ROCKBlue

Online Lecture Series (OLS)

Access to Finance and Creditworthiness for Water Utilities

04 June 2020

Questions and Answers

Summary:

Participation in the 04 June Access to Finance and Creditworthiness for Water Utilities lecture was well-attended with over 125 registrants from 24 countries. During the course of the lecture, many participants posed questions via the Zoom Chat function and a number of them were answered during the lecture's Q&A sessions. However, given the time constraints of the lecture, the presenters were only able to respond to a fraction of the questions posed. Herein is an embellishment on some of the questions already answered as well as answers to questions that had not yet been answered.

Access to Finance:

Q1. As water utilities are public or quasi-public entities, how can they better present themselves to access finance for capital investment?

A1. Financiers of water utilities, particularly development finance institutions (DFIs) and other development partners, are likely to conduct their own internal assessment of creditworthiness for utilities in addition to the more market-driven ratings conducted by ratings agencies. These will largely take into account the nuances of the sector. Institutional investors, who typically are driven more by financial than social returns, will look for successful debt service on concessionary loans from DFIs as indicators of future success.

Q2. How can a credit rating be helpful in raising money from grant-making entities?

A2. Although typically framed as being beneficial for capital infrastructure at commercial market rates, water utilities seeking money from foundations or aid agencies can also benefit from demonstrating their creditworthiness, especially as this is one indicator of a number of factors that describe the utilities performance (not exclusively the financial health of the utility). Whilst a credit rating is rarely a requirement for a grant-making body, it can help to demonstrate the transparency and accountability of the water utility and also demonstrate, if the rating itself is strong, that the utility is on a progression that may ultimately yield a financially-sustainable entity; this, for example, is well in line with the USAID 'journey to self-reliance.'

Q3. How do limited capital markets constrain access to finance for water utilities?

A4. At first glance, an external observer might think that markets in the global south are severely limited, particularly for water utilities, given the relatively low number of issuances in domestic markets. A deeper exploration, though, might yield that this is not the case. In fact, both the institutional investors in capital markets – insurance companies and pension funds – and the market regulators themselves are keen to see more investment opportunities denominated in local currency at fixed rates over a long period of time, which is a perfect match for infrastructure investment in the water sector. A constraint instead might be that the water utilities themselves perceive themselves to be non-creditworthy to the institutional investors, which is a point that can be disproven through an independent credit rating.

Q4. Which has been more significant in determining utilities' appetite/demand for commercial finance - (1) internal variables - i.e., creditworthiness rating or (2) is it exogenous political economy variables beyond creditworthiness ratings?

Q5. Although closely linked, a utility's demand for commercial finance is not driven by a credit rating; instead, a strong credit rating is a useful tool to help a utility in its quest for commercial finance.

Lenders/investors offering commercial finance may use a strong credit rating as a prompt in the early-screening of potential deals in their respective pipelines to conduct deeper due diligence. The appetite for commercial finance is likely driven more by the availability of concessionary finance – which is offered at attractive rates – and the urgency of project delivery – as commercial financiers are traditionally able to make investment decisions more quickly than their concessionary peers.

Q6. How can risk mitigants, particularly guarantees, attract commercial finance, particularly for entities or instruments that are not investment-grade?

A6. As described in the lecture, risk mitigants, traditionally in the form of guarantees, have been successfully introduced to raise the credit rating of an entity or an instrument, as found in the proposed Kenya Pooled Water Fund. In most countries, institutional investors, particularly pension funds, are mandated to invest only in local-scale investment-grade instruments and entities, which is likely to preclude many water utilities across the global south. The introduction of a credit enhancement can be extremely valuable as, in some instances, it can raise the credit rating of a utility or instrument from speculative-grade to investment-grade, thereby opening a wide range of potential investors that would otherwise view the water sector as inaccessible.

Q7. Can the wealthy uncle be a technology that ensures that the investor gets paid?

A7. The description of the wealthy uncle, acting as a guarantor for all of the borrowing nephews, is a metaphor for the role that guarantees play in helping to mitigate risk on transactions. Whether it comes from the national government, from an external development partner, or a private-sector intermediary, a guarantee from a well-rated financial institution with deep pockets will inevitably help to raise a credit rating for a speculative-grade issuer or instrument.

Credit ratings:

Q8. How do credit ratings agencies differentiate between current and past management, particularly in terms of poor governance and leadership, in making an assessment?

A8. GCR's credit ratings take three years back two years forward approach to financial analysis. Accordingly, the adverse performance of an organisation, whether due to shareholders, management or external factors is considered when analysing the financial position, particularly if weaknesses in the current financial position are informed by poor historical performance. However, to the extent that new policies and procedures have been implemented to rectify past underperformance, including a change in the management team, these will be considered in the forward-looking projections and rating analysis. However, GCR is unlikely to improve a credit rating just because a new management team has been appointed or a new strategy is being implemented. Rather the potential positive movement from such improvements will be highlighted in the positive rating triggers, and higher ratings may be accorded if the improvements materialise in a stronger entity financial and operating profile.

Q9. How widely can a credit rating for a utility, especially if it is a public entity, differ from that of the sovereign?

A9. A credit rating for a utility will not be able to pierce the Sovereign ceiling indicated by the National Governments credit rating. However, it can certainly fall below the sovereign. This will depend on *inter alia*, the financial performance of the utility, the type and extent of financial support from the National Government, the importance of the utility to the National Government, the quantum of support that will likely be required.

Q10. What is the impact of the ratio 'accounts receivable/revenue' on creditworthiness? What is the frequency of commissioning of shadow credit ratings? How do they differ in practice, and in price, from public credit ratings?

A10. An analysis of accounts receivable is critical in terms of determining the operating efficiency of the organisation (can they bill correctly and collect their debt) and in terms of making cash flow projections. There is little point in recognising revenue and profitability when it cannot be collected.

Q11. How is governance performance measured in practice? In general, what is (versus should be) the weight of ESG performance in the overall creditworthiness of water utilities, taking into account that utilities are expected to achieve social objectives?

A11. For most entities ESG will not be an important factor in the credit rating, as they generally fulfil some sort of public good. However, ESG may have a negative impact on the rating where it impacts a utility's access to funding. For example, a power utility that operates substantial coal fired power plants may find that it is no longer able to access concessionary development funding because of its carbon footprint.

Q12. Many utilities are granted exclusive rights for coverage in a particular area, effectively giving them a monopoly. How does a credit rating capture this when thinking about potential competition?

A12. The business profile of a monopoly utility will likely be high because of its monopoly position. However, other factors such as operating efficiency, quality infrastructure (or lack thereof), operating flexibility afforded (or constrained) by legislation, will also contribute to the assessment.

Q13. How does low investment in sanitation services, particularly as universal access to water and sanitation is foremost in SDG 6, impact a credit rating for a utility responsible for provision of services in both sectors?

A13. GCR will consider the impact the utility's social responsibilities will have on its financial profile. Thus, any free services a utility is required to provide will be considered in assessing production and income forecasts. Similarly, substantial capex obligations will be considered against future cash requirements.

A credit rating aims to be as impartial as possible and avoids factoring in pledges made by entities other than the entity or instrument discretely being rated. If, however, government announces a pledge that all water utilities will need to provide comprehensive water and sanitation infrastructure by 2030 without an accompanying additional amount of money, a credit rating agency will include this information in its future projections in line with what the utility itself predicts.

GCR will consider all obligations on the utility, as well as commitments of funding. However, determination will be made as to the likelihood and the actual quantum of the obligations/ commitments. GCR will factor in all capex obligations for which there is committed expenditure, and to a lesser extent capex for which there are firm plans in place, but no approvals or commitments. Similarly, firm funding commitments from the National Government of development agencies, especially where there is a track record of such support

Q14. In addition to private-sector credit ratings agencies, assessments of utility performances are also conducted by other entities, such as WASREB in Kenya. How do these assessments factor into the credit rating of a private-sector credit ratings agency, and how greatly – again in the case of WASREB – did the ratings for the water service providers differ between GCR and WASREB?

A14. GCR will perform its own analysis on each entity as our reports have a very specific focus. Nevertheless, assessments conducted by other agencies may be utilised for informational purposes, especially to gleam broader market research and statistics.

Q15. How exactly is corporate governance taken into account for a credit rating?: 1) Is the external audit report the only source of information you consider or are other factors equally considered (structure of the BoD, possible regulators compliance with corporate governance standards)?

A15. GCR defines management as the control of a company's operations within the context of its strategies, policies, processes, and procedures set by a governing body. Whereas governance is the creation, measurement and compliance with the same policies, processes, and procedures. If management are concerned about achieving results, then the governing bodies should be concerned about how the results are achieved.

GCR views the score purely as a negative adjustment on the competitive position score. For most rated entities, the score will remain neutral. Often, management and governance failures are not seen until after the event, when it has already impacted the financial or competitive profile. However, if GCR finds significant single or cumulative concerns, GCR may create a negative score for the issuer.

Factors that GCR will include in our Governance assessment for utilities include

- Composition of the Board and where authority to appoint the Board resides
- Ability of executive management to operate without political interference
- Strength and independence of oversight bodies
- Incidence of malfeasance and track record of holding guilty parties to account
- Stability and implementation of corporate strategy

Q16. On the last slide for National Water in Uganda, the presenter showed that the utility enjoys substantial donor funds. How significantly did those grants impact the utility's performance and, subsequently, its credit-rating?

A16. Being able to demonstrate strong working relationships with development organisations is important or utilities in developing countries, because it widens the access to funding, and such funding is often on concessionary term. Furthermore, development agencies also often a lot of technical and management support that may be valuable to the efficient running of the utility.