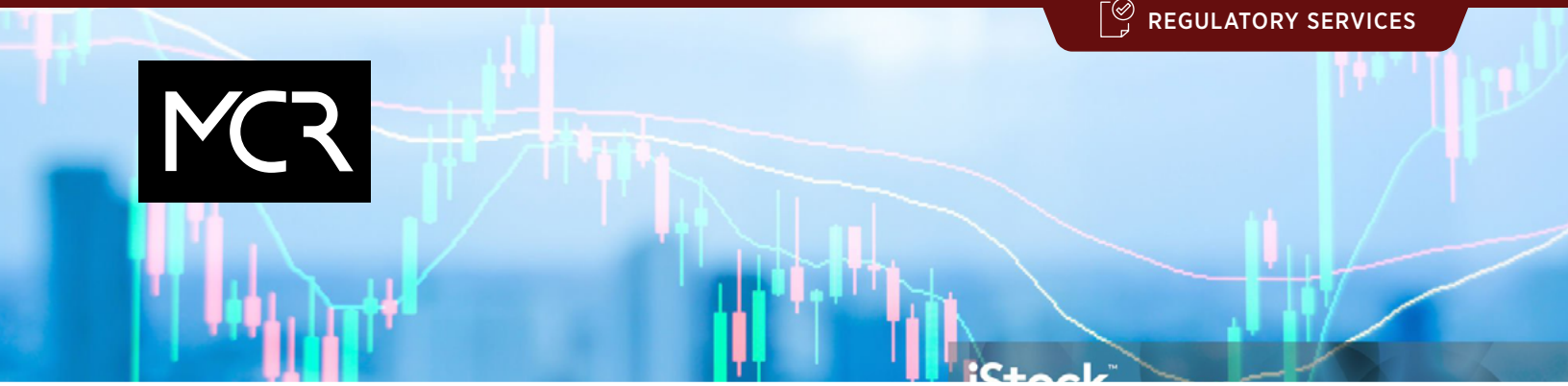

CASH WORKING CAPITAL AND LEAD-LAG STUDIES

In the evolving regulatory landscape, utilities across the electric, gas, and water sectors are facing increasing scrutiny from regulators who are demanding more detailed calculations of cash working capital. This requirement reflects a broader push for greater accuracy in the financial management of utilities, ensuring that rates charged to customers are fair and reflective of actual operational needs.

What Is Cash Working Capital?

Cash working capital refers to the amount of money a utility needs on hand to meet its day-to-day operational expenses. This includes the funds required to bridge the time gap between when a utility pays for labor, materials, and other operational costs and when it receives payment from customers for the services rendered. Essentially, cash working capital is the lifeblood that keeps a utility functioning smoothly, allowing it to maintain uninterrupted service to its customers. The amount of cash working capital included in a utility's rate base often requires an in-depth lead-lag study to satisfy regulatory scrutiny.

Utilities are typically allowed to recover their cash working capital as part of the rate base. The rate base is the value of a utility's investment in facilities and working capital upon which it is allowed to earn a return. Cash working capital is included because it represents an essential investment required to ensure reliable and continuous service. By recovering this as a rate base component, utilities can maintain the necessary cash flow to cover operational expenses, invest in infrastructure, and meet regulatory requirements, all while ensuring financial stability.

Methods for Calculating Cash Working Capital

Two primary methods are used to calculate cash working capital: the 1/8th method and the lead-lag study.

- **1/8th method:** This simplified approach estimates cash working capital as one-eighth of a utility's annual operating expenses. It assumes a uniform distribution of expenses and revenues throughout the year, with 1/8th (or 45 days) representing the average time delay in cash flow.

- **Lead-lag study:** A lead-lag study offers a more detailed and accurate calculation. It involves analyzing the actual time lags between when services are rendered and when payment is received (revenue lag), as well as time lags between when expenses are incurred and when they are paid

(expense lead). This method provides a tailored calculation of the cash working capital needs of a specific utility.

How a Lead-Lag Study Works

A lead-lag study is an in-depth financial analysis that tracks the timing of cash flows within a utility. The critical drivers of that flow are revenue lag and expense lead.

Revenue lag represents the delay between when a service is provided and when payment is received. Several factors contribute to this lag, including billing cycles, payment processing times, and customer payment behavior. A longer revenue lag means a greater need for cash working capital, as the utility must cover its expenses for a longer period before being paid.

Expense lead refers to the time between when a utility incurs costs for goods, services, or labor and when it actually disburses payments. For example, a utility might pay for fuel or other supplies several weeks after receiving them. Understanding how long a utility can defer payment after incurring an obligation affects the overall cash working capital requirement.

The lead-lag study involves detailed analysis of financial records that document a utility's actual cash flow to measure the revenue lag and the expense lead. It includes appropriate adjustments to account for operational anomalies. By calculating these intervals, the lead-lag study determines the precise amount of cash working capital required to ensure that a utility can cover its expenses before receiving revenues.

Partner with Experts: MCR Performance Solutions

At MCR Performance Solutions, we are experts in conducting lead-lag studies tailored to the specific needs of utilities. Our team understands the complexities of cash flow management and the regulatory environment, ensuring that your utility's cash working capital is calculated accurately and efficiently. By partnering with us, you can confidently meet regulatory requirements, optimize your financial operations, and focus on delivering reliable service to your customers.

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