Department of Planning and Environment

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Local water utility dividend eligibility criteria, calculation methods and other requirements

Consultation Paper

November 2022

Acknowledgement of Country

The Department of Planning and Environment acknowledges that it stands on Aboriginal land. We acknowledge the Traditional Custodians of the land and we show our respect for Elders past, present and emerging through thoughtful and collaborative approaches to our work, seeking to demonstrate our ongoing commitment to providing places in which Aboriginal people are included socially, culturally and economically.

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1. Introduction

This Consultation Paper is the first stage of the NSW Department of Planning and Environment's (the department's) review of local water utility dividend eligibility criteria, calculation methods and other requirements ('dividend requirements').

The objectives of this review are to identify improvements to local water utility dividend requirements to ensure that councils can receive an appropriate return on their efficient investment, while retaining sufficient funds in the water utility to allow it to cover its efficient costs and provide services to customers at suitable levels over time.

The review is not intended to compel local water utilities to pay dividends or to specify the level of dividends that should be paid (particularly as the optimal level of dividend payments will vary across local water utilities and over time). Rather, this review aims to remove any unnecessary regulatory impediments to paying dividends, while seeking to ensure that local water utility dividend payments do not come at the expense of efficient pricing or service levels to customers.

1.1 Existing dividend requirements

A dividend is a return on investment paid to the 'shareholder' of a business. In the case of local water utilities, the 'shareholder' is essentially the council (or constituent councils of a county council) responsible for investing in the utility's water supply and sewerage functions.

Under section 409 of the NSW *Local Government Act 1993* (the LG Act), a local water utility must use the revenue it receives from levying water and sewerage charges to provide water and sewerage services, although the council may receive a return on its capital invested in the utility (a dividend) and use this for any purpose allowed under the LG Act or any other Act.

Before taking a dividend, a council must comply with guidelines relating to the provision of water and sewerage services and any related directions issued by the Minister, and must indicate in an open meeting of the council that it has complied with the guidelines (and any related direction).

The guidelines are currently in the form of section 4 of the department's *Regulatory and assurance framework for local water utilities* (the Guidelines), July 2022.[1]

Under the Guidelines, a dividend from local water utilities comprises two parts:

- **A dividend calculated for tax equivalents** – i.e., the tax equivalent payments the utility makes to the council and recovers via its prices (consistent with the principles of competitive neutrality). The upper limit for such dividend payments from each local water utility is currently set at $3 per assessment.
- **A dividend from the utility's surplus**. The utility's surplus is its income from operations (service availability charges, usage charges, grants for non-capital purposes, profit on the

[1] NSW Department of Planning and Environment (DPE), *Regulatory and assurance framework for local water utilities*, July 2022, p 33-35.

sale of assets, other ordinary income, developer charges and contributions) less expenses from operations less depreciation, interest and dividends for tax equivalents.

For a dividend from the utility's surplus, the Guidelines also specify **eligibility criteria**, a **calculation methodology (including caps)** and requirements for the **provision of information** to the department, as outlined in Chapter **Error! Reference source not found.** of this paper.

1.2 Why dividends are important

Provided it does not come at the expense of efficient pricing[2] or appropriate service levels[3], the payment of dividends by local water utilities can:

- **Enhance transparency and hence accountability around the performance of the utility's management in maximising efficiencies.** For instance, provided prices reflect efficient costs and service levels are maintained at appropriate levels, dividends can be an effective measure of the extent to which the utility has achieved operational efficiency, including the efficient use of its assets.
- **Allow the council to determine how to best use its return on investment rather than simply retaining it in the water utility.** This can promote the efficient use of capital, as the council can use its return on investment to generate the greatest benefit to the community. This could result in, for example, an improvement in the overall financial health of the council, enhancement of the non-water services the council can offer rate payers and/or a reduction in the general rates and other charges paid by ratepayers.
- **Promote efficient financing of capital expenditure.** Through a combination of debt and equity, there will likely be a lower cost means of financing capital costs than the local water utility relying solely on its retained surpluses (see Box 1 below).

Furthermore, to be consistent with competitive neutrality and National Water Initiative (NWI) pricing principles, local water utilities' prices should be set to allow for dividends (including a return on efficient investment). Specifically:

- To comply with National Competition Policy, the NSW Government has noted that Category 1 local government businesses[4] would be expected to generate a return on capital employed that is comparable to returns on capital for private sector businesses operating in a similar field, with the council retaining any dividend as the owner of the business.[5]
- Under the NWI, a water utility should achieve at least lower bound pricing and move towards upper bound pricing where practicable.[6] Among other cost items, lower bound pricing allows

[2] That is, dividends should not be the result of the utility setting prices to recover revenue above efficient costs, although efficient pricing (and the calculation of efficient costs) should allow for a benchmark return on efficient capital expenditure – see overview of National Water Initiative Pricing Principles in Box 5, Section 4.3 of this paper. The department will provide guidance on its expectations of how councils can achieve sound pricing to a reasonable standard as part of its *Regulatory and assurance framework for local water utilities*.

[3] That is, dividends should not be the result of the utility under-spending to the extent that services are or will be provided at levels lower than required by regulators or water and sewerage customers, considering customers' capacity and ability to pay. The department will provide guidance on its expectations of how councils can understand service needs to a reasonable standard as part of its *Regulatory and assurance framework for local water utilities*.

[4] Category 1 businesses have annual sales turnovers (annual gross operating income) of $2 million and above.

[5] NSW Government Policy Statement on the Application of National Competition Policy to Local Government, June 1996, paragraph 4.21.

[6] Under the NWI, a water utility should achieve upper bound pricing it if services more than 50,000 connections.

for prices to be set to recover dividends “set at a level that reflects commercial realities and stimulates a competitive market outcome”. Upper bound pricing allows prices to be set to recover the cost of capital, calculated using a Weighted Average Cost of Capital – which includes provision for a return on equity.[7]

Box 1: Debt and equity financing

Capital expenditure can be financed through a combination of debt and equity. Issuing debt or equity is associated with a cost in the form of providing a return to the debt or equity investors:

- The cost of debt relates to the return needed to compensate debt investors (which are different to the ‘shareholder’/council).
- The cost of equity is the return on equity investment paid to the ‘shareholder’ in the form of dividends, which compensates the equity investor for the opportunity cost of investment in the business.

Equity is typically the riskiest and, therefore, the most expensive form of finance because equity investors are remunerated only after all other expenses, debt investors and other obligations (for example, tax equivalent payments) have been made. Since shareholders have other potential uses for their funds, investing equity capital in a water utility has an opportunity cost to its shareholders. Heavy reliance on equity finance will mean that the opportunity cost incurred by the shareholders of the water utility (that is, the foregone uses to which that equity could have been put) would be relatively high.

Hence, if surpluses are retained by the water utility for the purpose of financing capital expenditure (rather than being paid to the council as dividends), the equity capital invested by the council in the water utility will accumulate, and the opportunity cost of those funds will also grow. That is, the water utility could have been financed more cheaply by paying out some dividends and undertaking some borrowing.

Debt finance, whilst typically cheaper than equity finance, also has limitations. The greater the amount of debt held by the water utility, the greater will be its debt servicing obligations, and the greater its exposure to the risk of default against those obligations. Since shareholders are paid only after debt investors, the greater the amount of debt taken on by the water utility (that is, the higher the level of financial leverage), the greater the water utility shareholder’s exposure to risk.

Therefore, there is typically a balance between the level of equity and debt finance that may be adopted by water utilities and the optimal capital structure for any entity – which represents the mix of debt and equity financing that maximises a business’s value while minimising its opportunity cost of capital (combination of the cost of debt and the cost of equity).

If councils (the ‘shareholder’) do not seek or expect a return on the equity they provide (that is, they do not seek or expect a dividend), this may ‘under-price’ equity compared to the cost of debt – which can distort decision-making regarding the optimal mix of debt and equity, as well as a range of other related investment and consumption decisions.

[7] 2004 COAG Intergovernmental Agreement on National Water Initiative.

1.3 Purpose of this consultation paper

This Consultation Paper seeks stakeholder views on what dividend requirements (including dividend eligibility criteria, calculation methods, caps and related requirements) should be in place for local water utilities. In doing so, it provides relevant contextual information; outlines current criteria, methods and requirements for local water utility dividends; and seeks stakeholder views on potential changes to these criteria, methods and requirements.

This Paper is structured as follows:

- Chapter 2 outlines the extent to which local water utilities have paid dividends to their council shareholders, presents possible explanations for this level of dividend payments, and seeks stakeholder views on these explanations and the potential implications for dividend requirements.
- Chapter 3 discusses the regulation of local water utilities, provides an overview of the governance or requirements around dividends in other sectors, presents some proposed principles for governing NSW local water utility dividends to inform the assessment of potential changes to current requirements, and seeks stakeholder feedback on these principles.
- Chapter 4 presents current requirements around tax equivalent dividend payments and seeks stakeholder feedback on potential changes to these requirements.
- Chapter 5 outlines current criteria, methods and requirements for calculating and paying dividends from surpluses and seeks stakeholder views on potential changes to these criteria, methods and requirements.
- A consolidated list of stakeholder questions is provided in Appendix A.

1.4 The department is seeking feedback on this paper

The department's Town Water Risk Reduction Program is seeking stakeholder views on what dividend eligibility criteria, calculation methods and other requirements should apply to local water utilities.

The department invites submissions in response to the questions and issues raised in this Consultation Paper, in addition to any other issues relevant to this review. Submissions are due by **Friday, 16 December 2022**. You can send your submission to regional.town.water@dpie.nsw.gov.au

2. Dividends from local water utilities

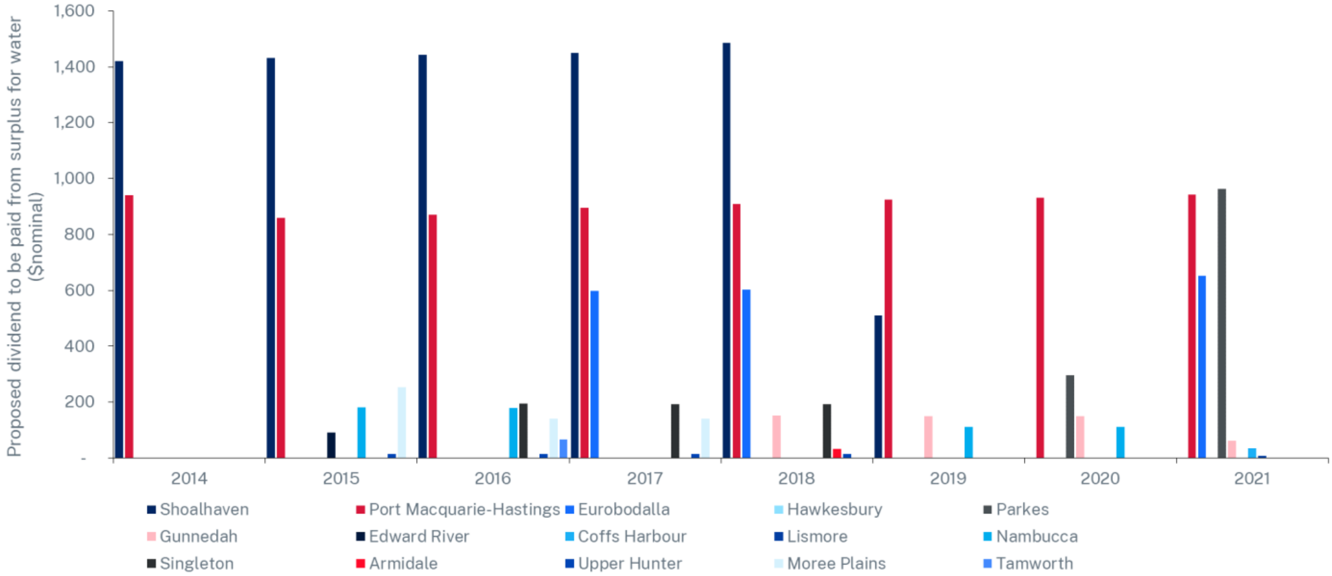
This chapter provides an overview of the extent of dividends paid by NSW local water utilities, and seeks stakeholder views on why only relatively few local water utilities pay dividends and the potential implications of this, if any, for changes that should be made to dividend requirements.

2.1 Dividends paid by NSW local water utilities

Very few local water utilities have paid dividends from surpluses to their council shareholder. For example, as shown in **Figure 1** and **Figure 2** only 15 of 89 council-owned local water utilities have paid a dividend from surpluses in the last eight years. Of particular note:

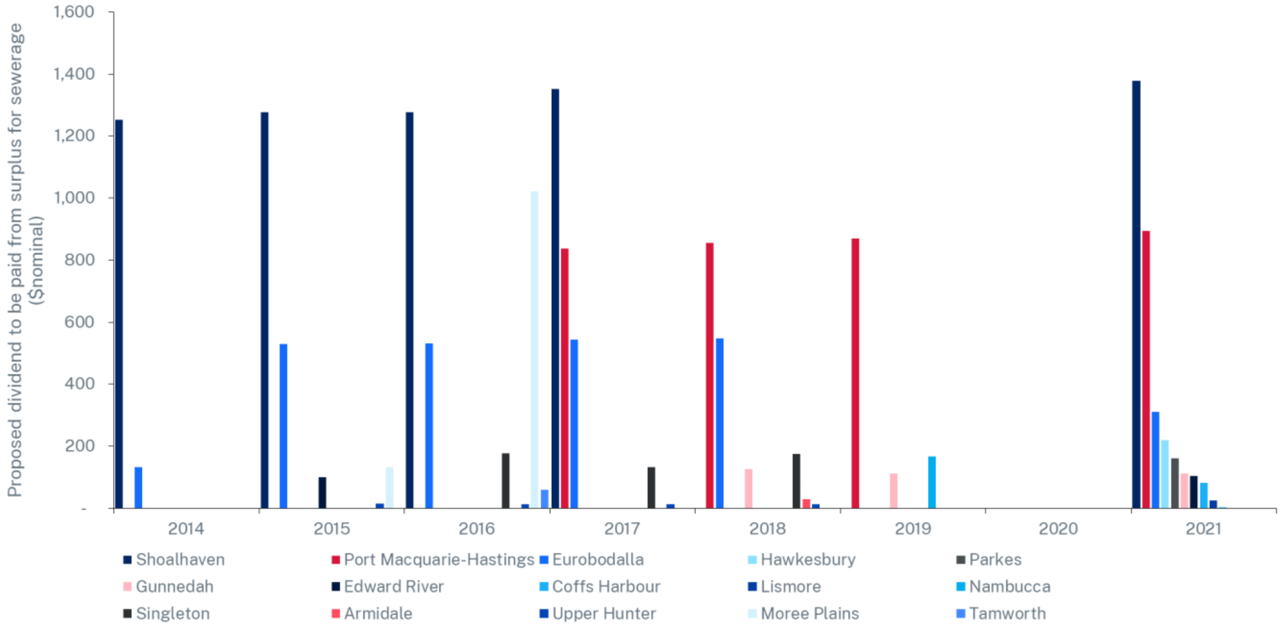
- The councils that have consistently, or close to consistently, paid dividends over the last eight years (such as Shoalhaven, Port Macquarie-Hastings and Eurobodalla) typically have a much larger number of connected properties (all three have more than 10,000 connected properties).
- No small (less than 1,500 connected properties) and very few medium-sized (less than 4,000 connected properties) councils have paid dividends over the last eight years (Edward River is the only medium-sized council to have paid dividends in the last eight years).
- A larger number of councils have paid dividends related to sewerage services than water services.

Figure 1: Proposed dividend to be paid from water surplus ($'000)



Source: NSW Government, Local Water Performance Monitoring available here < https://www.industry.nsw.gov.au/water/water-utilities/lwu-performance-monitoring-data>

Figure 2: Proposed dividend to be paid from sewerage surplus ($'000)



Source: NSW Government, Local Water Performance Monitoring available here < https://www.industry.nsw.gov.au/water/water-utilities/lwu-performance-monitoring-data>

This is not a recent occurrence. In 2006, for example, the *Independent Inquiry into the Financial Sustainability of NSW Local Government* (the Inquiry) noted that in 2003-04 only 10% of local water utilities complied with the then department's guidelines[8] and could thus pay a dividend.[9] In this context, it also reported that:

- Dividend requirements for local water utilities were considered more onerous than those applied to State-owned businesses.
- The department contended that comparison of local water utilities with State-owned businesses was inappropriate since state-owned enterprises are required to pay a dividend to another party (State Treasury) whereas councils, without Guidelines, would be able to strike their own dividends with impunity. However, the Inquiry was not convinced that councils would be less restrained in setting dividends than the NSW Treasurer, as excessive dividends to the councils would have a political cost.
- The department was confident that at least 70% of local water utilities would be compliant with the Guidelines and be eligible to pay dividends by 2009.

Significantly more local water utilities generate a surplus than are paying dividends. For example, in 2020-21, of the 69 local water utilities that reported information on their Net Profit After Tax (NPAT), 45 were in surplus (that is, had a positive NPAT). Specifically, of the local water utilities that reported their NPAT:

- 33% of small local water utilities were in surplus
- 58% of medium local water utilities were in surplus

[8] Then the NSW Department of Energy, Utilities and Sustainability (DEUS).

[9] *Independent Inquiry into Financial Sustainability of NSW Local Government (2006), p.166.*

- 67% of large local water utilities were in surplus
- 90% of major local water utilities were in surplus.

The above figures only relate to the payment of dividends from surpluses. There is limited information available on the extent to which councils pay tax equivalent dividends.

2.2 The reasons why few local water utilities pay dividends

There may be a range of reasons why a local water utility does not pay a dividend from its surplus to its council's consolidated fund, and these reasons may vary by council and over time. For example, reasons could include a combination of the following:

- **The local water utility does not generate a surplus from its supply of water and/or sewerage services.** In turn, this could reflect cost pressures in the supply of water and/or sewerage services, combined with revenue constraints. Many local water utilities serve geographically large areas with small and dispersed customer bases, which can mean relatively high costs to serve each customer. At the same time, customers may have limited capacity to pay cost-reflective prices (including a return on capital) – particularly those in socio-economically disadvantaged areas.
- **The local water utility (and its council shareholder) may prefer to retain earnings in the water utility to finance future capital investment (instead of debt financing) and/or mitigate any future price increases or revenue volatility.**
- **The dividend eligibility criteria, cap on dividends and/or other requirements may impede dividend payments**, either because:
    - the local water utility does not comply with the eligibility criteria – for example, very few local water utilities finalised an Integrated Water Cycle Management (IWCM) plan, which was one of the criteria[10] to qualify for a dividend payment under the department's *Best-Practice Management of Water Supply and Sewerage Guidelines* 2007 (which has now been replaced by the *Regulatory and assurance framework for local water utilities*); or
    - the compliance or regulatory burden of the eligibility criteria, cap on dividends and/or the other requirements may be considered too great.

Dividend requirements cannot determine the level of surpluses local water utilities generate, nor should they compel utilities to pay a specified amount of dividends, as the appropriate level of dividend payment is likely to vary case by case.

However, the governance or regulation of dividends can aim to remove any unnecessary regulatory impediments to paying dividends, while seeking to ensure that local water utility dividend payments do not come at the expense of efficient pricing or appropriate service levels to customers.

[10] Under the *Best-Practice Management of Water Supply and Sewerage Guidelines*, the criteria to be met to qualify for a dividend payment related to strategic business planning, pricing, water conservation, drought management, performance reporting and integrated water cycle management.

Therefore, a relevant consideration for this review is whether the current dividend eligibility criteria, caps on dividends and/or other requirements have unduly impeded the payment of dividends to local councils.

Have your say:

1. Why has your local water utility not paid a dividend from its surpluses? What determines whether it pays a dividend and, if so, how much?
2. Why do only a few local water utilities pay dividends from surpluses?
3. What, if any, implication does this have for our review of dividend requirements?

3. Dividend policy and principles

This chapter explains the rationale for regulating local water utilities, outlines the governance of dividend payments by other entities and presents proposed key principles for governing NSW local water utility dividend payments.

3.1. The regulation of local water utilities

In a competitive market, a rate of return from which a business can pay dividends will only be sustainably earned if the business controls costs and provides adequate services over time to maintain or increase its market share relative to its competitors. If a business operating in a competitive market increases its prices above efficient levels simply to provide a return on investment or under-invests in the business at the expense of its services, it would lose market share – thus making such practices unsustainable.

Local water utilities should be subject to the same discipline. That is, their rates of return and dividend payments should only arise from prices reflecting efficient costs and supplying services to meet the needs and expectations of their customers. They should not be the result of the utility increasing its prices above levels that reflect efficient costs or earning a surplus from under-investment in the network.

However, local water utilities are generally natural monopolies – which means there is no competition to ensure that their prices reflect efficient costs and that service levels meet the needs of their customers. This suggests there is a case for some form of regulation or oversight of pricing and service levels to mimic the positive effects of competition – which, in turn, should ensure that dividends do not come at the expense of efficient pricing or appropriate service levels.

The department has recently published its *Regulatory and assurance framework for local water utilities*, which sets out the strategic planning outcomes it expects local water utilities to achieve to a reasonable standard – including outcomes related to pricing and service levels. Rather than being overly prescriptive, this framework seeks to be risk-based, outcomes-focused and proportionate, recognising that (unlike some other monopoly service providers) local water utilities are owned by local councils whose councillors are ultimately accountable to their constituents, which are largely comprised of customers of the water utility.

If efficient pricing and appropriate service levels are assured through the regulation and governance of local water utilities, thereby ensuring that dividend payments cannot come at the expense of these outcomes, we consider there is no need for restrictions on local water utility dividend payments. That is, provided local water utilities' prices reflect efficient costs and they supply water and sewerage services to their customers at appropriate levels, they (and their councils owners) should be allowed to determine their levels of dividend payments.

3.2 The governance of dividends from other water utilities and sectors

The section provides an outline of the governance of dividends in other sectors, including NSW State Owned Corporations (SOCs), other NSW Government owned businesses, SOCs and water utilities in other jurisdictions, and the broader economy (i.e., non-government owned businesses).

3.2.1 NSW State Owned Corporations (SOCs)

The NSW Government, as shareholder of the SOCs, expects SOCs to pay dividends annually. The amount of dividend paid is determined by an agreement between the shareholder and NSW Treasury, following a recommendation from the government business. At times, the shareholder can determine a dividend is not required. For example, this might occur when there is no surplus or a small surplus or when a large capital investment is expected in the near future. A guiding principle is that dividend payments should not be made at the expense of increased pressure on prices, service quality or the future reliability of the business.

The NSW Government benchmarks dividend payments at 70% of net profit after tax (NPAT) as a starting point for initial discussions, although the basis for this benchmark is unclear.

Unlike for local water utilities, SOCs are not subject to caps on dividends and dividends are paid regularly. However, dividends paid by SOCs seem to vary depending on the financial position of the SOC. Some examples of SOCs paying dividends include:

- Sydney Water's Statement of Corporate Intent reflects an intention to pay a dividend in FY2022, FY2023 and FY2024. The dividend payout ratio is forecast to be less than 70%, at 63%, 57% and 61% of NPAT, respectively.[11]
- Hunter Water's Statement of Corporate Intent reflects an intention to pay a dividend in FY2022, FY2023 and FY2024, with a target dividend payout ratio of 70% of NPAT.
- The Forestry Corporation's dividend policy specifies that dividends will equate to 70% of NPAT. Historically, it has met this target, although a dividend exemption was established to allow it to recover from the impact of the 2019-20 bushfires.[12]
- The NSW Port Authority Statement of Corporate Intent reflects an intention to pay dividends in FY2022, FY2023 and FY2024, with the dividend pay-out ratio reported as being 185%, 239%, and 149% of NPAT, respectively.[13]

An outline of the expectations of dividend payments from SOCs is presented in Box 2 below.

[11] Sydney Water (2021), Annual Report 2020-21, available at: https://www.sydneywater.com.au/content/dam/sydneywater/documents/annual-report-2020-21.pdf and Sydney Water (2021), Statement of Corporate Intent 2021-22, available at: https://www.sydneywater.com.au/content/dam/sydneywater/documents/statement-of-corporate-intent_2021-22.pdf

[12] Forestry Corporation, Statement of Corporate Intent 2021-22, https://www.forestrycorporation.com.au/__data/assets/pdf_file/0011/1377317/2021-22-Statement-of-Corporate-Intent-Forestry-Corporation-of-NSW.pdf

[13] NSW Port Authority (2021), Annual Report 2020-21, available at: https://www.portauthoritynsw.com.au/media/5125/port-authority-annual-report-2021.pdf

Box 2: Dividend expectations of SOCs and other government businesses

SOCs are allowed to pay dividends under Section 14 of the State Owned Corporations Act 1989:

1. The board of a company SOC and the voting shareholders may agree that payments required to be made by the SOC or any of its subsidiaries in respect of dividends will be applied in the purchase of shares by shareholders in the SOC.
2. If any such payments are applied in the purchase of shares, the payments may be appropriated for that purpose without being paid into the Consolidated Fund.
3. Otherwise, dividends declared for a company SOC or any of its subsidiaries and payable to eligible Ministers are to be paid to the Treasurer for payment into the Consolidated Fund.[14]

The NSW Government expects government businesses to pay dividends annually, except where the shareholder determines a payment is not required (for example, if re-investment was needed to improve a balance sheet).[15] Dividend payments should not be made at the expense of increased pressure on prices, service quality or future reliability of the business.

Government expectations for dividend payments from SOCs and other government businesses are:

- Dividends are paid annually, except when the shareholder decides they are not required.
- Dividends should reflect shareholders' expectations or consideration in their forecast dividend profile and the annual dividend to be declared.
- The government business and shareholder should agree on a forecast dividend profile that covers the next ten financial years as part of the Statement of Intent and Business Plan process.
- The government business should determine the dividend payout ratio or an alternative approach to determining the forecast dividend profile. A ratio of 70% of Net Profit After Tax is commonly used as the initial reference point.
- For each financial year, the government business must recommend to the shareholder the dividend to be declared in a Dividend Recommendation Letter. The letter explains the determination of the dividend amount, which includes payout ratio or consideration of the Minimum Credit Rating and Target Capital Structure. Treasury advises the Government whether to accept the dividend or approve a different dividend. This agreed amount is reflected in the business's end-of-financial year statements.

The dividend scheme of the SOC also takes into consideration the agreed Target Capital Structure with NSW Treasury to maintain an efficient capital structure consistent with the Target Credit Rating (above Baa2/ BBB – Moody's/ Fitch or Standard & Poor's minimum credit rating, unless otherwise agreed with Treasury).

[14] NSW Government, State Owned Corporations Act 1989 No 134, Section 14, available at: https://legislation.nsw.gov.au/view/whole/html/inforce/current/act-1989-134#sec.14

[15] NSW Treasury (2021), NSW Treasury Policy and Guidelines TPG21-10 Capital Structure and Financial Distribution Policy for Government Businesses, available at: https://www.treasury.nsw.gov.au/sites/default/files/2021-12/tpg2110_capital_structure_and_financial_distribution_policy.pdf

SOCs also pay tax equivalent dividends. Under the State Owned Corporations Act 1989, SOCs must pay the equivalent amount of tax to Treasury that they would pay if they were liable to pay taxes, or an amount agreed between the SOC and the Treasurer. If the SOC does need to pay taxes, it is not liable to pay tax equivalents to the Treasury.[16] The Treasury Capital Structure and Financial Distribution Policy does not consider these payments to be financial distributions but rather expenses incurred by government businesses to align with competitive neutrality principles.

Sources: NSW Treasury Policy and Guidelines PG21-10 Capital Structure and Financial Distribution Policy for Government Businesses

3.2.2 Other NSW Government owned businesses

Other NSW Government owned businesses generally pay dividends if determined by the shareholders and NSW Treasury.

- For Public Non-Financial Corporations and Public Financial Corporations, the shareholder determines whether the business should pay a financial distribution, as communicated by Treasury. They should apply the dividend requirements for SOCs to the extent practicable.
- General Government Businesses pay a dividend if determined by Treasury. Some General Government Businesses with profits from commercial activities have arrangements whereby they return these profits to Treasury. These businesses pay distributions in lieu of dividends.
- Companies wholly owned by the Government and incorporated under the Corporations Act 2001 pay a dividend subject to the company's constitution and the Government's expectations on financial distributions from the company.[17]

3.2.3 Government owned water utilities in other jurisdictions

Queensland GOCs

Queensland's equivalent of SOC's, Government Owned Corporations (GOCs), are required to specify each year whether they will pay a dividend. As in NSW, the GOC's board recommends to the shareholding Ministers what the specific dividend payment should be (or if no dividend payment should be made). This is supported by the estimated profits for the financial year after the provision of tax.

For example, SunWater (a GOC) is required to determine whether to pay a dividend each year. Its dividend policy is stated in the Statement of Corporate Intent and it considers the return its shareholding Ministers expect on the government's investment. Recently, the Minister accepted the directors' recommendation to not pay a dividend, given large, expected costs for dam improvements in future years.

[16] NSW Government, State Owned Corporations Act 1989 No 134, Section 15, available at: https://legislation.nsw.gov.au/view/whole/html/inforce/current/act-1989-134#sec.15

[17] NSW Treasury (2021), NSW Treasury Policy and Guidelines TPG21-10 Capital Structure and Financial Distribution Policy for Government Businesses, available at: https://www.treasury.nsw.gov.au/sites/default/files/2021-12/tpg21-10_capital_structure_and_financial_distribution_policy.pdf

Victorian water utilities

Victorian water utilities are required to pay dividends to the State Government. The dividend amount is based on consultation between the utility's board, the Treasurer and the Portfolio Minister. This consultation considers the water utility's financial position and performance and the State's budget position.

In Victoria, the following benchmarks have been generally used:

- 50% of NPAT
- Dividends and income tax equivalent paid or payable of 65% of pre-tax profit.

Other factors which have also been considered include the views of the board, reported profit, liquidity, operating cash flow and forecast cash requirements of each business (including planned capital works), gearing and interest cover of the business, retained earnings and any other specific factors relating to individual businesses.[18]

State Owned Enterprises (SOEs) of OECD-surveyed countries

The OECD found that most countries have established guidelines or targets to align dividend payout levels of State Owned Enterprises with private sector practices. They are expressed as either:

- broad guidelines identifying the factors that should be taken into account when establishing dividend levels
- dividends as an explicit percentage of net income, or
- the level of dividends required to maintain an optimal capital structure, as measured by the achievement of a target credit rating.

According to the OECD, the latter practice – implemented by Australia, New Zealand and Sweden – would presumably result in dividend levels most consistent with private sector practices. Fewer than half of surveyed countries have no dividend guidelines or targets in place, with dividends negotiated annually between SOE boards and the state shareholder, and not subject to guidelines. This OECD considers this could potentially hinder capital structure optimisation.[19]

3.2.4 The broader economy (i.e., non-government businesses)

Most businesses pay a dividend to their shareholders. Dividends can be paid in cash to shareholders or reinvested in the business. The company's board of directors decides whether to pay a dividend and how much. Most ASX-listed companies pay two dividends a year – an interim dividend and a final dividend.

In Australia, dividend payments are governed by the Corporations Act 2001 (see Box 3).

Box 3: **The Corporations Act 2001**

Under Section 254T(1) of the Corporations Act, a company must not pay a dividend unless:

[18] https://researchoutput.csu.edu.au/ws/portalfiles/portal/11571766/11549005_Published_report_OA.pdf

[19] The OECD, *Ownership and Governance of State-Owned Enterprises, A Compendium of National Practices 2021*

- the company's assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend
- the payment of the dividend is fair and reasonable to the company's shareholders as a whole
- the payment of the dividend does not materially prejudice the company's ability to pay its creditors.

Sources: The OECD, Ownership and Governance of State-Owned Enterprises, A Compendium of National Practices 2021

Examples of ASX-listed companies' target payout ratios and actual payout ratios include:

- BHP's Board determined for 2021/22 that total cash dividends would be equivalent to a 77% payout ratio. BHP's dividend policy stipulates a minimum 50% payout of underlying attributable profit at every reporting period.[20]
- The Commonwealth Bank targets a full-year payout ratio of 70% - 80%. The FY2021 dividend was 71% of CBA's cash earnings.[21]
- NAB targets a dividend payout ratio of 65-75% on sustainable earnings, subject to circumstances at the time.[22] FY2021 dividends were paid out at a cash earnings ratio of 68.6%.

3.3 Principles for governing NSW local water utility dividends

Dividend payments should not be made at the expense of efficient pricing or service quality to customers.

We also consider that dividend requirements should not seek to prescribe the level of local water utility dividend payments, nor should they impose unnecessary restrictions, impediments or regulatory burden on the payment of dividends.

Rather, we consider that local water utilities should be allowed to make dividend payments where the utility or council can show that the utility's prices are efficient and its service levels to customers are appropriate.

Have your say:

4. What principles should be used to guide dividend requirements for local water utilities in NSW?

[20] BHP (2022), BHP results for the year ended 30 June 2022, and BHP, Shareholder FAQs, https://www.bhp.com/investors/shareholder-information/faqs

[21] https://www.commbank.com.au/about-us/investors/dividend-information.html

[22] NAB (2021), 2021 Annual Financial Report

4. Tax equivalent dividend payments

This chapter outlines the rationale for Tax Equivalent Regime (TER) payments, current requirements relating to these payments (as tax equivalent 'dividends') and potential changes to these requirements.

4.1 The rationale for tax equivalent payments

Principles of competitive neutrality require Category 1 local water utilities[23] to make tax equivalent payments to their local councils and to recover the costs of these payments via their water and sewerage prices, and for Category 2 local water utilities to do likewise where practicable.

Tax equivalent (or TER) payments should reflect the value of taxes that are not actually imposed on the local water utility because of its local council ownership, but which would be imposed if it was an equivalent privately owned business (see Box 4).

Box 4: Tax equivalent regime (TER) payments

The system of Tax Equivalent Regime (TER) payments requires a calculation of those taxes for which the council is not liable, but an equivalent privately owned business would be liable, consistent with the principles of competitive neutrality.

Once a calculation is made, a TER payment is made from the business activity to the owner of the business (i.e., the council). TER payments do not represent an actual cashflow outside the council, but nevertheless must be recognised through a payment from the business activity to the council.

All council Category 1 businesses are required to apply TER payments, with Category 2 businesses also required to apply these payments where practicable.

Source: Department of Local Government, Pricing & Costing for Council Businesses, A Guide to Competitive Neutrality, p 19

Tax equivalent payments are also recognised in the NWI's pricing principles (see **Error! Reference source not found.**).

[23] Category 1 businesses have annual sales turnovers (annual gross operating income) of $2 million and above.

Box 5: National Water Initiative (NWI) Pricing Principles – Lower and Upper Bound Pricing

Consistent with the NWI (agreed by COAG in 2004), a utility should set its prices to achieve:

- at least lower bound pricing and move towards upper bound pricing where practicable
- upper bound pricing if it serves more than 50,000 connections

Under upper bound pricing, a water business should not recover more than the operational, maintenance and administrative costs, externalities, taxes or TERs [tax equivalent regime], provision for the cost of asset consumption and cost of capital, the latter being calculated using a WACC [weighted average cost of capital] – which includes provision for the cost of debt and equity (that is, a return on equity).

Under lower bound pricing, to be viable a water business should recover, at least, the operational, maintenance and administrative costs, externalities, taxes or TERs (not including income tax), the interest cost on debt, dividends (if any) and make provision for future assets refurbishment/ replacement. Dividends should be set at a level that reflects commercial realities and stimulates a competitive market outcome.

Source: National Water Initiative Pricing Principles, 2004.

4.2 Current requirements for tax equivalent dividend payments

The department's Guidelines state that:

"*All council-owned water supply or sewerage businesses must make a dividend payment for the amount calculated as the annual tax equivalent payment*"; and the utility's "*prices should be set so annual cost recovery by a council's water supply or sewerage business includes taxes or tax equivalents (excluding income tax).*"[24]

The Guidelines also note, however, that the upper limit for tax equivalent dividend payments from each of a council's water supply or sewerage businesses is set at $3 per assessment.[25]

4.3 Proposed changes to tax equivalent dividend payments

We do not consider there is a case for imposing a cap on tax equivalent dividend payments (below the local water utility's annual tax equivalent liability), given the principles of competitive neutrality.

Further, the basis or rationale for setting the cap at $3 per assessment is uncertain. The previous (2007) guidelines stated that the reported tax equivalent expenses (excluding income tax) for most NSW local water utilities were under $1 per assessment and that, accordingly, the upper limit for

[24] NSW Department of Planning and Environment, *Regulatory and assurance framework for local water utilities*, p. 33-34, July 2022.

[25] NSW Department of Planning and Environment, *Regulatory and assurance framework for local water utilities*, p. 33-34, July 2022.

such dividend payments for each of a local water utility's water supply and sewerage business is set at $3 per assessment.[26]

However, we seek stakeholder views on the question of a cap for tax equivalent dividend payments.

Have your say:

5. Should there be a cap on tax equivalent dividend payments, or should the cap be removed?
6. If there should be a cap on tax equivalent dividend payments, why and what should be the cap?

[26] NSW Department of Water & Energy, *Best-Practice Management of Water Supply and Sewerage Guidelines*, August 2007, p 16.

5. Dividends from surpluses

This chapter outlines the rationale for dividends from surpluses, current requirements relating to these payments (including eligibility criteria) and potential changes to these requirements.

The utility's surplus is its income from operations (service availability charges, usage charges, grants and contributions for non-capital purposes, profit on the sale of assets, other ordinary income and developer charges) less expenses from operations less depreciation, interest and dividends for tax equivalents.[27]

5.1 Eligibility criteria for dividends from surpluses

5.1.1 Current criteria for dividends from surpluses

Under the current Guidelines, before taking a dividend payment from the surplus of the local water utility, a council must:

- calculate the dividend based on the income statement of the business activity in the council's audited special-purpose financial reports.
- be able to demonstrate there is a surplus in its water and sewerage business
- demonstrate full cost-recovery pricing and developer charges are in place for its water and/or sewerage business
- have in place effective, evidence-based strategic planning in accordance with section 3 of the department's *Regulatory and assurance framework for local water utilities*
- demonstrate that water supply and/or sewerage special-purpose financial reports are a true and accurate reflection of the business, with an unqualified financial audit report
- demonstrate that the overhead reallocation charge to the water and/or sewerage business is a fair and reasonable cost, with an independent audit report of cost allocation of the water and/or sewerage business.[28]

5.1.2 Potential changes to eligibility criteria for dividends from surpluses

The current criteria are generally consistent with our view that dividend payments should be contingent on the utility setting efficient prices (prices recover no more than efficient costs) and delivering appropriate service levels.

[27] NSW Government Department of Water & Energy, Best Practice Management of Water Supply and Sewerage Guidelines, August 2007, p 18.

[28] NSW Department of Planning and Environment, *Regulatory and assurance framework for local water utilities*, p. 34, July 2022.

For example, while section 3 of the department's *Regulatory and assurance framework for local water utilities* (the third criterion above) includes a broad range of strategic planning outcomes, the achievement of these outcomes to a reasonable standard would indicate that the utility is setting reasonable prices and providing services to an appropriate standard and there are adequate measures in place to ensure this continues for the foreseeable future.

Nevertheless, we are interested in stakeholder views on whether these criteria can be improved or streamlined, and what local councils should do to demonstrate compliance.

Potential criteria could be as follows:

Before taking a dividend payment from the surplus of the council's water supply and/or sewerage business, the local council must be able to demonstrate:

- ***there is a surplus in its water and sewerage business***
- ***the water and sewerage business has efficient pricing in place (prices recovering efficient costs, including developer charges) and is providing adequate levels of services to water and sewerage customers***

This could be satisfied by demonstrating that the water utility is achieving the strategic planning outcomes in Section 3 of the *Regulatory and assurance framework for local water utilities* to a reasonable standard.

- ***the financial reports of the business (water supply and/or sewerage) are a true and accurate reflection of the business, and that common costs (including overheads) are allocated in a reasonable way to the water and/or sewerage business.***

This could be satisfied with an unqualified independent financial audit report of the special-purpose financial statements for the water supply and/or sewerage business, confirming that these statements are a true and accurate reflection of the business and that cost allocation to the water and/or sewerage business is fair and reasonable.

We understand that such audits do not currently review the methodology to allocate common costs to the water and/or sewerage business, but simply confirm that the councillors and council management certify that the allocation is fair and reasonable.

We also note that guidance on the strategic planning outcome of sound pricing and prudent financial management (one of the strategic planning outcomes in section 3 of the *Regulatory and assurance framework for local water utilities*) includes expectations relating to cost allocation.

- ***the operational performance of the business (water supply and/or sewerage) is of a reasonable standard and meets the needs of customers***

The department would like to consider the inclusion of more specific operational performance as an eligibility criterion in the future. We accept that there is a lot to be taken into account before implementing this, including what is considered a reasonable standard, what performance indicators are used and how differences in a local water utility's operating environment are taken into account, for example.

We seek stakeholder views on the eligibility criteria and how to best demonstrate compliance with the criteria.

5.2 Calculation method and caps for dividends from surpluses

5.2.1 Current calculation method and caps

Under the current Guidelines, the dividend must be calculated based on the income statement of the business activity in the council's audited special-purpose financial reports (the department's dividend payment form[29] gives a step-by-step process for calculating the maximum dividend from surplus).

The payment of a dividend from the surplus of a local water utility is the least of the following conditions:

- the dividend from surplus must not exceed 50% of this surplus in any one financial year
- the dividend from surplus must not exceed the number of water supply or sewerage assessments as of 30 June of the relevant year multiplied by $30 less the dividend for tax equivalents
- the total dividend from surplus paid in each rolling three -year period must not exceed the total relevant surplus in the same period (see **Figure 3** below).

Further, under the Guidelines, councils facing major capital expenditure for new or replacement water supply and/or sewerage infrastructure should defer paying a significant dividend from their surplus. Such capital expenditure in any financial year is defined as that which exceeds 3% of the current replacement cost of the council's water supply or sewerage assets.

[29] https://www.industry.nsw.gov.au/__data/assets/pdf_file/0005/518774/PUB22-605-Dividend-payment-form-July-2022.pdf

Figure 3: Calculation of dividend from surplus

<table>
<tr><th>No.</th><th colspan="2">Item</th><th>Amount ($)</th></tr>
<tr><td>(1)</td><td colspan="2">50% of 'Surplus before Dividends' (from audited Special Purpose Financial Report – Income Statement of Sewerage Business Activity)</td><td></td></tr>
<tr><td>(2)</td><td colspan="2">No. of assessments connected to sewerage multiplied by $30/assessment, less Dividend for TE</td><td></td></tr>
<tr><td rowspan="2">(3)</td><td>(a) Cumulative 'Surplus for dividend calculation purposes' for the 3 years to 30 June of the dividend year[6].</td><td rowspan="2">Cumulative 'Surplus for dividend calculation purposes' for the 3 years to the dividend year less cumulative dividends paid for preceding 2 years prior to the dividend year [(a)-(b)]</td><td rowspan="2"></td></tr>
<tr><td>(b) Cumulative dividends paid for the preceding 2 years prior to the dividend year.</td></tr>
<tr><td>(4)</td><td colspan="2">Maximum Dividend from Surplus (least of (1) (2) and (3))</td><td></td></tr>
</table>

Source: The department's Dividend Payment Form July 2022

5.2.2 Potential changes to calculation method and caps on dividends from surpluses

Below we consider three key issues related to the current calculation method for dividends from surpluses: caps and restrictions on dividend payments, the treatment of developer charges and the application of the Guidelines to County Councils.

The caps and restrictions on dividends from surpluses

The justification for the above-mentioned caps on dividends from surpluses is unclear. As discussed above, SOCs do not have a cap on the size of dividends from surpluses. The NSW Government benchmarks dividends payments from SOCs at 70% of net profit after tax, but this is a starting point for discussions and SOCs can increase or decrease the payment based on their own prevailing circumstances.

We also consider that the restriction on councils facing major capital expenditure (with such capital expenditure defined as 3% of total asset replacement costs) is unnecessary and overly prescriptive. It is reasonable that councils facing major capital expenditure may elect to defer the payment of significant dividends. However, this is best considered by councils on a case-by-case basis, taking into account a range of factors such as the size and timing of the capital expenditure, the local water utility's existing levels of retained earnings, the council's level of debt and the volatility of the utility's costs and revenues.

Drawing on the approach of NSW SOCs, a potential reference point for dividend payments by local water utilities could be 70% of NPAT. However, whether the utility decides to pay dividends that are higher or lower than this in any given year would likely depend on a range of factors.

Box 6 below lists examples of factors that local water utilities may wish to consider in determining their dividend payment amounts. The box shows that it is difficult to be prescriptive, as there can be a range of utility-specific factors to consider.

Box 6: Factors to consider when paying dividends

The decision to pay a dividend and how much likely depends on the circumstances facing the local water utility, including:

- **Revenue and/or cost volatility**: a utility may decide to have a lower dividend payment and higher level of retained earnings to assist in managing significant revenue and/or cost volatility. On the other hand, if the utility's costs and revenues are relatively predictable, it may favour a higher dividend payment.
- **Level of existing retained earnings**: if the utility has a large amount of retained earnings, it may decide to pay a higher level of dividends.
- **Where the utility is in its expenditure cycle:** for example, if faced with a period of significant increases in expenditure requirements or lumpy expenditure, the utility may choose to reduce or not pay dividends to manage that expenditure and to meet any other obligations it may face (for example, the costs of servicing debt).
- **Debt to equity balance**: if a utility has little debt, there may be scope to increase its debt to equity ratio by paying a higher dividend. If the ratio is high and there is proportionally a large amount of debt, the utility may choose to reduce or not pay dividends.
- **Expectations of shareholders (the council):** the council's policies, fiscal position, strategic initiatives, general service objectives or challenges and capital investment programs may inform decisions on the level of dividends to be paid from the local water utility.
- **The local water utility's level of prices, service quality and/or reliability:** where warranted, the utility may be able to reduce its prices, or improve service quality and/or reliability by foregoing or reducing some payment of dividends.

If local water utilities can comply with eligibility criteria demonstrating efficient pricing and service outcomes, we see no basis for caps or restrictions on dividends from surpluses. We therefore propose removing the caps and restrictions on dividends from surpluses.

Removing caps and restrictions on dividends from surpluses would provide local councils and their utilities with the discretion to determine how much of the utility's surplus should be paid as dividends (while the eligibility criteria and information/reporting requirements should provide other stakeholders with assurance that dividends are not coming at the expense of efficient pricing and service outcomes).

The treatment of developer charges revenue

Initial consultation suggested that some stakeholders were unclear about whether revenue from water and sewerage developer charges should be included as income when calculating a local water utility's surplus.

Like revenue from periodic water and sewerage prices, water and sewerage developer charges recover a share of the capital and operating costs of providing water and sewerage services to new development. This includes an allowance for a return on the utility's capital investment in water and sewerage assets[30], which is an economic cost of providing water and sewerage services.

The methodology local water utilities should use in setting their water and sewerage developer charges is outlined in the department's developer charges guidance, currently titled *2016 Developer Charges Guidelines for Water Supply, Sewerage and Stormwater*.

In our view, there is no reason why revenue from developer charges should not be included as income when calculating a local water utility's surplus.

Application to county councils

We consider the same dividend requirements should apply to county councils as to other councils, in terms of the dividends to apply to the county council in aggregate.

While the distribution of dividends between the constituent councils of county councils adds an element of complexity to the payment of dividends, it does not preclude the application of the same dividend requirements as to other councils.

In terms of how to distribute the dividends across the constituent councils, the current Guidelines state:

> *"A county council may pay a dividend to its constituent councils on a pro-rata basis, based on the number of assessments."*[31]

This appears to be a reasonable and relatively simple way of allocating dividend payments across constituent councils. However, there are also other potential methods – for example, dividends could be allocated in proportion to each constituent council's level of capital investment or total expenditure in the water and/or sewerage business over a relevant time period (although this is likely to be related to number of assessments).

Hence, we are interested in stakeholder views on:

- whether individual county councils should be given flexibility as to how dividend payments are allocated across their constituent councils
- what allocation method or methods should be applied, if such methods are to be specified in the Guidelines.

We would also like to hear whether there should be any additional dividend requirements for county councils.

[30] Through the discount rate in the developer charges methodology (see: Department of Primary Industries, Water, *2016 Developer Charges Guidelines for Water Supply, Sewerage and Stormwater*, June 2016).

[31] NSW Department of Planning and Environment, Regulatory and Assurance Framework for Local Water Utilities, p. 33-34, July 2022.

5.3 Information/reporting requirements for dividends from surpluses

5.3.1 Current requirements

Under the current Guidelines, a council wishing to receive a dividend from its water utility should give the department:

- the council's minutes resolving achievement of the eligibility criteria and its decision to pay a dividend, including the amount of the dividend
- a statement of compliance and statement of dividend payment
- a dividend payment form with its calculation of the maximum dividend
- its special-purpose financial statements for the dividend year
- an unqualified independent financial audit report for the water supply and/or sewerage business(es)
- an independent audit report verifying that overhead reallocation charges are fair and reasonable.

The department will assess the information supplied and the local water utility's current strategic planning assessment and pricing outcomes, and advise the council and/or the Minister of any non-compliance with the Guidelines.[32]

5.3.2 Proposed changes

The current information and reporting provisions appear aimed at ensuring that dividend payments are accurate and consistent with dividend requirements, including the eligibility criteria. This suggests they may need to change if the dividend requirements change. They may also depend on what is required for councils to demonstrate compliance with the eligibility criteria (see section 5.1.2).

Given stakeholder views on dividend requirements (including dividend eligibility criteria and caps), we seek comment on whether and, if so, how the current information/reporting requirements can be improved. For example, some stakeholders may consider some information/reporting requirements are unnecessary (and hence add unnecessary regulatory burden), whereas others may consider there is a case for additional or alternative information.

We note that if county councils are given flexibility as to how dividend payments are allocated across their constituent councils (discussed above), then an additional reporting requirement for county councils could relate to the allocation methodology used and the resulting dividend payment amounts to constituent councils. For example, this could be a requirement for an independent audit report verifying that the allocation of dividend payments across constituent councils is fair and reasonable, or simply a statement from the county council explaining the allocation method and amounts and supporting it as fair and reasonable. We are interested in stakeholder views on the

[32] NSW Department of Planning and Environment, Regulatory and Assurance Framework for Local Water Utilities, p. 35, July 2022.

merits of such requirements, including whether their benefits would exceed their costs and how they might work in practice.

Have your say on dividends from surpluses

Eligibility criteria

7. Can the current criteria for dividends from surpluses be improved? If so, how?
8. What are your views on the potential eligibility criteria presented in this Paper?
9. Should the eligibility criteria consider any other factors, such as operational performance; what do you think about that?
10. How could compliance with the eligibility criteria be best demonstrated?

Caps and restrictions on dividends

11. Should the current caps and restrictions on dividends from surpluses be removed?

Calculation methodology

12. Should revenue from developer charges be included in operating income when calculating a local water utility's surplus?

Apportioning dividend payments across county councils

13. Should individual county councils be given flexibility as to how dividend payments are allocated across their constituent councils?
14. What method or methods should a county council be able to apply in allocating dividends across its constituent councils, if such methods are to be specified in the Guidelines?
15. Should there be any additional dividend requirements for county councils?

Information/reporting requirements

16. Can the current information/reporting requirements be improved to promote efficient dividend outcomes?
17. If individual county councils are given flexibility as to how to allocate dividend payments across their constituent councils, what if any assurance or reporting requirements should apply to these payments?

A. Summary of stakeholder consultation questions

The table below provides a full list of the questions raised in this Consultation Paper. We invite stakeholders to respond to these questions and to raise any other issues relevant to this review.

Table 1: Summary of consultation questions

	Summary of stakeholder consultation questions
Dividends from local water utilities	
1.	Why has your local water utility not paid a dividend from its surpluses? What determines whether it pays a dividend and, if so, how much?
2.	Why do only a few local water utilities pay dividends from surpluses?
3.	What, if any, implication does this have for our review of dividend requirements?
Dividend requirements and principles	
4.	What principles should be used to guide dividend requirements for local water utilities in NSW?
Tax equivalent dividend payments	
5.	Should there be a cap on tax equivalent dividend payments, or should the cap be removed?
6.	If there should be a cap on tax equivalent dividend payments, why and what should be the cap?
Dividends from surpluses	
7.	Can the current criteria for dividends from surpluses be improved? If so, how?
8.	What are your views on the potential eligibility criteria presented in this Paper?
9.	Should the eligibility criteria consider any other factors, such as operational performance; what do you think about that?
10.	How could compliance with the eligibility criteria be best demonstrated?
11.	Should the current caps and restrictions on dividends from surpluses be removed?

	Summary of stakeholder consultation questions
12.	Should revenue from developer charges be included in operating income when calculating a local water utility's surplus?
13.	Should individual county councils be given flexibility as to how dividend payments are allocated across their constituent councils?
14.	What method or methods should a county council be able to apply when allocating dividends among its constituent councils, if such methods are to be specified in the Guidelines?
15.	Should there be any additional dividend requirements for county councils?
Information/reporting requirements	
16.	Can the current information/reporting requirements be improved to promote efficient dividend outcomes?
17.	If individual county councils are given flexibility as to how to allocate dividend payments across their constituent councils, what if any assurance or reporting requirements should apply to these payments?

Source: The department