued revenues.

Accrued revenue represents revenue for services which have been delivered but not yet billed, and arises as a consequence of the gap between meter reading and billing cycles. Accrued revenue should be taken into account while determining working capital requirements for a business as, similar to receivables, it represents a lag in collecting cash for services which have already been provided to customers and therefore imposes an economic cost to the business.

GST receivables are a component of account receivables and should also be included in working capital requirements. Based on our review, we understand that prepayments do not relate to the 22 bulk water schemes. If this is not correct, prepayments should also be included in the working capital requirements.

The table below summarises our analysis on trade debtors and compares our assessment with SunWater's calculations.

Table 4.2 Analysis of SunWater's Current Assets (\$'000)

	Deloitte analysis			SunWater analysis		
	2007-08	2008-09	2009-10	2007-08	2008-09	2009-10
Trade debtors	12,367	9,697	9,138	12,367	9,697	9,138
Term trade debtors	27	49	38	27	49	38
Provision for impairment	1,100	1,100	1,100	1,100	1,100	1,100
Receivables	11,294	8,646	8,076	11,294	8,646	8,076
GST receivable	1,079	1,562	1,054			
Accrued revenue	14,841	15,473	13,273			
Other current assets	15,920	17,035	14,327	0	0	0
Total	27,214	25,681	22,403	11,294	8,646	8,076

Source: SunWater annual accounts and Deloitte analysis

We conclude that SunWater has underestimated its Current Assets by not including accrued revenue and GST receivables.

4.3.2 Current Liabilities (Trade creditors)

In its annual financial accounting statements, SunWater categorises its current liabilities into four broad categories: payables, provisions, borrowings and other.

Current borrowings reflect current debt which needs to be refinanced in the short term, and are not considered part of working capital requirements.

As such, the three key categories worth considering are payables, provisions and other. In its calculations of working capital requirements, SunWater has only included the trade payables component of the payables category and has ignored all other relevant current liabilities.

The table below summarises our analysis and compares with SunWater's analysis.

Table 4.3 Analysis of SunWater's Current Liabilities (\$'000)

	Deloitte analysis			SunWater analysis		
	2007-08	2008-09	2009-10	2007-08	2008-09	2009-10
Trade creditors	4,495	7,365	4,118		7,365	4,118
Other creditors & accruals	14,050	15,025	16,814			
Payables	18,545	22,390	20,932	0	7,365	4,118
Employee benefits	4,980	4,888	4,239	0	0	0
Provisions	4,980	4,888	4,239	0	0	0
Other current liabilities	640	0	0	0	0	0
Other liabilities	640	0	0	0	0	0
Total	24,165	27,278	25,171	0	7,365	4,118

Source: SunWater annual accounts and Deloitte analysis

As table 4.3 presents, SunWater has only considered its trade creditors when calculating its working capital requirements. In our view, current liabilities in the categories of other creditors and accruals and employee benefits should also be included in calculating working capital requirements. This is because SunWater has procured services from other creditors in the course of providing water services to its customers, for which it has yet to pay for (based on its payment terms and conditions with those service providers). Similarly, employee benefits are incurred during the normal course of business and represent employee benefits expensed, but not yet paid. Both of these cost categories are similar to trade creditors, all have been incurred in the normal course of business, but have yet to be paid, and therefore reduce the need for working capital.

In calculating its working capital requirements, SunWater also recognised an unearned annuity as a current liability. However, this unearned annuity represents a mismatch between the revenue received from the renewals annuity and corresponding refurbishment expenditure. The economic cost of this mismatch is taken into

consideration in setting next year's renewal annuity, and therefore, it is our view that including the unearned annuity balance in the working capital requirement is not appropriate.

By incorporating the impact of other creditors, accruals and employee benefits, SunWater's current liabilities increase significantly from \$4.1 million in 2009-10 (as presented by SunWater) to \$25.2 million based on our analysis.

4.3.3 Inventories

SunWater should earn a regulated return on its investment made in inventories. As SunWater will not earn a return on inventories as part of its building block revenue calculations (due to the Ministerial directive discussed above), working capital requirements should account for the investment made in inventories.

SunWater's calculations indicate that it used the inventory amounts which reconcile with historical accounts, and are accordingly appropriate.

4.4 Conclusion: Recommended working capital requirement

We have reviewed SunWater's historical financial accounts over 2007 to 2010, and conclude that SunWater's forecast working capital requirement of \$6.543 million is excessive.

As discussed above, it is our view that SunWater's working capital requirement should be calculated specifically on the basis of forecasts of the efficient revenues and cash flows for its irrigation schemes, rather than using an approach which averages historical accounting information for the whole of SunWater's business. We recommend that the QCA consider taking this approach in its final decision on SunWater's revenue for the 2012-17 regulatory period, however acknowledge that there is currently insufficient information to take this approach.

In the absence of efficient forecast information, and in light of our views on the appropriate methodology to estimate average historical working capital requirements, we have calculated an alternative working capital requirement for SunWater. Our alternative working capital calculation for SunWater is outlined in Table 4.5.

Table 4.5 Analysis of SunWater’s Working Capital requirements (\$’000)

	Deloitte analysis			SunWater analysis		
	2007-08	2008-09	2009-10	2007-08	2008-09	2009-10
Receivables	11,294	8,646	8,076	11,294	8,646	8,076
Other current assets	15,920	17,035	14,327	0	0	0
Current Assets	27,214	25,681	22,403	11,294	8,646	8,076
Payables	18,545	22,390	20,932	4,495	7,365	4,118
Employee benefits	4,980	4,888	4,239	0	0	0
Other current liabilities	640	0	0	0	0	0
Current Liabilities	24,165	27,278	25,171	4,495	7,365	4,118
Inventories	2,444	2,639	2,527	2444	2,639	2,527
Working Capital	5,493	1,042	-241	9,243	3,920	6,485
Average Working Capital		3,268	401		6,582	5,203

Source: SunWater annual accounts and Deloitte analysis

The differences between our approach and that taken by SunWater include:

- We have restricted the historical analysis to the last three years only. Our preference would have been to rely on efficient forecast data for the Irrigation business of SunWater, but in the absence of forecast data we prefer to use recent historical data, acknowledging this as a second best approach.
- We have included all relevant current assets and liabilities in calculating the historical working capital requirements for SunWater.

In conclusion, based on our analysis of SunWater’s historical financial accounts (and in the absence of forecasts of efficient revenue and cash flows for SunWater’s irrigation schemes), we recommend that:

- SunWater be allowed to recover the economic cost of maintaining an annual working capital requirement of \$1.834 million (\$1.834 million multiplied by WACC)
- The economic cost of working capital should be added to SunWater's forecasts of efficient operating costs to be recovered through the annual revenue requirement calculation (based on the building block model).

Statement of responsibility

This report: SunWater working capital allowance (Final report) was prepared for the Queensland Competition Authority (QCA) solely for the purposes of assisting the QCA to make an assessment of the working capital requirements for SunWater.

In preparing this report we have relied on the accuracy and completeness of the information provided to us by SunWater and from publicly available sources. We have not audited or otherwise verified the accuracy or completeness of the information. We have not contemplated the requirements or circumstances of anyone other than QCA.

The information contained in this report is general in nature and is not intended to be applied to anyone's particular circumstances. This report may not be sufficient or appropriate for your purposes. It may not address or reflect matters in which you may be interested or which may be material to you.

Events may have occurred since we prepared this report which may impact on it and its conclusions.

No one is entitled to rely on this report for any purpose. We do not accept or assume any responsibility to any one in respect of our work or this report.

This document and the information contained in it are confidential and should not be used or disclosed in any way without our prior consent.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/au/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and deep local expertise to help clients succeed wherever they operate. Deloitte's approximately 170,000 professionals are committed to becoming the standard of excellence

About Deloitte Australia

In Australia, the member firm is the Australian partnership of Deloitte Touche Tohmatsu. As one of Australia's leading professional services firms, Deloitte Touche Tohmatsu and its affiliates provide audit, tax, consulting, and financial advisory services through approximately 5,400 people across the country. Focused on the creation of value and growth, and known as an employer of choice for innovative human resources programs, we are dedicated to helping our clients and our people excel. For more information, please visit our web site at www.deloitte.com.au.

Liability limited by a scheme approved under Professional Standards Legislation.

Member of Deloitte Touche Tohmatsu Limited

This document and the information contained in it are confidential and should not be used or disclosed in any way without our prior consent.

© 2011 Deloitte Touche Tohmatsu