



**Dividend Policy Issues for Government Business
Enterprises engaged in providing water services**

Report for the National Competition Council

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1 Introduction

1.1 Project brief

This study considers the CoAG cost recovery guidelines for water/sewerage service providers which require that:

‘dividends (if any) should be set at a level that reflects commercial realities and simulates a competitive market outcome.’

In recent years, the dividend policies of the South Australian Government, and dividend distributions set by the ACT Government are examples of what appears to be a growing trend among Australian governments of increasing dividend payout ratios. This has raised concerns given that:

- water businesses are highly capital intensive with very low revenues compared with their capital bases. Hence, they are susceptible to unanticipated requirements for new investment (e.g. sewerage plant breakdown);
- water businesses’ revenues are variable due to climatic conditions and hence a buffer is needed to accommodate asset renewal in low income years; and
- under the Corporations Act 2001 (Cth), dividends may be paid only out of profits (section 254T).¹

¹ Profits in this context include accumulated retained profits as well as the current year’s profit. The purpose of this restriction is to protect creditors by maintaining a company’s capital.

In light of these developments, NECG has been asked to provide advice to the National Competition Council on appropriate dividend policies/dividend distributions where paid by Government Business Enterprises (GBEs) engaged in providing water services (Water GBEs), with a view to addressing the following two questions:

- on what basis should dividends be set; and
- what are the implications if dividends are too high?

1.2 Structure of this report

This report addresses the brief in the following steps. First, in the next section, we identify the underlying economic issues. Second, we set out the method of analysis. Third, we explain the data sources upon which the analysis is founded. Fourth, we present the results of this analysis and discuss its implications. Finally we present preliminary conclusions.

2 Issues

Dividend policy merely forms part of a wider capital structure policy for GBEs and must be considered in that context. In addition, dividend policy for GBEs serves a number of distinct objectives which are not all relevant to a privately owned firm. Many GBEs in the water sector are established with relatively low levels of gearing. For example, of the 18 Water GBEs surveyed in this study, the median ratio of debt to value (gearing) was 21%. The most highly geared organisations in our sample included Melbourne Water with 56% gearing. Other Victorian water businesses City West Water, South East Water, and Yarra Valley Water all had gearing ratios in excess of 40%. Private sector utility firms in the energy industries typically have gearing levels in the neighbourhood of 50% - 60%. It would therefore appear that one objective of government dividend policies is to increase the gearing levels of Water GBEs by repatriating equity through 'dividends' or 'special dividends', and requiring the GBE to use debt to fund the resulting capital shortfall.

The ostensible rationale for this balance sheet restructuring is as follows – it is claimed (we believe, within a wide range of capital structure parameters, wrongly) that debt is a less expensive form of finance than equity for assets such as water businesses, so increasing the leverage of a low-risk, mostly-equity financed firm can lead to a lower average cost of capital

and therefore a more efficient capital structure.² This step had not been taken in many cases as a result of the misguided, but common, view among managers of these organisations that government equity funding was ‘free’ as no return had to be paid on it.

Nevertheless, a possible socially desirable rationale for increasing gearing levels can be found in addressing, at least in part, the underlying principal-agent problem arising from the differing objectives of the managers and owners of a Water GBE. It is argued that Governments are not always able to monitor the performance of GBEs as effectively as private capital markets. In a sense therefore, higher levels of debt can provide something of a substitute for some of the disciplines imposed by the rigorous monitoring by private capital markets. This is because the discipline of having to make steady, predictable and non-discretionary debt repayments obliges managers to work hard to make the businesses more profitable. Without this discipline, managers might become comfortable with less effort, more expenditure on managerial perquisites, and a less productively efficient firm.

Depending on the ultimate level of gearing, though, substituting debt for equity can create various financial risks for a firm. Any firm facing high financial risks could find it difficult to fund necessary renewals or capital expansions and, in the extreme, to obtain acceptable credit terms from suppliers. This situation could jeopardise its ability to provide continuity of service to its customers at the required level of quality. Given the essential nature of water services, any risks to continuity of service must be taken seriously.

With this background, we return to the COAG cost recovery guidelines which require that:

‘dividends (if any) should be set at a level that reflects commercial realities and simulates a competitive market outcome.’

² Whilst it has been said that debt financing is cheaper than equity financing, such statements overlook the reality that the weighted average cost of capital does not vary significantly between a broad range of capital structure parameters, especially in the presence of dividend imputation. Accordingly, we do not believe that increasing the gearing of GBEs will reduce the cost of capital so long as extreme capital structures are avoided. However, very high gearing can introduce a significant risk of default, so continuing to gear a firm beyond the optimal point will increase the average cost of capital.

In this context, 'commercial realities' can be considered to reflect issues such as solvency³ and long term sustainability⁴ and a 'competitive market outcome' should be both efficient and competitively neutral. Accordingly, we interpret the CoAG guidelines as requiring a Water GBE's dividend policy be consistent with economic efficiency and competitive neutrality requirements of the CoAG guidelines, while not creating an undue risk that creditors will not be paid or posing any threat to the sustainability of essential services. These issues are addressed in turn below.

2.1 Efficiency of sources of capital

Financing CAPEX from current cashflows can be problematic if CAPEX is lumpy. Prevailing GBE revenues may often be insufficient, without price changes, to fund current CAPEX in the year it is incurred. If pricing were adjusted each year to meet current capital funding needs, it would lead to allocative inefficiencies and unacceptable levels of price volatility. Thus capital market funding is usually employed to smooth out these lumps. In broad terms, the capital market options are debt or equity funding.

The conventional wisdom holds that debt financing is cheaper than equity financing. If this comparison is made on a post-tax basis and the equity cost is properly risk-weighted, however, any difference in cost is likely to be small. It is true that interest payments attract a tax shield which is not available for dividend payments, making debt finance less expensive for private firms which are subject to Commonwealth income tax. However, government owned water businesses are not subject to Commonwealth income tax at present.

An assessment of the efficiency justification for preferring debt finance to equity for Water GBEs begins with the observation that most, if not all, Australian governments have centralised their borrowing functions. For example, TCorp borrows funds on behalf of all NSW Government authorities and corporations. NSW GBEs each obtain a private credit rating from a recognised credit rating agency, and this is used to determine the government guarantee fee (a small interest rate premium) which is added to the prevailing TCorp bond rate to determine the interest rate at which that GBE borrows from the NSW Government.

³ Ability to meet debts as and when they fall due.

⁴ Ability to fund capital investments which are necessary to continue to provide service at the required level of quality, and to expand service as required by customers.

This approach is intended to mimic capital market mechanisms, but in its elemental legal form it is the Crown, rather than the GBE, which borrows from lenders in the market.

This means that, whatever the form of the financing arrangements between the Government and its GBE, all taxes as well as capital costs, be they interest or dividend payments, are paid to the Government. Except to the extent that the Government's own credit rating may be affected by the structure of these financing arrangements with GBEs⁵ the cost of capital imposed by a single GBE is not likely to be affected by the choice between debt or equity style financing contracts with its owner.

The true efficiency gain from imposing a debt-style financing contract on the managers of a GBE arises in the context of addressing a principal agent problem. There are limitations on the effectiveness of monitoring the performance of GBEs relative to the disciplines imposed by private capital markets. One means of at least partially addressing this problem involves increasing gearing levels of GBEs, as doing so reduces the discretion available to GBE managers. This is because debt obligations, unlike equity, require a fixed pattern of interest payments over time. Regular, predictable and unavoidable payments, as opposed to the somewhat ad hoc dividend payments, constrain cash availability and thereby create incentives for the managers to strive to minimise operating costs and to maximise operating revenue. Hence, especially in activities that are relatively mature, the level of stress upon managers can be increased by increasing the proportion of debt finance in the capital structure. By incenting managers to try harder, the GBE's productive efficiency is likely to be improved.

Similar principal agent considerations may apply with respect to investment decisions. If a capital structure involving low levels of leverage signals to the firm's managers a cost of capital that is below the true opportunity cost of capital to the public sector, the firm's asset base may be expanded beyond the efficient level.

⁵ The Government's credit rating will depend largely on such exogenous factors as the Government's current debt exposure, its fiscal policy, and the productive efficiency and pricing policies of GBEs as a whole.

2.2 Competitive neutrality

The question of competitive neutrality requires careful analysis when applied to Water GBEs. To a large extent, water businesses hold regional monopolies, as the nature of the infrastructure makes duplication inefficient. That is not to say that some competition among water businesses is not feasible. Near boundaries between two water businesses there is the possibility of substitution. Furthermore, it may be feasible for facility-based competition to take place for the business of large water customers. To the extent that such competition pits a government-owned water business against a private sector business, it will be important to ensure the economic framework applied to the government business does not compromise a level playing field.

Dividend policy may play some role in this level playing field, as it forms part of the capital financing arrangements which apply to a Water GBE. Anything which gives the government-owned business a lower (or higher) apparent cost of financing investments than its private sector counterparts, which may be reflected in a more flexible dividend policy that can apply to private sector counterparts, may violate the competitive neutrality principle. This point suggests that, in the interests of competitive neutrality, there is merit in ensuring that the dividend policies of Water GBEs follow the requirements imposed on private firms by corporations law.

Government businesses, even monopolies, compete with other firms for resources, including capital, and it is in this area that competitive neutrality is perhaps most important. Greater flexibility in dividend (and capital) policy for one sector of the economy could create a tendency for socially excessive resources to be directed to that sector of the economy.

One particular manifestation of this type of problem is the historic tendency of public water businesses to build new dams to satisfy expected demand growth without ever exploring the potential for demand management through pricing reform. In a famous example, the Hunter Water Corporation managed to delay by many years the construction of a new dam simply by rationalising its pricing structure towards a user-pays philosophy. This very dynamic could be interpreted as a manifestation of the principal-agent problems inherent in lowly geared balance sheets. When equity funding imposed no particular burdens on the managers of a government water business, expansion investment no doubt appeared a more comfortable solution than facing the public backlash which inevitably attends any attempt at pricing reform. If the new dam must be debt funded and that debt must be repaid from the firm's net revenues, the managers will probably be prepared to accept a greater level of discomfort in progressing price reform.

2.3 Solvency, dividends and capital restructuring

In law, a company is solvent if it is able to pay its debts as and when they become due and payable.⁶ Good commercial practice requires that companies remain solvent in order to ensure that the residual beneficiaries of a company, the shareholders, do not prejudice the interests of debt-holders (or creditors) who have first claim on a company's assets.

As the following discussion shows, maintenance of solvency is a principal requirement of the Corporations Act (2001) (the "Corporations Act"), in the payment of dividends and a requirement under general law in respect of capital restructuring.⁷ Although GBEs are not generally covered by the Corporations Act, and the State Acts covering them do not generally contain these requirements,⁸ the guidance provided by the Corporations Act to the formulation of a dividends policy is relevant to 'commercial realities' and to simulating 'a competitive market outcome'.

2.3.1 Dividends

General policy

Under section 254T of the Corporations Act 2001 (Cth) (the "Corporations Act"), a dividend may only be paid out of the profits of a company. This requirement flows from the principle that paid-up capital should not be returned to shareholders before a winding up, except under strict controls. The object is to protect creditors of the company – whilst creditors must accept the risk that the company may lose money in the ordinary course of business, they are entitled to protection against reduction of the company's net assets in other ways such as

⁶ See section 95A of the Corporations Act 2001 (Cth).

⁷ In the case of share buy-backs, for example, it is the responsibility of the director/s of the company to ensure that a share buy-back does not cause the company to become insolvent. If it does, the director/s may be personally liable for the loss. Further, if a share buy-back causes the company to become insolvent, the liquidator may be able to recover compensation from the selling shareholders.

⁸ With the exception of Queensland's Government Owned Corporations Act (1993), which requires that dividends may not exceed profits.

return of paid-up capital to shareholders by way of purported but improper dividend, by unregulated buying-back of shares before a winding up, or by giving its assets away in a manner not incidental to its business.⁹

This principle consequently entails some legal conditions governing the determination of the amount available for distribution in the form of dividend. Were this not the case, there could be an unauthorised return of capital disguised as a dividend. Accordingly, for example:

- dividends cannot be declared if payment would leave the company unable to pay its debts as they fall due; and
- dividends cannot be declared out of loan funds, if the company has no divisible profits (although the company can use borrowed funds to pay dividends to the extent it has distributable profits¹⁰).

Furthermore, liability can attach to officers of the company and the company's auditors in appropriate cases:

- a director who authorises payment of a dividend out of capital may be personally liable to repay the amount of the dividend to the company;¹¹ and
- an auditor who negligently reports favourably on company accounts that purport to show a profit can be liable to the company to restore a dividend paid in reliance on the report where it turns out that the accounts incorrectly disclosed profits (clearly so, for example, where the company is insolvent).

Meaning of “profits” for dividend purposes

The key question becomes, of course, what are “profits”. It has generally been the policy of the Australian legislature and courts not to provide any precise directions as to the ascertainment in a particular company of distributable profits.

⁹ *ANZ Executors and Trustee Co Ltd v Qintex Australia Ltd* (1990) 2 ACSR 676.

¹⁰ *Re Mercantile Trading Co* (1869) 4 Ch App 475.

¹¹ *Re Oxford Benefit Building Society* (1886) 35 Ch D 502. See, also, section 588G of the Corporations Act.

Having said that, the generally accepted method¹² is to find the total trading revenue over the trading period (meaning the receipts arising from dealings in the normal course of the conduct of the company's business) and then to set off against that trading revenue those expenditures over the trading period that are referable to the routine conduct of the company's business. The next step is to compare the value of the stock of those assets which are consumed or turned over in the conduct of the company's business, as held at the beginning of the trading period, and the value of the similar assets held at the end of that trading period, and to add or deduct the difference to or from the difference between revenue receipts and revenue expenditure, as the case requires. An estimate in good faith of taxes that may be payable may also have to be made and taken into account.¹³ This approach leaves out of account:

- changes in the value of assets not consumed or turned over in the course of the company's business;
- gains realised or losses incurred on the sale of any assets of that kind; and
- expenditure not set off against revenue receipts.

If, without taking those things into account, there is an excess of trading revenue over trading expenses after taking into account any decline in the value of stock held, that excess is called revenue profit. Determination of the matters, by way of incomings and outgoings, actual or accrued, which must or may be taken into account in finding revenue profits is a matter for business persons provided they act responsibly. In an appropriate case, however, a court will hold that particular items should have been brought to account.¹⁴

¹² We note that the following has been greatly simplified for the purposes of clarity and brevity.

¹³ *Commonwealth v O'Reilly* (1984) 8 ACLR 804.

¹⁴ *Marra Developments Ltd v B W Rofe Pty Limited* [1977] 2 NSWLR 616, 629 per Mahoney JA.

In determining the level of dividend, a number of other complexities arise both as matters of statutory interpretation and the rules to be found within a company's articles of association. This may include, for example:

- whether dividends can be distributed out of revenue profits without providing for losses or depreciation of fixed assets;
- the treatment of revenue losses from previous years; and
- whether realised profit on sale of a fixed asset may be distributed by way of dividend.

Generally speaking, profits which are not distributed may be carried to a reserve and, unless other provision is made by the memorandum or articles of association, they remain distributable by way of dividend.

Where a company has large undistributed profits, it may wish to restore equilibrium between its issued share capital and the real value of its assets. Unless that is done, its annual profits will appear to be disproportionately high in relation to its issued capital. This objective is often achieved by an issue of 'bonus shares', thus allowing the conversion of undistributed profits into share capital. However, section 254S of the Corporations Act provides that a company may capitalise profits and that such capitalisation need not be accompanied by the issue of shares.

2.3.2 Using dividends to effect capital restructuring of GBEs

As the NCC has identified, governments have recently tended to seek to extract dividends from GBEs in excess of the revenue profits of the GBEs. However, as seen in the previous section, such dividend payments would be prohibited in respect of "corporations" under the Corporations Act.

In effect, it could be argued that this is a form of capital restructuring by stealth. This is because that portion of the dividend sought to be extracted that exceeds revenue profits in the relevant trading period, if not funded from retained earnings, must be funded by debt. In some cases, the move to a capital structure more highly geared towards debt has been actively pursued by governments.

If the principles of competitive neutrality were to govern this concern, this would suggest that a dividend policy for GBEs, consistent with those principles, would prohibit the practice of extracting dividends from GBEs in excess of revenue profits.

In other words, the principle of competitive neutrality would seem to require that in order to effect balance sheet restructuring, Governments should pursue the more transparent processes allowed by the Corporations Act, such as share buy-back schemes, where explicit rules govern the repatriation of capital, instead of the less transparent (and perhaps even surreptitious) process of excessive dividend payout ratios.

2.4 Long term sustainability

Government-owned monopolies (particularly those franchised to a specific geographic area) generally have an obligation to serve all who have applied for service within an area. Additionally, they are usually obliged by regulation to meet certain service standards (usually as a requirement of their operating licence).¹⁵

These obligations will require ongoing replacement, upgrading and possibly expansion of capital assets from time to time. This capital expenditure (CAPEX) must be met either from retained profits, current cashflows, debt financing, new injections of capital from the shareholding government or through private investment.

To the extent that the governing legislation of a GBE provides for enforceable penalties in relation to any breach of a service standard and those penalties are both:

- appropriate (in terms of their consequences for the GBE and hence impact on the incentives of the GBE concerned, not only to comply with the service standards, but also to invest in replacing, upgrading and maintaining the infrastructure needed to provide services at those standards); and
- enforced,

then the NCC's concerns about the outputs of GBEs should be adequately addressed.

¹⁵ For example in Sydney Water Act 1994 , at section 14(1)a.

In the context of GBEs particularly, the question of appropriate and enforceable penalties for non-compliance with service standards may well exceed, in importance, the question of a dividend policy applying to GBEs. This is because the underlying policy rationale for non-GBE corporations making dividend payments only from their revenue profits, is in order to protect the creditors of the company. For GBEs, their government-owned status may well mean that creditor protection is of less concern than that of securing both:

- a requisite standard of output; and
- a level of infrastructure investment that is consistent with being able to maintain that requisite standard of output over the longer term (in other words, ensuring that GBEs invest in maintaining, upgrading and servicing infrastructure to the levels efficiently needed in order to meet the requisite service standards).

As such, it would be important to ensure that the compliance and penalties regime in respect of service standards fulfilled the objectives noted above.¹⁶

3 Analytical method

The empirical work underpinning this report used a sample of 18 water businesses covering all states and territories. Annual report data for these organisations for the 2001 financial year were used to examine indicators of profitability, liquidity, debt servicing capability, capital structure, and ability to fund capex from cashflows. Variations among the water businesses on these indicators were examined.

Comparisons to private sector counterparts were made at two levels. Dividend payout ratios were examined for the top 50 firms on the ASX employing data sourced from Commonwealth Securities Limited for the past 10 years. These ratios were compared to the ratios for the 2001 year for the 18 water businesses.

¹⁶ However, the government-owned status of Water GBEs also raises the prospect that Governments may prefer to set lower service quality standards than would otherwise be the case if doing so enhances the dividend paying capacity of GBEs.

Indicators of profitability, liquidity, debt servicing capability, capital structure, and ability to fund capex from cashflows were compared to the same indicators, where available, for three listed infrastructure firms in the energy sector.

These comparisons are used to understand the extent to which dividend policies of water businesses differ materially from those of their private sector counterparts, and whether these dividend payouts were likely to create undue financial risks for the water businesses.

3.1 Data sources

Data was sourced primarily from 2001 Annual Reports. Parent entity results were employed in preference to consolidated, as the parent entity only has limited ability to draw on the financial resources of its associated companies, and is not liable for its associates' debts. An exception was made in instances where either only the consolidated results were reported, or where the parent entity had no direct involvement in infrastructure (that is, where the parent entity was purely a holding company). The dividend figure used was dividends paid, from the statements of cashflows.

Data on CAPEX was sourced primarily from a recent Productivity Commission report.¹⁷ This data (and the CAPEXs sourced from ASX comparator annual reports) is on a consolidated basis.

3.2 Private sector comparators

Given that the COAG guidelines specify 'commercial realities' as the basis for setting GBE dividends, we have examined a sample of ASX-listed¹⁸ infrastructure companies as comparators to gauge the correlation between private and public sector practice on these issues.

¹⁷ *Financial Performance of Government Trading Enterprises, 1996-97 to 2000-01*, Productivity Commission 2002.

¹⁸ ASX-listed companies were chosen for reasons of both information availability.

For financial ratio analysis, the following three ASX-listed infrastructure companies were chosen as comparators, both because the nature of their assets and businesses bears significant similarities to the Water GBEs, and because the data needed for comparisons is relatively available. The three selected firms are:

- United Energy;
- Australian Pipeline Trust; and
- AlintaGas.

While the selection of these particular firms may seem somewhat arbitrary, the conclusions drawn from these comparisons are not so strong as to invite concern about selection effects.

For analysis of dividend payout ratios, a larger sample encompassing the top 50 ASX firms including dividend data for each of the past 10 years was used.

3.3 Comparison criteria

In assessing how the Water GBEs' dividend policies impact on these issues, we will evaluate a number of summary ratios, concentrating on standard accounting ratios, where available, both after the dividend is paid ('post-dividend'), and if the dividend had not been paid.

Profitability is assessed using the ratio of Earnings Before Interest and Taxation (EBIT) to total assets.

Liquidity in the short term is assessed using the quick asset ratio (current assets less inventory, divided by current liabilities); and

Debt servicing capability is assessed using the interest cover ratio (EBIT divided by interest expense).

Capital structure is summarised using the gearing ratio (liabilities divided by the firm's value, which is proxied using total assets).

Ability to fund CAPEX from cashflows is assessed crudely using the ratio of CAPEX to sum of undistributed profit and depreciation in the same year.

This last ratio measures the ability of a business to fund capital expenditure out of retained profits, after depreciation has been added back in. The reason for adding depreciation back is that it represents a part of the firm's free cash flow.

4 Results

4.1 Analysis of results – financial ratios

The ratio analysis is summarised in Table 1 below, which shows the minimum, median, and maximum values across the 18 water businesses, for each indicator, and compares these to the same indicators calculated for the three listed energy utility firms. The dividend payout ratios for 2001 are shown on the first row. These vary quite significantly across the 18 water businesses. In the next few rows, the profitability, liquidity, debt servicing capability, capital structure, and ability to fund capex ratios are given for the 2001 taking account of the dividend which was paid. In the final three rows, the liquidity, capital structure, and ability to fund capex ratios are re-calculated assuming that the 2001 dividend had not been paid but had instead been retained by the firm.

Table 1. Financial indicators

	Minimum	Median	Maximum	United Energy	Australian Pipeline Trust (Consol)	Alinta (Consol)	Gas
Payout ratio	0.0%	68.8%	134.4%				
Post-dividend							
EBIT/total assets	1.0%	4.8%	14.7%	8.2%	8.8%	11.9%	
Quick asset ratio	0.2	0.8	5.5	0.3	0.5	1.9	
Interest cover	1.6	3.8	14.8	3.5	1.9	3.1	
Gearing (debt/value)	3.9%	24.1%	62.2%	59%	68%	62%	
CAPEX to undist. Profit + depr	15.5%	69.3%	124.1%	128%	N/A	35%	
Assuming no dividend							
Quick asset ratio	0.4	1.5	5.6				
Gearing (debt/value)	4%	21%	55%				
CAPEX to undist. Profit + dept	15%	48%	96%				

As can be seen in table 1, the Water GBEs are generally less profitable, perhaps somewhat more liquid on average, somewhat more conservative regarding debt servicing capability, and distinctly more lowly geared than their private sector counterparts.

As one might expect, profitability of the government water businesses is generally lower than that of the listed comparators. However some of the water businesses are comparable to the listed energy utilities on the EBIT/assets measure.

The median quick asset ratio for the water businesses is higher (indicating greater liquidity) than two of the three comparators. Had the 2001 water dividends not been paid, the median quick asset ratio for Water GBEs would become nearly as high as the highest of the comparators.

While the interest cover ratio is defined so as not to be directly affected by the dividend payout in any one year, dividend payouts which create a need for additional borrowing may threaten solvency if the interest cover ratio is already low. Additional debt will increase the interest expense in subsequent years, which will worsen the future interest cover ratios unless earnings improve.

Gearing ratios for the water businesses, with the exception of the metropolitan Victorian water corporations, ACTEW, and SEQ water, are significantly lower than for the comparators. Given the high interest cover ratios for these businesses, the hypothesis that balance sheets are unduly lightly leveraged has superficial plausibility, though any such conclusion is subject both to a more detailed review of individual firms' circumstances and to the wider economic considerations set out above.

For those businesses for which CAPEX figures were available, the ratio of CAPEX to free cash flow (estimated as undistributed profit plus depreciation) is less than 100% in every case but that of Sydney Water. That means that those businesses could have funded the 2001 year CAPEX from internally generated funds, despite having had to pay dividends. In the case of very lumpy CAPEX, funding from cashflows generated within the year should not be necessary. However in cases where CAPEX requirements are generally high in every year, the inability to fund these from cashflows may indicate a threat to viability. Further to this analysis, Sydney Water would have been able to fund its 2001 CAPEX from internally generated cashflows if it had not paid a dividend that year. One of the comparators, United Energy, had a similar ratio to Sydney Water post-dividend.

4.2 Analysis of results – dividend payout ratios

Table 2 below shows the range of dividend payout ratios for the top 50 ASX firms over the past 10 years. The payout ratio is defined as the ratio of dividends to the net profit after tax, minority interests and preference dividends (but before extraordinary items).

Table 2. Private firm dividend payout ratios

		<u>Payout ratio %</u>									
		1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
AUSTRALIAN GAS LIGHT FPO	AGL	--	--	--	--	--	71	69	70	100	60
ARISTOCRAT LEISURE FPO	ALL					33	48	58	33	71	63
AMCOR LIMITED FPO	AMC	--	--	--	--	--	136	96	84	88	75
AMP LIMITED FPO	AMP					--	--	17	25	44	93
ANZ BANKING GRP LTD FPO	ANZ	-32	89	46	47	55	61	68	62	62	63
AXA ASIA PACIFIC FPO	AXA						52	69	54	54	34
BHP BILLITON LIMITED FPO	BHP	78	44	51	48	63	60	66	242	49	31
BRAMBLES INDUSTRIES FPO	BIL	69	77	89	75	71	65	59	54	51	62
COMMONWEALTH BANK. FPO	CBA	8	66	78	77	78	78	77	90	74	89
COCA-COLA AMATIL FPO	CCL	--	--	--	--	69	62	70	64	112	55
COLES MYER LTD. FPO	CML		65	65	62	85	78	70	63	61	120
COMPUTERSHARE LTD FPO	CPU			73	66	80	74	44	27	13	11
CSL LIMITED FPO	CSL		26	--	--	--	58	59	59	57	51
CSR LIMITED FPO	CSR		--	--	--	--	42	73	68	51	46
FOSTER'S GROUP FPO	FGL	--	--	--	--	--	80	70	64	59	64
FAIRFAX (JOHN) FPO	FXJ	--	50	32	49	74	89	68	61	50	64
GENERAL PROP. TRUST UNIT	GPT										
HARVEY NORMAN FPO	HVN	--	--	--	--	--	34	35	35	32	39
INSURANCE AUSTRALIA FPO	IAG							--	--	--	97
JAMES HARDIE INDUST. CDI	JHX		--	91	65	86	53	70	67	26	85
LEND LEASE CORP. FPO	LLC		74	75	76	78	70	74	72	76	62
MAYNE GROUP LIMITED FPO	MAY	--	--	--	--	--	41	76	96	77	63
MACQUARIE BANK LTD FPO	MBL						56	58	67	69	67
MIRVAC GROUP STAPLED	MGR										
MACQUARIE INFRA. STAPLED	MIG						51	50	28	175	120
M.I.M. HOLDINGS LTD FPO	MIM	--	--	--	--	--	114	49	-110	50	54
NATIONAL AUST. BANK FPO	NAB	71	61	60	60	60	62	59	62	60	72
NEWS CORPORATION FPO	NCP	--	6	9	8	8	9	6	8	6	13
NEWS CORPORATION PREFERRED											
PUBLISHING & BROAD FPO	PBL	--	58	--	--	--	50	--	--	--	--
QANTAS AIRWAYS FPO	QAN						54	49	59	242	86
QBE INSURANCE GROUP FPO	QBE			49	57	63	67	103	64	75	-612
RIO TINTO LIMITED FPO	RIO		58	68	39	65	65	104	60	54	33
RESMED INC CDI 10:1	RMD										
ST GEORGE BANK FPO	SGB	74	109	63	70	69	97	102	107	89	80
STOCKLAND TRUST GRP STAPLED	SGP										
SINGAPORE TELECOMM. CDI	SGT								--	--	--
SOUTHCORP LIMITED FPO	SRP	72	69	74	81	80	75	71	68	64	75
SANTOS LTD FPO	STO		61	85	82	66	71	86	75	50	41
SUNCORP-METWAY. FPO	SUN	69	70	61	69	69	83	96	89	66	62
TABCORP HOLDINGS LTD FPO	TAH				--	107	105	95	66	103	92
TELECOM CORPORATION FPO NZ	TEL						98	--	92	--	38
TELSTRA CORPORATION. FPO	TLS			--	--	--	18	60	63	57	55
WESTPAC BANKING CORP FPO	WBC	-29	97	52	54	58	58	63	62	62	61
WESFARMERS LIMITED FPO	WES	--	--	--	--	--	96	98	97	100	94
WESTFIELD AMERICA UNIT	WFA										
WESTFIELD TRUST UNIT	WFT										
WMC LIMITED FPO	WMC		61	60	74	62	64	64	56	62	104
WOOLWORTHS LIMITED FPO	WOW		--	61	62	69	69	64	66	73	67
WOODSIDE PETROLEUM FPO	WPL		--	--	--	--	49	51	37	57	51
Sample size		9	18	20	20	23	40	39	40	39	41
Average of sample		42.22	63.39	62.1	61.05	67.3	66.58	67.08	62.65	69.77	48.29
Minimum		-32	6	9	8	8	9	6	-110	6	-612
Median		69	63	62	63.5	69	64.5	68	63.5	62	63
Maximum		78	109	91	82	107	136	104	242	242	120

List of companies sourced from Commonwealth Securities Limited: "Top 50 Leaders - Closing values for Friday 12, July 2002"
<http://www.comsec.com.au/PublicAccess/Prices/TBC-Top50Leaders.asp>

Payout Ratio data sourced from:
<http://investor.ninems.com.au/>

Table 2 shows that mean and median payout ratios for the top 50 ASX listed firms are typically in the range from 60% to 70% of post-tax net profit. This result is consistent with the median result for the 18 water businesses, which was a payout ratio of 68.8%. While there do tend to be high single-year payout ratios for the top 50 firms,¹⁹ payout ratios of more than 100% are quite uncommon among the top 50 firms. Approximately 4% of payout ratios from table 2 were 100% or more. In contrast, 4 of the 18 water businesses had payout ratios in excess of 100%--that is 22% of the sample.

These four are the Hunter Water Corporation, the Water Corporation of Western Australia, the Hobart Regional Water Authority, and the Power and Water Authority of the Northern Territory (PAWA). With the exception of PAWA, all of these are characterised by low gearing ratios (below 25%) and high interest cover ratios (6.5 for the Hunter Water Corporation, and 14.8 for the Water Corporation of Western Australia). For these three a preliminary analysis of the financial indicators suggests a capability to sustain higher levels of debt.

Care, however, needs to be taken with this analysis. In particular, in the available time we have only considered a one year history in GBE dividend payments. Since water businesses are characterised by the need for lumpy investment, consistent and continued application of very high dividend payout ratios could lead to unacceptable levels of financial stress for the affected businesses at some stage in the future.

5 Conclusion

In light of the foregoing analysis, there is a case to be made that competitive neutrality would be served best if corporations law requirements were mirrored in dividend policies for Government water businesses. In the same vein, to the extent that competitive neutrality depends on imposing similar levels of financial discipline on the managers of private and public sector water businesses, there is also a case that public sector gearing levels should be increased to the level of their private sector counterparts.

¹⁹ While dividends must be paid out of profits, they may be paid out of accumulated profits from prior years. Thus it is consistent with the corporations law that single year dividend payouts could exceed the profit in that year.

However, the apparently common practice of using dividend policy as a backdoor means of capital restructuring lacks transparency, and is undesirable for that reason. Instead, capital restructuring of government water businesses should rely on measures similar to those in the corporations law.

The increased financial pressure being placed on their water businesses by governments also heightens the need for effective service quality regulation in each jurisdiction. In this brief study we have been unable to assess the effectiveness of such quality regulations as are presently in place. To the extent that the governing legislation of a GBE provides for enforceable penalties in relation to any breach of a service standard and those penalties are:

- appropriate (in terms of their consequences for the GBE and hence impact on the incentives of the GBE concerned, not only to comply with the service standards, but also to invest in replacing, upgrading and maintaining the infrastructure needed to provide services at those standards); and
- enforced,

then the NCC's concerns about the outputs of GBEs should be adequately addressed.

The empirical analysis conducted in this study has demonstrated that water businesses tend generally to have lower profitability, somewhat greater liquidity and debt servicing capability, and significantly lower gearing on average than their private sector counterparts.

While median dividend payout ratios tend to be on a par with those for the top 50 ASX listed firms, the incidence of payout ratios in excess of 100% of one year's net profit is significantly higher for the water businesses.

These findings give some indication of what may happen if dividend payout rates are set too high for government water businesses. On one hand, while less than ideal from the perspective of transparency, dividend payout ratios in excess of 100% may form part of a capital restructuring program which need not pose any significant threat to the firm's ability to pay creditors or ensure continuity of service to customers. Of the four water businesses with 100% + payout ratios examined above, three were characterised by low gearing and very high interest cover ratios, suggesting an ability to increase gearing.

On the other hand, where a water business already has high gearing and a low interest cover ratio, as some do, the practice of paying out 100% + of net profits as dividends could create financial risks, including solvency risks. These could have short term consequences for creditors, and longer term consequences for customers if needed renewals and capital investments are not undertaken at the optimal time.

More generally, we view capital structure in GBE's as essentially directed to principal-agent problems, and more particularly, to providing incentives for managers to pursue efficiency objectives. Seen in this light, it is important that moves to capital restructuring be transparent, and involve clearly announced goals that can help inform the response of GBE management to their changed financial environment. As a result, 'backdoor' approaches to financial restructuring not only pose risks to long term viability, but may also be less effective in securing desirable policy outcomes.

Additionally, such 'backdoor' approaches can undermine the transparency of the government's financial position as a whole. What are in fact capital transactions may, from the point of view of the community, appear to merely involve recurrent income. This would exacerbate principal-agent problems in the setting and control of public expenditure overall, and could be inconsistent with the longer term pursuit of an efficient and competitive economy.

In summary, the objective of increasing gearing levels of government water businesses does not pose problems of principle. In fact, competitive neutrality may demand it in some circumstances. There are, however, important issues as to how this objective is pursued. From a practical perspective, gearing levels should only be increased where they are not already high compared to proxy companies and where such indicators as the interest cover ratio are sufficiently high.²⁰ The adoption of corporations law requirements for government

²⁰ Clearly there are limits to the level of gearing which any firm can sustain. Some equity finance creates a buffer against volatile earnings. While different businesses require

water businesses would safeguard them against financial default, and would also place capital restructuring initiatives in a more transparent framework.

different levels of buffering, and water businesses are likely to be less volatile than many other types of businesses, every firm requires some equity for this reason.



Appendix 1. Full comparison results

	62%	118%	34%	45%	75%	83%	88%	0%	52%	19%	95%	107%	134%	76%	53%	134%	0%	0%			
	Sydney Water Corporation	Hunter Water Corporation	Sydney Catchment Authority	Melbourne Water Corporation	City West Water	South East Water	Yarra Valley Water	Barwon Regional Water Authority	Central Highlands Water	Goulburn Water	SA Water Corporation	Water Corporation	Hobart Regional Water Authority	Esk Water	ACTEW	PAWA	SEQ Water	Sunwater	United Energy	Australian Pipeline Trust (Consolidated)	AlintaGas (Consolidated)
	NSW	NSW	NSW	VIC	VIC	VIC	VIC	VIC	VIC	VIC	SA	WA	TAS	TAS	ACT	NT	QLD	QLD	ASX	ASX	ASX
Payout ratio																					
Post-dividend																					
EBIT/total assets	3%	2%	9%	10%	15%	12%	9%	1%	1%	1%	8%	5%	3%	3%	9%	5%	5%	2%	8%	9%	12%
Quick asset ratio	0.5	1.0	0.7	0.2	0.6	0.6	0.4	1.1	4.7	5.5	0.9	0.5	0.4	1.7	0.7	0.9	2.3	2.4	0.3	0.5	1.9
Interest cover	2.9	6.5	5.7	2.0	8.1	6.0	3.6	2.0	3.1	4.1	5.4	14.8	2.2	3.9	3.4	1.9	1.6	10.8	3.5	1.9	3.1
Gearing (debt/value)	19%	8%	29%	56%	42%	44%	52%	9%	4%	5%	23%	14%	25%	12%	62%	35%	50%	15%	59%	68%	62%
CAPEX to undist. profit + depr	124%	84%	15%	55%			49%					97%							128%		35%
Assuming no dividend																					
Quick asset ratio	0.7	1.6	0.9	0.4	1.6	1.5	1.0	1.1	5.0	5.6	1.9	2.0	0.5	2.3	1.7	1.1	2.3	2.4			
Gearing (debt/value)	19%	8%	28%	55%	39%	41%	49%	9%	4%	5%	22%	14%	25%	12%	59%	34%	50%	15%			
CAPEX to undist. profit + depr	96%	54%	15%	42%			31%					59%									

Appendix 2. Review of legislation

A.01 Corporations Act 2001

Dividends

The Corporations Act 2001 places two relevant restrictions on the payment of dividends:

- they may only be paid out of profits (section 254T); and
- they may not be paid if this renders the company insolvent (section 588G).

Capital restructuring

The majority of the rules relating to capital restructuring concern procedures for their authorisation by shareholders and ensuring fairness between shareholders. The main restriction is a prohibition against a reduction in share capital or a buy-back of shares if this renders the company insolvent (section 588G).

A.02 State Owned Corporations Act (1989) - NSW

This Act divides State Owned Corporations (SOCs) into two categories, Statutory SOCs and Company SOCs, with the former defined to include:

- Hunter Water Corporation; and
- Sydney Water Corporation.

We will therefore restrict our analysis to the Act as it applied to Statutory SOCs.

Dividends

This Act makes no restriction on the level of payment of dividends. The Act (at Section 20S):

- requires the statutory SOC to have a share dividend scheme, as provided in its constitution, in a form approved by the Treasurer; and

- allows the Treasurer, under section 59B of the Public Finance and Audit Act 1983, to at any time require payment of any dividend the Treasurer requires.

A.03 State Owned Enterprises Act (1992) – Victoria

Dividends

This Act makes no restriction on the level of payment of dividends. The Act (at Section 16B), requires each state body to pay to the State a dividend determined by the Treasurer after consultation with the board and the relevant Minister.

Repayment of capital

This Act (at section 16A) permits the Treasurer to direct repayment of capital, after consultation with the board and the relevant Minister, having regard to any advice that the board has given to the Treasurer.

A.04 Government Owned Corporations Act (1993) – Queensland

Dividends (Section 159)

Within 4 months of the end of the financial year, the board must, after consultation with the shareholding minister, recommend that the Government Owned Corporation (GOC) pay, or not pay a dividend. Within one month of receiving this recommendation, the ministers must approve the recommendation or direct the payment of a (different) specified dividend. The level of this dividend is restricted as follows:

- for Company GOCs (a GOC that is incorporated or registered under the Corporations Act), the dividend must not exceed the amount allowed under the Corporations Act; and
- for Statutory GOCs (a GOC that is established as a body corporate under an Act and is not registered under the Corporations Act), the dividend must not exceed profits, after:
 - provision has been made for tax (or its equivalent); and

- any unrealised capital gains have been excluded.

A.05 Public Corporations Act (1993) – South Australia

Dividends

This Act makes no restriction on the level of payment of dividends. It requires (at section 30) the public corporation to recommend the level of dividend to the Treasurer before the end of the financial year, which the Treasurer may approve, or may determine a different dividend. Additionally, the Treasurer may require the public corporation to recommend an interim dividend.