



State Comptroller of Israel | Annual Report 72a – Part Two | 2021

Mekorot Water Company Ltd.

Mekorot Water Company Ltd. – Financial Audit

Mekorot Water Company Ltd. – Financial Audit

Background

Mekorot Water Company Ltd (the Company or Mekorot) is a government company designed to develop the water resources in Israel and provide water to its residents. The Company is the provider of a vital service and a natural monopoly in the field of water supply. The Company is also a "National Water Authority" and its duties include establishing the national water enterprise (the National Water Carrier), managing it and provide water from it. Government decision 4514 of February 2019¹ determined several steps to reinforce the financial resilience of Mekorot and improve the efficiency of the water economy, among others due to a situation that requires performing significant investments in the water economy. The Government Authority for Water and Sewage (the Water Authority) is in charge of managing the water and sewage economy and among others determines the revenues and the tariff of Mekorot.

1 Decision 4514 by the 34th government "Creating an infrastructure to increase the extent of development in the water economy in order to contend with prolonged periods of drought and amendment of government decisions" (24.2.19)



Key figures

20%

The portion of the Mekorot component in the average water tariff for home consumers in years 2012–2019².

1,659 MCUM

Supplied by Mekorot in 2020, which are 69% of the total water supply in Israel and approximately 82% of home consumption.

NIS 1.5 billion

The extent of Mekorot investments for each year from 2020–2022 according to the development plan approved by the Water Authority in December 2019.

5.4%

The actual rate of return on capital for 2020 (1.6% in 2019). Mekorot's normative yield rate totals 5.5% according to cost rules.

NIS 13.5

billion

Mekorot's total liabilities as of December 2020. In this component there has been a growth of 24% in years 2016–2020 compared to a growth of 24% in fixed assets and a growth of 16% in equity. This situation weakens the Company's financial resilience.

NIS 3.9 billion

Total revenues from water sales for 2020. The total profit for this year reached NIS 199 million (compared to a loss of NIS 24 million in 2019 among others due to the costs of the early retirement program which totaled NIS 264 million, according to the collective agreement of June 2019 regarding Mekorot's efficiency).

² Thus, for example, in 2019 Mekorot comprised an average consumer tariff of NIS 1.829 per CM which is 20% of the average residential consumer tariff which totaled NIS 9.02 per CM.

Audit actions

 From August to December 2020 the State Comptroller's office audited financial issues associated with the Mekorot Company's consolidated statements – which include the subsidiaries that are almost fully owned by Mekorot. The subjects examined were: presentation of the consolidated financial statements, analysis of essential sections in the consolidated balance sheet and the profit and loss statement; financial ratios from the consolidated statements; analysis of the disparities between recognized costs in tariff sources and actual costs; analysis of the budget against actual performance; the implementation status of steps determined by government decision 4514 and obstructions to implementation. In addition, data for 2016–2020 was examined. The audit was conducted at Mekorot and the Water Authority. Supplementary examinations were conducted at the Ministry of Finance, the Ministry for Water Resources and the Government Companies Authority.

Key findings

 **Debt coverage ratio** – in 2015–2016 the debt coverage ratio³ of Mekorot was over 10% and reached 14.6% in 2016. From 2016 a sharp drop occurred in the debt coverage ratio to a rate of 4.5% in 2018, which expresses a decrease in the Company's debt repayment ability through the annual flow from ongoing activities. In 2019 an increase to a rate of 7.2% occurred. According to Mekorot statements from December 2020, the rate of this ratio is 8.6%. It should be stated that the debt coverage ratio of Mekorot is low compared to the average ratio for 2016–2018 of infrastructure companies in Israel and worldwide, where it ranges from 10%–18%.

 **The leverage ratio** – since 2017 there has been a consistent increase in the leverage ratio⁴, and it reached a rate of 69% in 2019. According to Mekorot statements from December 2020, this ratio is 70.6%. The higher the leverage ratio, the more the Company relies on external capital for financing its activity and less on its own equity. It should be stated that the leverage ratio of Mekorot is high compared to the average

3 The debt coverage ratio expresses an operational profit (loss) with added depreciation discounts and additional sections that do not entail cash flows and deducted of interest and tax payment, relating to the scale of debt. The index expresses the Company's ability to regularly fulfill repayment of its loans (including bonds).

4 The leverage ratio is calculated as the ratio between the adjusted debt and the equity capital.



leverage ratio for 2016–2018 of infrastructure companies in Israel and worldwide, where the ratio is 60%.

-  **Reporting of activity sectors** – the sectoral reporting in the Mekorot books does not differentiate between activities according to the various types of water as separate profit centers – desalinated water, natural clear water, treated waste water and brackish water – as required by government decision 2318⁵.
-  **Investments in the innovations and improvements budget** – from 2015–2019 the annual companies water utilities depreciation was on average NIS 525 million. The development budget for those same years was on average NIS 843 million, and the innovations and improvements budget was on average NIS 153 million, and matched the maximum investment amount defined in the rules. However, the average innovations and improvements budget was 4 times lower than the average annual depreciation for these years and 3 times the annual depreciation for 2019. The data indicates that most of the Company investments are in new water utilities and not in upgrading or improving existing water utilities, among others, due to the need for establishing new water utilities to expand the supply network and increase the transferable quantity of water, reliability of the water supply and the connection of areas that are not yet connected to the water system.
-  **The actual interest costs compared to recognized interest costs** – the actual interest costs of Mekorot for 2015–2019 were higher than the recognized interest costs in the tariff, due to weighted raising of average 12 years life span bonds which is higher than the average life span recognized in the tariff (ten years). In 2019 the difference was NIS 80 million. This difference and its expansion may affect the Company's upholding of financial resilience objectives.
-  **Collecting water fees from private producers** – by the audit completion date, December 2020, NIS 245 million owed by private producers were not collected, however according to rules of costs by the end of 2020 the Mekorot tariff for 2019 included NIS 115 million recognized as income from water fees, despite Mekorot not having actually collected them. Despite the Ministry of Energy CEO and the Water Authority's Economy Deputy Director General having notified at the Mekorot board of directors meeting in December 2019 of the Water Authority Administration's commitment to the outline of amending recognition in the tariff concerning private producers' debts, by the audit completion date the Water Authority Council had not yet amended the recognition outline as said.
-  **Implementation of the directives determined in Government Decision 4514 of 2019 to reinforce the financial resilience of Mekorot** – by the audit completion date the following steps included in the government decision had not been completed –

⁵ Government decision 2318, "Structural change in the Mekorot Group" (26.8.07).

transfer of rights in NWC assets⁶ and sale of the wastewater utilities and establishment of two other wastewater utilities (the wastewater issue is a condition for transferring NWC assets). Implementing these steps is among the conditions for promoting vital programs to improve Mekorot's financial ratios and its attainment of the goals set by the Financial Resilience Team according to Government Decision 4514, including the plan to register NWC assets in the Mekorot books and the program for betterment and sale of Mekorot lands and assets.

 **The program for betterment and sale of lands and assets** – Mekorot located four real estate assets for sale, of which the board of directors approved two for sale. The sale thereof is expected to improve the debt coverage ratio and leverage ratio. It was found that at the audit completion date, public tenders for the sale of the four real estate properties, which are designated for sale by tender procedure, had not yet been published.

 **Sale of recovery water utilities that Mekorot is required to sell** – due to a dispute between the Water Authority and Mekorot concerning the sales procedure of six wastewater treatment water utilities to private wastewater suppliers, Mekorot has not completed the sale of these water utilities, despite the government decision having determined and it being agreed by Mekorot that the sale would be performed no later than 31.10.19.

 **The financial goals set for Mekorot** – the Financial Resilience Team⁷, acting according to Government Decision 4514, set the following financial goals for Mekorot: (a) debt coverage ratio for 2020 to 2025 of no less than 8%; for 2026 to 2029 no less than 9%; and from 2030 no less than 10%; (b) a maximum leverage ratio that will not exceed 70% of year 2022, and aspiring to achieve 65%. In view of the findings in this report and the obstructions preventing unification of the NWC assets stated in the Mekorot books, there is concern that the Company may not achieve all of the determined goals.



Mekorot rating – Mekorot rating for June 20 is AAA\Stable. This rating is high and stable compared to tariffed government infrastructure companies in Israel.

Improving the efficiency of Mekorot's energy expenses – From 2015–2019 the Company improved its energy efficiency. In 2015 actual expenses exceeded the tariff

6 The assets of the National Water Carrier (NWC) were defined in Government Decision 2306, "Mekorot - structural change" (30.7.02), as "real estate assets and the attached thereto known together as the National Water Carrier that are designated, used and held to provide water and all the government assets designated and used to provide water and are held by the Mekorot Water Company for the government...".

7 A team headed by the Companies Authority Manager and the Water Authority Manager and participated by representatives from the Budgets Department, the Accountant General and the Ministry of Energy together with Mekorot.



recognized expenses by a total of NIS 3.1 million; in comparison, in 2019 the actual expenses were lower than the normative expenses creating a profit of NIS 26.4 million. Most of the energy efficiency derived from electricity purchasing agreements with private electricity manufacturers and replacing equipment to reduce energy expenses.

Key recommendations

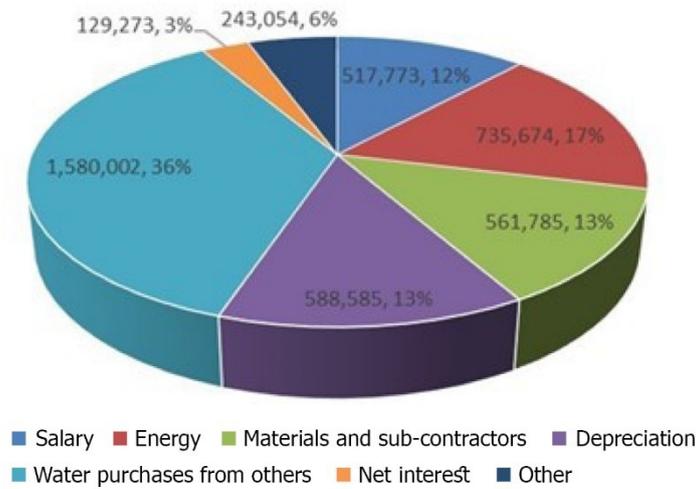
-  It is recommended that Mekorot, the Water Authority and the Financial Resilience Team operate to prevent deterioration in the Company's debt coverage and continue to act to implement the steps determined in Government Decision 4514 of 2019 to reinforce the Company's financial resilience and thereby prevent any situation where demoting Mekorot's rating may be considered.
-  It is recommended that alongside the promotion of new water utilities in the development program determined by the Water Authority, as part of the development program determination process the Water Authority examine Mekorot's investments in the existing systems compared to their annual depreciation and life span in order to maximize the benefit in preserving existing systems.
-  It is recommended that Mekorot continue to act to complete the realization of the four assets it located and formulate a multi-year plan for asset betterment. This becomes more acute in view of the value differences of the said four assets between their current condition and their condition as available for construction. It is further recommended that Mekorot perform assessor evaluations of additional relevant assets and consider presentation at fair value in the notes to the financial statements, particularly in view of their substantial asset value.
-  The Ministry of Energy, which is expected to receive the authority of the Ministry of Water Resources, the Water Authority, the Companies Authority and Mekorot should settle their disputes and operates to remove the obstructions preventing the implementation of the government decision on sale of wastewater utilities, which constitutes an obstruction to the unification of the NWC assets stated in Mekorot books and to sale of the Mekorot real estate assets, and to the implementation of the program for the redemption of recovery water utilities. Those actions should be taken particularly in relation to recovery utilities that are not exempt from the obligation to conduct tenders according to the Ministry of Justice decision. Moreover, the Water Authority and Mekorot should push for a solution that will enable implementation of the government decision regarding the establishment of two companies for the wastewater treatment utilities in the Jezreel Valley and in the Hefer Valley under the conditions detailed in the government decision. If the government decision on certain issues cannot be implemented, it is recommended that the Ministry of Energy and the Companies Authority promote alternative solutions, including initiating a proposal to amend Government Decision 4514 on said issue, so that it can be implemented.

It is recommended that the Financial Resilience team meet at the frequency determined by its decision of December 2019. It would be appropriate for the implementation team, headed by the Ministry of Energy CEO, to whom the authority of the Water Resources Ministry are expected to be transferred, will continue to monitor the implementation of the government decision and act to advance it.



It is recommended that as part of the periodical update of the Mekorot tariff, the Water Authority Council examine the recognized costs calculation for the Company's financing costs. It is further recommended that the Companies Authority and Mekorot continue to examine from time to time the average life span of loans it takes. It is also recommended that the Financial Resilience Team continue to monitor the development of disparities between the set tariff interest and the actual interest paid by Mekorot, and discuss this matter.

**Segmentation of Mekorot expenses for 2020
(in thousands of NIS)**





Summary

Mekorot is a government company with high and stable rating, whose bonds are traded on the stock exchange. However, it is facing many challenges, including a significant growth in the extent of the Company's development programs; its liabilities are 77% of the balance sheet; the debt coverage and leverage ratios are not as good as their ratios in similar companies in Israel and worldwide and even compared to its set goals. Most of the steps determined by Government decision 4514, intended for reinforcing Mekorot's financial resilience, have been performed or are in the process of being performed. The steps determined regarding wastewater treatment have not yet been implemented, despite constituting a condition for performing additional steps that are vital for its financial resilience. In view of the importance of Mekorot's financial resilience to the success of implementing the development program and due to the national importance of this program which is designed to prepare for prolonged periods of drought, the Ministry of Energy, to which the Water Resources Ministry authority are expected to transfer, the Water Authority, the Companies Authority and Mekorot should resolve their disputes and act to remove the obstructions preventing the implementation of these steps.