



New South Wales
T R E A S U R Y

COMMERCIAL POLICY FRAMEWORK

**REPORTING AND MONITORING POLICY
FOR GOVERNMENT BUSINESSES**

Office of Financial Management

**Policy &
Guidelines Paper**

PREFACE

The *Commercial Policy Framework* is a suite of policies that seeks to replicate within Government businesses appropriate disciplines and incentives that lead private sector businesses towards efficient commercial practices.

One key element of the Framework is effective monitoring of Government businesses. Effective measuring and reporting of performance enables the Government to safeguard the value of Government businesses and ensures accountability for performance.

This *Reporting and Monitoring Policy* applies to all NSW Government businesses.

The *Reporting and Monitoring Policy for Government Businesses* replaces the *Monitoring Policy for NSW Government Businesses*, October 1992. This *Policy* updates monitoring and reporting practices in line with developments in Government policy and in private sector requirements and practices. Major changes from the 1992 Policy include increased disclosure for capital projects and an obligation for Government businesses to continuously disclose material information as it arises.

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EXECUTIVE SUMMARY

The *Reporting and Monitoring Policy for Government Businesses* provides the requirements for information disclosure and communications in businesses planning, performance monitoring and reporting.

This *Policy* focuses on reporting and monitoring from a shareholder perspective. For Government businesses, it is a surrogate mechanism for accountability disciplines and reporting requirements faced by private sector counterparts.

Government businesses must disclose strategy, objectives and performance targets, to their owners, the people of New South Wales as represented by the Government, and NSW Treasury as financial agent for the Government.

As such Government businesses are required to:

- undertake a corporate planning process including preparing a business plan, in consultation with NSW Treasury, that aligns with the State Budget preparation cycle and is the basis for the annual Statement of Corporate Intent (SCI) or Statement of Business Intent (SBI),
- demonstrate a commitment to achieving financial and non-financial objectives and targets set by the Government when undertaking corporate planning,
- sign an SCI or SBI which represents an agreement with the Government on the objectives and obligations by which the business will operate over the next 12 months and following years,
- provide quarterly reports of performance and other requested information to their relevant Minister and NSW Treasury on behalf of the Treasurer,
- provide timely disclosure of information which may have a material effect on the value of the business including information which may influence Government decisions or may require the Government to comment, and
- have in place robust internal procedures for capital projects and provide information to NSW Treasury on major capital projects including quarterly reports required in this policy.

1 BACKGROUND

Government businesses deliver a range of essential goods and services to the community. The Government expects these businesses to deliver strong financial performance, as well as efficient and reliable services for the NSW community.

The *Commercial Policy Framework* has applied to Government businesses since 1988. The Framework consists of a suite of guidelines and policies aimed at replicating appropriate disciplines and incentives that lead private sector businesses towards efficient commercial practices. The objective of the *Commercial Policy Framework* is to maximise the contribution made by Government businesses to the wealth and welfare of the people of New South Wales by requiring Government businesses to allocate and use resources efficiently.

One of the key conditions required to achieve efficiency is independent performance monitoring and accountability by the management and board (if applicable) for financial performance. Government businesses are not subject to performance assessment by external equity and debt markets to which private sector organisations are accountable to. Hence, the Government needs to establish performance monitoring arrangements to ensure management and boards are held accountable for performance. Robust monitoring is also an important governance mechanism to ensure that the exercise of power within and by businesses is appropriate.

NSW Treasury acts to ensure the Government's financial interests as the owner of Government businesses are adequately protected and, as financial advisor, assists the Government to monitor performance from a shareholder's perspective.

1.1 Objectives of the Policy

The Policy aims to:

- safeguard the value of Government businesses and help ensure appropriate returns from taxpayers' investments,
- enhance accountability in the management and control of the businesses and provide clarity on reporting and monitoring requirements,
- balance the need for accurate and timely information against any compliance burden, with appropriate best-practice from the private sector and consistency with legislation, and
- promote co-operation, openness, mutual respect and sharing of information between management, boards, the Treasurer and other Ministers, regulatory agencies, and NSW Treasury

1.2 Definitions

Government business refers to:

- Public Trading Enterprises (or Public Non-Financial Corporations under ABS classifications). Public Trading Enterprises that have been corporatised, State Owned Corporations (SOCs), are included in this classification,
- Public Financial Enterprises (or Public Financial Corporations under ABS classifications), and
- General Government businesses or business units (or General Government agencies under ABS classifications) which are also non-Budget dependent and to which the *Commercial Policy Framework* applies. Generally, applicability is determined by NSW Treasury by looking at factors such as the extent to which the entity:
 - engages in market production,
 - is in open competition with private sector companies,
 - generates sufficient revenues to cover production costs, and
 - relies on independent sources of income other than government subsidies.

Shareholders for the purposes of this Policy means:

- in respect of SOCs, the Voting Shareholders as defined in the *State Owned Corporations Act 1989 (NSW) (SOC Act)* and other legislation¹.
- in respect of all other Government businesses (non-SOC Government businesses), Ministers of the State who act as representatives of the people of New South Wales, for example, the Treasurer/Minister for Finance and the Portfolio Minister.

1.3 Application and Scope

This Policy applies to all Government businesses as defined above.

Government businesses have various disclosure obligations.² These include formal and statutory reporting, responses to ad-hoc requests, and disclosure of various decisions and other developments. This Policy replaces the *Monitoring Policy for NSW Government Businesses*, 1992, and is not intended to amend or replace any other reporting requirements that exist under legislation, Government circular or memoranda, other Government policies or Treasurer's Directions.

¹ For example, under the *Public Sector Employment and Management (Treasurer) Order 2005 (NSW)*, the Minister for Finance is a voting shareholder for all statutory State Owned Corporations except for the rail SOCs.

² For example, see Appendix 1 for a list of legislative reporting requirements.

1.4 Working with NSW Treasury

NSW Treasury, as the principal financial advisor to the Government, monitors the financial performance and position of Government businesses. NSW Treasury and Government businesses should work collaboratively, with ongoing and open communication, to achieve strong financial performance and to maximise wealth on behalf of the shareholders, ultimately the people of New South Wales

Each business has an appointed NSW Treasury officer who is the first point of contact for all financial matters related to the business. Generally, financial reporting and communications should be directed to this officer in the first instance. The NSW Treasury officer can also provide assistance to the business with any financial-related query and/or liaise with other areas of NSW Treasury to provide assistance, and may also coordinate matters on behalf of the Treasurer in relation to administrative, financial and policy tasks. For SOCs, NSW Treasury may also co-ordinate matters on behalf of the Shareholders.

1.5 Relationship to Other Policies in the Commercial Policy Framework

Compliance and adherence to other policies within the *Commercial Policy Framework* are regularly monitored and reviewed as part of this *Reporting and Monitoring Policy*. These include:

- *Financial Distribution Policy for Government Businesses*³
- *Capital Structure Policy for Government Businesses*⁴
- *Government Guarantee Fee Policy for Government Businesses*⁵
- *Treasury Management Policy*⁶
- *Tax Equivalent Regime for Government Businesses*⁷
- *Manual for the National Tax Equivalent Regime*⁸
- *Social Program Policy for NSW GTEs*⁹
- *Guidelines for Assessment of Projects of State Significance*¹⁰
- *State Owned Corporations Indemnity Policy*¹¹

The above policies are available on the NSW Treasury website at www.treasury.nsw.gov.au.

³ NSW Treasury, *Financial Distribution Policy for Government Businesses*, TPP 02-3, June 2002

⁴ NSW Treasury, *Capital Structure Policy for Government Businesses*, TPP 02-7, September 2002

⁵ NSW Treasury, *Government Guarantee Fee Policy for Government Businesses*, TPP 04-2, July 2004

⁶ NSW Treasury, *Treasury Management Policy*, TPP 02-5, September 2002

⁷ NSW Treasury, *Tax Equivalent Regime for Government Businesses*, TPP 03-4, June 2003

⁸ Australian Taxation Office, *Manual for the National Tax Equivalent Regime*, October 2001

⁹ NSW Treasury, *Social Program Policy for NSW GTEs*, July 1994

¹⁰ NSW Treasury, *Guidelines for Assessment of Projects of State Significance*, TPP 02-4, June 2002

¹¹ NSW Treasury, *State Owned Corporation Indemnity Policy*, TPP 03-6, October 2003

2 STATEMENT OF CORPORATE INTENT/ STATEMENT OF BUSINESS INTENT

2.1 Purpose and content

The Statement of Corporate Intent (SCI) for SOCs and Statement of Business Intent (SBI) for non-SOC Government businesses is an annual agreement between the Shareholders and the business. An essential purpose of this agreement is to enhance accountability for performance and provide the business with certainty as to the Shareholders' expectations for financial performance.

The SCI/SBI summarises the key elements of the business plan which the Government business has formulated as part of its annual corporate planning process. It is a critical document for commercial performance monitoring of Government businesses as it documents the objectives, strategies and obligations by which the business will operate over the next 12 months and the following years. In particular, it sets financial targets and sets clear limits on the scope of activities the business may undertake.

Content requirements are outlined in **Appendix 2**. Additionally, guidelines are released by NSW Treasury annually that detail specific required content, forecast period and format. For SOCs in competitive markets, the *SCI Guidelines* also indicate content that is commercial-in-confidence and not to be tabled in Parliament but included in a commercial-in-confidence attachment.

2.2 Process

Negotiating the SCI/SBI is a key process in which the priorities and preferences of the Shareholders are reflected in the strategic direction, activities and financial parameters of the business. It is a process in which Shareholders concerns are addressed.

The business planning process which culminates in the SCI/SBI should be collaborative between the Government businesses and the Shareholders, with the Treasurer represented by NSW Treasury. The planning process should be characterised by ongoing and open communication between NSW Treasury and the business. A Government business should hold at least one formal meeting with NSW Treasury on its business plan and the related SCI/SBI prior to their finalisation.

The timetable and process for the SCI/SBI will be advised by NSW Treasury annually and timing may vary due to requirements of the NSW annual budget statement (the State Budget). For SOCs, the SCI is required under legislation to be completed and delivered to the Shareholders by the end of September¹² and is tabled in Parliament.¹³

¹² SOC Act, section 21(3)

¹³ *ibid*, section 26(1)(d)

2.3 Alignment with the NSW State Budget

The planning process and the business plan should be the basis of financial projections that feed into both the State Budget and the SCI/SBI. Accurate financial projections are essential for State Budget purposes as financial distributions (dividends) and tax equivalent payments from Government businesses are a source of revenue to the State and intrinsic to the State's fiscal strategy.

Businesses are required to align the substantive completion of their planning process, including internal approval of the business plan, with the preparation of the State Budget.

In exceptional cases where circumstances change between submitting projections for the State Budget and finalising the SCI/SBI, the SCI/SBI may be amended to take into account the changed circumstances. Such exceptional circumstances would only generally include those outside the control of the business such as a regulatory determination.

2.4 The Business Plan

The SCI/SBI must be underpinned and supported by a business plan and financial targets set during the planning process of the business.

Business plans, detailing the strategy and operations of the business for the short, medium and long term, should be submitted to NSW Treasury, as supporting documentation, with the SCI/SBI. Business plans are internal working documents and may contain commercially sensitive information. If so, they should be labelled "commercial-in-confidence" although generally, the business plan is confidential to the Shareholders.

The Government business is responsible for the format and content of the business plan although minimum content requirements are outlined in **Appendix 2**.

The business plan should outline the performance indicators to be used in measuring the business's accomplishments vis-à-vis its objectives. The indicators should include standard financial measures of profitability, liquidity and leverage (see **Appendix 3**) as well as value based measures of performance (see **Appendix 4**).

3 REPORTING REQUIREMENTS

Government businesses are responsible for regular and timely disclosure of information to the Shareholders including consultation with NSW Treasury as advisor to and the representative of the Shareholders. Government businesses are encouraged to communicate with NSW Treasury on any financial matter in which the Shareholders may be interested. The reporting requirements described in this section and section 4 detail the minimum level of disclosure required.

3.1 Quarterly reports

Government businesses should provide a report on performance for each three month period to NSW Treasury. These quarterly reports should emphasise actual quarterly and year-to-date performance of the business, comparisons with targets in the SCI/SBI and highlight any significant issues. Government businesses are encouraged to meet with NSW Treasury to discuss the results for the quarter. While these reports are not made public, if they contain commercially sensitive information they should be labelled “commercial-in-confidence”. Specific content requirements are outlined in **Appendix 2**.

A quarterly report should be provided to NSW Treasury as soon as practicable:

- **For businesses requiring approval from a governing board:** within ten working days of the board meeting following quarter end at which the quarterly results are considered, extended to 20 working days for the quarter end which is also financial year end.
- **For all other businesses:** within 20 working days after quarter end, extended to 30 working days for the quarter which is also financial year end.

3.2 Half-yearly reports (State Owned Corporations only)

The SOC Act requires SOCs to submit a report on the operations covering the first six months of the financial year and the SCI must state the kind of information that is to be included in the half-yearly report. This must be delivered to the Voting Shareholders within one month after the end of the first six months of the year¹⁴.

The half-yearly report should contain summary financial statements (Statement of Financial Performance, Statement of Financial Position and Statement of Cash Flows) as well as a brief commentary highlighting key issues and performance relative to its SCI targets. Issues may include full-year performance expectations, changes in risk factors, capital expenditure projects, strategic issues or other factors significantly impacting on, or expected to impact on, performance.

The half-yearly report is tabled in Parliament and, hence, should not contain commercial-in-confidence information.

¹⁴ SOC Act, section 23

Relationship with the Quarterly Report for the 2nd Quarter

As the half-yearly report is due at around the same time and may contain similar information as the quarterly report for the 2nd quarter, in some cases, the SOC and NSW Treasury may agree that a separate quarterly report is not required. In such cases, the half-yearly report should be submitted with a commercial-in-confidence attachment containing information that would have been included in the report for the 2nd quarter but is not included in the half-yearly report.

This attachment will be used for quarterly monitoring purposes and is not part of the half-yearly report that is tabled in Parliament.

3.3 Forecasts for the State Budget

Both accrual and cash based projections for financial distributions and tax equivalents for the current financial year and the following four years must be periodically reported as part of the State Budget revenue projections. The specific timing and format of the projections is advised by NSW Treasury as required for State Budget purposes.

As discussed in Section 2, financial forecasts provided for the State Budget should be based on the business plan and other current information. This requires businesses to align the substantive completion of their planning process with the preparation of the State Budget as forecasts should be based on the business plan.

3.4 Continuous Disclosure

Government businesses are required to disclose, in a timely manner, information to the Shareholders which a reasonable person would expect to have a material effect on the value of the Government business.¹⁵ This will include information which:

- may affect financial expectations (both short and medium term impacts on forecast revenue, profit or dividends by $\pm 10\%$ as well as long term impacts on value such as potential remediation costs)
- may influence Government decisions in relation to a Government business, or
- is of a legitimate interest to the Government and on which the Government may be required to comment

¹⁵ This mirrors continuous disclosure obligations for companies listed on the Australian Stock Exchange. ASX Listing Rule 3.1 requires disclosure of any information to the ASX that a reasonable person would expect to have a material effect on the value of the company, immediately the entity becomes aware of the information. While the legislative underpinning of this requirement (Corporations Act, s 674) is aimed at helping investment make better informed investment decisions (see ASIC Policy Statement 95), a key principle of the Listing Rules is “timely disclosure of information in which security holders...have a legitimate interest”. This recognises a duty of disclosure to shareholders (ASX Guidance Note 8) applicable to Government businesses.

Specific disclosure requirements will depend upon each Government business, their particular circumstances and the nature of the information. Businesses should be guided by the overall principle to disclose material information which could materially affect the value of the business. Further guidance on information required to be disclosed is provided in **Appendix 2**.

Disclosure should be made in writing and generally made to the Government business's NSW Treasury officer who is the point of contact. Timing will depend on the nature of the disclosure:

- where the information is likely to require immediate and urgent ministerial attention, the business should disclose the information as soon as practicable after becoming known to the business. Disclosure should also be made to the Shareholders concurrently with NSW Treasury,
- where the information is the result of a decision made by the business, the disclosure should be made within five working days of making the decision or before being made public, whichever is earlier,
- otherwise, the disclosure should be made as soon as practicable following the external event, but no later than ten working days

Businesses should not wait for the next quarterly report to disclose such information as delay may inhibit timely action.

If related to commercially sensitive matters, disclosures should be provided commercial-in-confidence and will remain confidential to the Shareholders and NSW Treasury.

4 CAPITAL PROJECTS

The Government is increasingly focused on ensuring all agencies, including Government businesses, make appropriate and informed procurement decisions that ensure best value for money. In particular, processes for capital projects should be robust. This section details specific requirements which have been introduced in this Policy.

The need to ensure value for money in procurement and physical asset management for all Government agencies requires a robust evaluation and monitoring system for capital projects and assets which comprises:

- appropriate internal procedures and monitoring,
- a review by NSW Treasury of capital projects under the *NSW Government Procurement Policy* and reporting of information at key points or milestones in the project (non-SOCs),
- a review by NSW Treasury of the capital program as part of the SCI process (SOCs),
- quarterly reporting of ongoing capital projects,
- review of certain projects and cost variations under the *Guidelines for Projects of State Significance*, and
- understanding of the remaining life and required maintenance of physical assets

4.1 Internal Procedures and Monitoring of Capital Projects

Government businesses should have a documented internal policy for capital asset planning, procurement and management. This document should:

- specify procedures for identifying, planning, monitoring and implementing proposed capital works and reviewing their actual against intended performance,
- specify procedures for planning, monitoring and implementing physical asset maintenance to manage asset risks through their effective service life, and
- identify responsibilities, accountabilities and sign-off limits for project approvals and variations, management, monitoring and review.

At a minimum, the internal policy should:

- require the development of an asset strategy, including an asset management plan for capital investment and asset maintenance, and a procurement strategy either:
 - **non-SOCs:** under the *NSW Government Procurement Policy (Procurement Policy)* and the *Total Asset Management Policy*¹⁶ (*TAM Policy*), or
 - **SOCs:** as internally developed requirements (SOCs are encouraged to follow the *Procurement Policy* and *TAM Policy* if consistent with their corporate intent).
- require the building of a business case¹⁷, including a financial appraisal or economic appraisal (indicating which one is appropriate under different circumstances) for all capital projects,

¹⁶ NSW Treasury, *NSW Government Procurement Policy*, TPP 04-1, July 2004

NSW Treasury, *Total Asset Management Policy*, TPP 04-3, August 2004

¹⁷ For further information on building a business case, refer Premier's Department, *Business Case Guidelines*, 2000, which includes a business case template

- require a review of the business case by persons independent of the project team, and
- incorporate the legislative and regulatory framework and Government policy requirements, including specific policies under the Commercial Policy Framework¹⁸ and *Working with Government - Guidelines for Private Financed Projects*¹⁹.

Upon request, businesses may be required to submit their internal policies to NSW Treasury (labelled commercial-in-confidence if appropriate) to ensure adherence to minimal requirements and promote best practice.

4.2 Review of Capital Projects

4.2.1 Non-SOC Government businesses and SOC Budget funded projects

Non-SOC Government businesses are subject to the *TAM Policy* and the *Procurement Policy*²⁰. The *TAM Policy* requires Government businesses to prepare and submit Total Asset Management plans to NSW Treasury annually. The *Procurement Policy* requires submission of Project Appraisal Reports to NSW Treasury prior to funding approval and milestone reports at key points of project implementation for high-risk projects or projects over \$50 million.

SOCs should also comply with the *TAM Policy* and the *Procurement Policy* for capital projects which are specifically Budget funded.

Due to the application of the above policies, the rest of this Section 4.2 does NOT apply to non-SOC Government businesses or SOC projects which are specifically Budget funded and comply with the *Procurement Policy*. The following section 4.2.2 only applies to self-funded capital projects of SOC to which the *Procurement Policy* has not been applied.

4.2.2 SOC

Where the capital project is a project of State Significance as defined under the *Guidelines for Projects of State Significance*, is otherwise high risk (see below) or the value of the project exceeds \$50 million, SOC are required to submit to NSW Treasury:

- the financial appraisal²¹,
- a risk assessment including risk identification and mitigation strategies,
- proposed timetable, and
- results of an independent review of the business case undertaken by persons independent from the project team.

¹⁸ NSW Treasury, *Guidelines for Assessment of Projects of State Significance*, TPP 02-4, June 2002

NSW Treasury, *Financial Appraisal Guidelines*, TPP 97-4, July 1997

¹⁹ NSW Treasury, *Working with Government – Guidelines for Privately Financed Projects*, November 2001

²⁰ Also refer NSW Treasury, *Procurement Policy Reform*, TC 04/07, 1 July 2004

²¹ NSW Treasury, *Financial Appraisal Guidelines*, TPP 97-4, July 1997

NSW Treasury's role in capital projects of SOCs

The overall capital works program and level is assessed annually by NSW Treasury and agreed with the Shareholders as part of the SCI process. In order to understand the drivers of the level and profile of capital works, NSW Treasury will review the business case of specific new capital projects as part of the SCI review.

In particular, NSW Treasury will review the business case for capital projects to commence in the year to which the SCI relates where they are considered high risk or where the value of the project exceeds \$50 million. This may be required before such a project can be included in the SCI. SOCs are encouraged to submit the required information on new capital projects as they emerge rather than waiting for the SCI process to commence. If a business case for such a project has not been completed at the time the SCI is finalised and the SCI's capital program includes the project, SOCs are required to submit the business case to NSW Treasury for review as soon as practicable during the year.

NSW Treasury's role is to check the business case for comprehensiveness, logic, compliance with applicable guidelines and policies and consistency with the strategic objectives of the corporation. Review by NSW Treasury does not lessen the responsibility or accountability of the board and management to make appropriate decisions based on complete and accurate business cases.

Risk Assessment of capital projects of SOCs

Whether the project is high-risk should be mutually agreed between NSW Treasury and the SOC. SOCs should have formal processes and procedures in place to assess the level and type of risk of projects.

If not mutually agreed with NSW Treasury, risk can be assessed by using the Gateway Risk Profile Assessment tool accessible from the NSW Treasury website²². The tool is a high level indicator of potential risk on projects by using a set of criteria. The online tool asks approximately 20 multiple-choice questions and produces a score which indicates whether a project is high risk. The tool also helps identify the resources and controls needed to manage the project. However, the output is not a replacement for a detailed risk assessment or plan.

Independent review of the business case of capital projects of SOCs

For capital projects of SOCs considered high-risk or where the total value exceeds \$50 million, an independent review of the business case should be undertaken after the project has been defined and all alternatives have been assessed but before seeking board approval²³.

This review should generally be undertaken by persons independent from the project team but can be an internal review conducted by the SOC. Where project team is made up of a cross-functional team which includes a senior member from the corporate centre (e.g. finance) who maintains clear reporting lines and remains independent and objective, such a member may undertake the review but they must cover the seven key elements described below.

²² www.treasury.nsw.gov.au

²³ Where internal policy does not require board approval, the independent review should be conducted before seeking final approval from the relevant decision-maker.

Alternatively, the SOC may request a review be done externally as a Gateway Review similar to that facilitated by the Department of Commerce on behalf of NSW Treasury for non-SOC Government agencies.

The independent review should assess whether seven key elements have been adequately considered: affordability, service delivery, governance, sustainability, risk management, stakeholder management and change management. The framework provided under the *Procurement Policy* of the business case Gateway Review is a useful tool for reviewers. The independent review is not a replacement for robust decision-making or management of project risk by management and the board.

The review findings may range from fine tuning project details, requiring more work to be done on the business case or recommending a change in direction. The findings should be submitted to the project leader for appropriate action. The review findings as well as any action the project leader has taken as a result of the review should also be submitted to NSW Treasury.

4.3 Quarterly Reporting of Projects

All Government businesses should provide quarterly information on their major capital projects. Government businesses who submit information to the Department of Commerce via the Major Projects Reporting System already satisfy this requirement.

For all other Government businesses a summary progress report on each of the business's major capital projects should be included in the quarterly report. Whether a project should be included in the quarterly report should be determined in consultation with NSW Treasury having regard to the overall nature and value of the project relative to the Government business, as well as the impact, type and size of any risks. In some businesses, it may be useful to use a value threshold to pre-determine what should be included as a major project. In other businesses, it may be appropriate to "screen out" routine capital expenditure spending for "stay-in-business" maintenance. Note that for SOCs, the list of "major capital projects" may be different to the projects that require additional submissions to NSW Treasury under section 4.2.2 above. The required format for quarterly reporting on capital projects will be advised annually through the *Guidelines for the Statement of Business/Corporate Intent*.

4.4 Projects of State Significance

For projects covered under the *Guidelines for the Assessment of Projects of State Significance*²⁴, businesses are also required to obtain in-principle approval from Budget Committee and final approval from the voting shareholders (SOCs) or the Treasurer (non-SOCs). Some additional information is required under those *Guidelines* such as certification of board approval (for SOCs) or Portfolio Minister approval (for other Government businesses). This applies to new projects defined under those *Guidelines* and any variations in cost over 10% or a significant change in the functionality of previously approved projects.

Businesses must also submit a post-implementation review 12 months after the completion of the implementation phase.

²⁴ NSW Treasury, *Guidelines for Assessment of Projects of State Significance*, TPP 02-4, June 2002

5 ROLES AND RESPONSIBILITIES

Management and boards (if applicable) of Government businesses are responsible for:

- conducting an annual business planning process which culminates in a business plan, SCI/SBI and forecasts for the State Budget,
- communicating with Shareholders, and NSW Treasury on behalf of the Shareholders, and consider the views of the Shareholders during the planning process, and
- making certain disclosures to the Shareholders including quarterly reports, information on capital projects and other timely disclosures where the information can be reasonably expected to have a material effect on the value of the business.

NSW Treasury analysts are responsible for:

- assisting, advising and ensuring Government businesses comply with the *Commercial Policy Framework* and other applicable Government policies,
- co-ordinating information and communicating with Government businesses on behalf of the Shareholders including during the planning process, and
- providing advice, analysis and assessment of the performance of Government businesses to the Shareholders and feedback to Government businesses.

NSW Treasury is responsible for the development of the *Reporting and Monitoring Policy* and its administration. The policy-making role involves:

- developing, promulgating and promoting the Policy,
- engaging stakeholders in consultative processes,
- gathering feedback on the effectiveness of the Policy, and
- updating and revising the Policy where necessary.

Further information

General inquiries concerning this document should be initially directed to:

Commercial Policy Branch
NSW Treasury
Telephone: (02) 9228 3095
www.treasury.nsw.gov.au

Appendix 1: Legislative reporting requirements

Generic legislative reporting requirements which Government businesses are subject to include, but are not limited to the following:

- *Annual Reports (Statutory Bodies) Act 1984 (NSW)* and *Annual Reports (Statutory Bodies) Regulation 2000 (NSW)* require Government businesses to submit Annual Reports to the appropriate Ministers, for tabling in both Houses of Parliament,
- *Public Finance and Audit Act 1983 (NSW)* requires Government businesses to prepare financial statements subject to audit by the Auditor-General, as well as scrutiny by the *Public Accounts Committee* of the Legislative Assembly²⁵,
- *Public Authorities (Financial Arrangements) Act 1987 (NSW)* includes regulations relating to borrowing and investment functions,
- *Independent Commission Against Corruption Act 1988 (NSW)* applies to Government businesses as public authorities, and to the directors, officers and employees of Government businesses as public officials,
- *Freedom of Information Act 1989 (NSW)* applies to Government businesses and their subsidiaries,
- *Protected Disclosures Act 1994 (NSW)* applies to public officials employed under the *Public Sector Employment Act 1988* and employees of SOCs and their subsidiaries,
- *Corporations Act 2001 (Cth)* (does not apply to statutory SOCs except as may be provided by regulation) applies to entities registered under the Act and to company SOCs, and
- *State Owned Corporations Act 1989 (NSW)* applies to corporatised Government businesses. The numerous reporting requirements include:
 - an annual *Statement of Corporate Intent* to be tabled in both Houses of Parliament,
 - half-yearly report to the Voting Shareholders on operations, and
 - other information as requested from time to time by the Voting Shareholders.

²⁵ Part 3, Part 4 and Section 59B applies to statutory SOCs and their subsidiaries

Appendix 2: Content requirements

A2.1 Statement of Corporate Intent and Statement of Business Intent

The *Guidelines for the Development of the Statement of Corporate Intent and Statement of Business Intent* are released by NSW Treasury annually. These Guidelines detail the required content, forecast period and the format of specific content. For SOCs in competitive markets, the *SCI Guidelines* also indicate content that is commercial-in-confidence and not to be tabled in Parliament but included in a commercial-in-confidence attachment.

The SCI/SBI must include:

- objectives of the business and summary of strategic direction,
- a description of core business activities,
- financial and non-financial performance targets that have been agreed with the Shareholders (see **Appendix 3** for a sample of financial performance targets),
- overview of the capital expenditure program containing a brief outline of its nature and purpose and linkage with business objectives and a list of new capital projects over \$50 million or high-risk,
- information on social programs and non-commercial activities,
- information on major risks, including financial risks,
- a statement regarding adherence to the *Commercial Policy Framework* including this *Policy*, accounting policies applied in the accounts and agreed disclosure obligations,
- information the business will include in its Half-Yearly Report (SOCs only), and
- any additional representation or commitment required by the Shareholders such as adherence to other Government requirements.

As an agreement between the Government business and the Shareholders, the final SCI/SBI should be signed by the Shareholders, the Chair (where applicable) and the Chief Executive/Managing Director.

A2.2 Business Plan

The business plan should be a high quality document and meet the Shareholders' requirements and expectations.

The business plan should generally cover a ten year planning period unless a shorter period between senior management and/or the board (if applicable) and NSW Treasury has been agreed. In any case, the business plan should cover no less than a five year planning horizon and the capital works program for no less than ten years.

At a minimum, the business plan must include:

- mission and objectives of the business including the nature and scope of activities,
- assessment of the internal and external environment the business operates,
- strategies including any key milestones and timing for achieving these milestones,
- detailed financial projections for ten years including capital expenditure, and a breakdown of assumptions and value/cost drivers,
- financial and non-financial performance targets underlying the financial projections (for example, capital structure targets), including compliance with *Commercial Policy Framework* policies and guidelines,
- detailed capital and investment program supporting the capital expenditure projections including the asset strategy clearly linking physical assets with business objectives and asset acquisition, maintenance and disposal plans,
- statement of the extent to which the business will provide returns on the Shareholders' investment in the business and value creation in the short, medium and long term, and
- an assessment of risk including an annual risk management return. Government businesses are required to demonstrate their understanding and management of their exposure to risks.

Measures of Financial Performance

The business plan must demonstrate that the business has a clear focus on financial performance, subject to any other mandated imperatives and objectives.

Business plans should contain an analysis of financial indicators to measure profitability, solvency and liquidity. Please see **Appendix 3** for some key financial indicators Government businesses should consider using. The business plan must also demonstrate how the business is enhancing value relative to the cost of capital. Please see **Appendix 4** for the method for measuring value-based business performance.

Where possible, businesses should include activity based costing analysis as part of their planning. This is recommended for strategic reviews when determining which activities and outputs will be undertaken or produced.

A2.3 Quarterly Reports

Quarterly reports should accurately report on a business's performance for the quarter. Government businesses and NSW Treasury should agree on the detailed contents and format of the quarterly report. At a minimum, the following should be included:

- 1 **Summary of the quarter's results** – quarter and year to date results and benchmarks compared against SCI/SBI targets, changes to full year forecasts, explanations of material variances ($\pm 10\%$) and comparisons with the previous quarter or the corresponding quarter from the previous year (whichever is more appropriate).
- 2 **Key driver analysis** – movements in the underlying drivers of the business and the impact of movements on financial performance.
- 3 **Financial health** – measures of profitability, liquidity, solvency and value as agreed with NSW Treasury (see **Appendix 3** and **4** for measures).
- 4 **Capital expenditure** – year-to-date capital expenditure and any corresponding impacts on future performance and a summary of progress of major projects (see section 4).
- 5 **Risk analysis** – a summary of any risk exceptions (or changes in risk status) and explanations of the implications or issues arising and actions undertaken to address the risk²⁶.
- 6 **Strategic Issues** – comments on strategic or other issues if required.
- 7 **Agency specific issues** – any other financial or non-financial information that may assist the Shareholders to understand the performance of the business.

If required, from the information provided by Government businesses and in consultation with the businesses, NSW Treasury will prepare an analysis or assessment report to the Shareholders on an “exceptions basis”.

A2.4 Continuous Disclosure

As part of the continuous disclosure requirements, businesses are not required to disclose exogenous general information. However, if the information has a particular effect on the entity (for example, it effects the viability or solvency of a business), then the effect may be required to be disclosed.

²⁶ This includes any changes to risks as outlined in the SCI/SBI and any new risks which have subsequently emerged. For new risks, the quarterly report should contain details including a description of the risk, the impact on value or other consequences, an assessment of the probability that the risk will materialise and proposed actions including responsibility, resources and timing

Whether or not information will need to be disclosed concerning an incomplete proposal or negotiation or other information which is not yet definite will depend upon the nature of the information, the size of the potential impact on the businesses and the degree of prior disclosure made to NSW Treasury or the Shareholders. For example, if a significant risk has been identified as part of the SCI/SBI or quarterly reporting process, ongoing disclosure will not be required regarding how the business is managing the risk. However, if the nature of the risk changes significantly, then this should be disclosed as part of the business's continuous disclosure obligation.

The fact that a Government business has entered into preliminary negotiations with a third party should be disclosed if the outcome has the potential to materially affect financial projections, may influence Government decisions or is of legitimate concern to the Shareholders. Where time allows, this may be disclosed as part of the quarterly monitoring regime.

Where information relates to an event or development where the impact can be reasonably quantified, the business should report its estimate of the likely financial effect, including its impact on projected financial distributions.

Appendix 3: Key Financial Ratios and Measures

Ratios

	Accounting Definition	FIS Definition ²⁷
Profitability Ratios		
EBITDA margin (%) Indicates profitability of operating revenues. It captures trends in operating revenues and expenses independent of accounting policies and capital and tax structures	$\text{EBITDA} / (\text{Total revenues} - \text{Capital grants received from government}^{28} - \text{Interest income})$	$\text{EBITDA} / (\text{Total revenues} - \text{CGRG} - \text{Interest income})$
Return on average assets (ROA) (%) Indicates the rate of return earned from assets, regardless of capital structure. It measures the efficiency with which an entity uses its assets to produce profits. It is useful for comparing profitability of businesses in similar industries. (Full year measure only.)	$\text{EBIT}_{\text{yr1}} / [(\text{Total assets}_{\text{yr0}} + \text{Total assets}_{\text{yr1}}) / 2]$	$\text{EBIT}_{\text{yr1}} / [(\text{Total assets}_{\text{yr1}} + \text{Total assets}_{\text{yr2}}) / 2]$
Return on average equity (ROE) (%) Indicates rate of return to equity shareholders after paying returns for debt providers. Useful to compare companies in similar industries and against return to alternative investments with similar risk level. (Full year measure only.)	$\text{OPAT}_{\text{yr1}} / (\text{Total equity}_{\text{yr1}} + \text{Total Equity}_{\text{yr0}}) / 2$	$\text{OPAT}_{\text{yr1}} / (\text{Total equity}_{\text{yr1}} + \text{Total Equity}_{\text{yr0}}) / 2$
Leverage		
Gearing (%) Indicates the extent to which a business is financed by debt, or its leverage. Should be compared against the SCI/SBI minimum-maximum targets	$\text{Interest bearing debt} / (\text{Interest bearing debt} + \text{Total Equity})$	$\text{Interest bearing debt} / (\text{Interest bearing debt} + \text{Total Equity})$
Debt to equity ratio (%) Another measure of financial leverage. The greater the debt to equity ratio the more geared is the business.	$\text{Total interest bearing liabilities} / \text{Total Equity}$	$\text{Total interest bearing liabilities} / \text{Total Equity}$

²⁷ FIS is NSW Treasury's financial information system. Should there be differing results between the two formulae, the Accounting-based formula should prevail.

²⁸ Capital grants received from government (CGRG) are grants received from Government entities to be used for capital projects and acquisitions.

	Accounting Definition	FIS Definition²⁷
Cash flow Adequacy		
EBITDA interest coverage Indicates the business's ability to meet periodic interest payments from operational cash earnings. Shows flexibility for interest payments to be maintained when interest rates increase or earnings are reduced	EBITDA/ Interest expense	EBITDA / Borrowing cost
FFO interest coverage Indicates the business's ability to meet periodic interest payments from cash earnings generated by the business. Like EBITDA Interest Cover, this shows the number of times interest can be paid from cash earnings.	FFO / Interest expense	FFO / Borrowing cost
FFO to total debt Indicates the percentage of debt payable from current cash earnings. When reversed, the measure indicates the number of years it would take a business to pay outstanding debt assuming no further debt raising or dividend payments and continuation of current cash flow levels. (Full year measure only.)	FFO / Interest bearing liabilities	FFO / Interest bearing liabilities
Other		
Dividend payout ratio Dividends as a proportion of earnings	Dividend / OPAT	Dividend / (Surplus before distribution – CGRG)
CSO funding Payments made by Government to Government businesses for non-commercial activities undertaken	CSO	CSO

Definitions²⁹

	Accounting Definition	FIS Definition
Earnings Before Interest and Taxes (EBIT)	Profit from ordinary activities before income tax - CGRG + Net borrowing cost	Surplus before distribution - CGRG + Net borrowing cost
Surplus before distribution		Retained revenues – Total expenses + Gains(Loss) from disposal of assets
Earnings Before Interest and Taxes, Depreciation and Amortisation (EBITDA)	EBIT + Depreciation + Amortisation	
Operating Profit Before Tax (OPBT)	Profit from ordinary activities before income tax – CGRG	Surplus before distribution – CGRG
Operating Profit After Income Tax (OPAT)	Profit from ordinary activities after income tax – CGRG	Surplus before distribution - CGRG - Tax equivalent
Net Borrowing Costs	Interest expense – interest income	Borrowing costs – interest income
Capital Grants from Government (CGRG)	Grants received from the Government to be used for specific capital projects and acquisitions.	
Funds from Operations	OPAT from continuing operations + Depreciation + Amortisation + Deferred income tax + any other major non-cash item	Surplus before distribution – Tax equivalent + Depreciation + Amortisation + Deferred income tax + any other major non-cash item

²⁹ Items defined here may also be used as indicators

Appendix 4: Measuring Business Value

Measuring and striving to maximise shareholder wealth is an important goal for managers of businesses, including Government businesses.

Shareholder value increases when the economic value of the business increases or when it generates economic profits. Economic profit is created when net profit exceeds the cost of capital. The fundamental notion is that the capital employed in a business is not free and the cost of capital should be included to calculate economic profit. Value based indicators, such as Economic Value Added³⁰, measure this increase in economic wealth.

The concept is applicable to Government businesses where there are opportunity costs borne by the Government of the capital employed (both debt and equity) by the businesses. Value-based measures of performance provide a meaningful performance benchmark of value to hold Government businesses accountable, especially in the absence of external markets for equity or debt and, in many cases, with limited or no directly comparable benchmarks.

Value based measures:

- ensure appropriate accountability for new investment decisions by identifying the correct hurdle rates, as well as measure returns on existing investments,
- enable business managers to be accountable for the growth or decline in value in the absence of an external market for equity (for example, a share price) or debt, and
- provide a meaningful performance benchmark, especially in the absence of relevant private sector benchmarks for businesses which have limited directly comparable peers.

In applying value-based measures of performance, cash flow is more meaningful than accounting profit given the varying impact of different accounting standards and the need to consider other investment requirements (such as working capital).

The value based indicator in this appendix (see formula below), the value based return (VBR), is the suggested value based measure for *for profit* Government businesses. It measures the incremental return that a business generates from using its capital assets on top of the cost of funding the assets. VBR aims to capture the gain over the cost of capital that the business has created in using these capital assets for a given period. It measures the profit generated by the business after covering both its operating expenses and capital costs. VBR can be used to assess whether businesses are continually contributing to shareholder value by generating positive returns. Simplicity of calculation, traceability and consistency of application across all Government businesses are the principles behind the preference for this measure.

³⁰ Stern et al, The EVA Challenge, Chapter 2

VBR consists of two components, the return on capital assets and cost of capital. Value is added when return on capital exceeds its cost, that is, when VBR is positive. Both the return on capital employed and the weighted average cost of capital are based on widely accepted, theoretically sound earnings and cost of capital measures.

The VBR formula is intended to be consistently and uniformly applied across Government businesses. However, differing circumstances under which these businesses operate may necessitate discretionary adjustments. These adjustments should be limited and only made when necessary to retain the measure's significance and intended meaning.

For instance, a less meaningful VBR could arise where businesses have invested in a capital project where returns will not be realised until some time in the future or where returns are restricted for reasons beyond the business's control. A similar case could arise if accounting profit is affected significantly by non-cash transactions. In these situations, accounting profit may be adjusted to the extent that:

- only transactions bearing on the cash position of the organisation are considered,
- non-cash effects resulting from accounting policies are minimised, and
- consistency between the revenue stream and the asset base is achieved

Modifying the VBR to make it completely cash-based should be avoided as this results in a plethora of adjustments which can vary widely even among similar entities.

Adjustments to the VBR formula require consultation and agreement with NSW Treasury. NSW Treasury's decision to allow the adjustment will consider materiality³¹, consistency (across reporting periods and across Government businesses) and traceability (allowing VBR to be independently re-computed based on readily accessible information). Adjustments should be clearly documented each time VBR is reported with changes from the previous period highlighted.

³¹ An amount which is at least 10% of the appropriate base amount may be presumed to be material unless there is convincing argument to the contrary.

Value Based Return (VBR)³²

$$\text{Value Based Return (\%)} = \text{RCE (\%)} - \text{WACC (\%)}$$

Where:

$$\text{Return on Capital Employed (RCE) (\%)} = \text{EBIAT} / \text{NOA}$$

$$\text{Weighted Average Cost of Capital (WACC) (\%)} = \frac{(1-t) R_e E}{(1-t + \gamma t) V} + \frac{(1-t) R_d D}{V}$$

$$\begin{aligned} \text{Earnings Before Interest After Tax}^{33} \\ \text{(EBIAT)} &= \text{Surplus before distributions} \\ &\quad - \text{Capital grants received from Government for capital expenditure} \\ &\quad - \text{Developer contributions} \\ &\quad + \text{Net Borrowing Cost} \\ &\quad + \text{Expenses (Gains) related to unfunded super} \\ &\quad - \text{Tax Equivalentents} \\ &\quad - \text{Tax Effect of Interest Expense} \end{aligned}$$

$$\text{Net Operating Assets (NOA)} = \text{Net Working Capital} + \text{Non-current Assets net of FITB}^{34} \text{ and Pre-paid Superannuation Contributions}^{35}$$

$$\text{Net Working Capital} = \text{Current Assets net of cash assets} - \text{Current Liabilities net of short term loans}$$

$$\text{Net Borrowing Cost} = \text{Interest Expense} - \text{Interest Income}$$

$$\text{Tax Effect of Interest Expense} = \text{Corporate tax rate}^{36} \times \text{Interest Expense}$$

Recommended Computation of WACC³⁷

Debt providers and shareholders require a return for their investments in Government businesses. These returns represent the cost of capital to the business normally computed as the weighted average cost of capital (WACC) derived using the capital asset pricing model.

For the purposes of calculating a Value-Based Return, a post-tax (WACC) is the appropriate cost of capital to use. This is in contrast to the pre-tax WACC required for the purposes of asset valuation³⁸.

³² FIS accounts are used to provide a common reference point. However, the measures may be derived on either FIS or accounting numbers.

³³ EBIAT is an after-tax, before-financing cost operating performance measure. It excludes the financing structure from operating performance but is after tax to align with investors' normal process of assessing investments in terms of after-tax yields.

³⁴ Future income tax benefits (FITB)

³⁵ An asset item reflecting the business's contributions over its superannuation liability at a particular time

³⁶ Currently 30%

³⁷ NSW Treasury's *Guidelines on Financial Appraisal* discusses WACC in more detail. Refer NSW Treasury's website for the latest issuance.

³⁸ AASB 136, paragraph 55. Refer NSW Treasury, *Guidelines for the Valuation of Physical Non-Current Assets at Fair Value*, available on the NSW Treasury website which includes a discussion on conversion and comparability issues between pre and post-tax WACC

The applicable formula is:

$$\begin{aligned} \text{WACC} &= \frac{(1-t) R_e E}{(1-t+\gamma t) V} + (1-t) R_d \frac{D}{V} \\ R_e &= R_f + \beta (R_m - R_f) \\ R_d &= R_f + \text{Debt premium} \end{aligned}$$

Where:

- E, D and V = target equity, target debt and total target equity and debt, respectively
- t = equivalent tax rate applicable to the business (currently 30%)
- γ = dividend imputation credits, unless further advised this is set at 50%
- R_e = the cost of equity
- R_f = risk free rate, unless further advised this will be the average yield to maturity of 10-yr Commonwealth Bond in the last 20 days
- R_d = cost of debt
- Debt premium = The Government Guarantee Fee rate applicable to the business (or its equivalent if entity is not under the GGF regime)
- β = equity beta, a measure of the sensitivity of the asset's returns to variations in the returns on the market portfolio, of the Government business
- $R_m - R_f$ = market risk premium³⁹

The WACC to be derived by each business is subject to review by NSW Treasury. For businesses with no debt and no prospect of raising any debt a target ratio of 30% debt to 70% equity will be used with debt premium set at zero. Equity betas may be derived by reference to the asset betas of representative firms, an industry or other acceptable benchmarks with these betas sourced from the Australian Graduate School of Management, Bloomberg or other reliable and reputable data providers. To estimate an appropriate equity beta for Government businesses⁴⁰:

1. Obtain equity betas from representative firms in Australia and other jurisdictions.
2. Convert the equity betas to asset betas for each firm:

$$\text{Asset beta} = \text{Equity beta} / (1 + (1-t + \gamma t) \text{Debt/Equity})$$

3. Estimate the asset beta appropriate to the Government business based on the computed asset betas of representative firms. Judgement will be required to choose an appropriate asset beta, such as based on asset betas of firms with a similar risk and business profile or by using averages or medians within an industry or sub-group within an industry.
4. Convert the appropriate asset beta to the equity beta using the Monkhouse formula assuming Debt Beta is zero and using the target debt (D) and target equity (E) of the business:

$$\beta = \text{Asset Beta} + (\text{Asset Beta} - \text{Debt Beta}) (1 - R_d / (1 + R_d) t) D / E$$

³⁹ Different studies have various market risk premium (MRP) estimates. Those considered to have an appropriate time horizons estimated MRP as between 5-7%. Unless further advised, the midpoint of this range (6%), close to the estimate used by most regulators, should be used as the common value for MRP.

⁴⁰ For further information and references, refer to Independent Pricing and Regulatory Tribunal, *Weighted Average Cost of Capital Discussion Paper*, 2002

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