



New South Wales
TREASURY

COMMERCIAL POLICY FRAMEWORK

GOVERNMENT GUARANTEE FEE POLICY FOR GOVERNMENT BUSINESSES

Office of Financial Management

Policy &
Guidelines Paper

Preface

The *Government Guarantee Fee Policy for Government Businesses* is a component of the NSW Government's Commercial Policy Framework.

The Framework aims to replicate within Government businesses the disciplines and incentives that lead private sector businesses towards efficient commercial practices.

The purpose of the *Government Guarantee Fee Policy for Government Businesses* is to ensure competitive neutrality between Government businesses and their private sector counterparts, with respect to the cost of debt. This document outlines the application of the Government guarantee fee and the methodology to determine the amount of the fee.

This policy supersedes the previous NSW Treasury policy document, *Government Guarantee Fee Policy for Government Businesses* (TPP 02-6, September 2002). This revised policy modifies the method for deriving the interest differentials used to calculate the guarantee fee.

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Secretary
NSW Treasury
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Executive Summary

The *Government Guarantee Fee Policy for Government Businesses* is a component of the NSW Government's Commercial Policy Framework. The Framework encourages Government businesses to operate in a commercial manner and to match the "best practice" performance of private sector businesses of similar risk.

The *Government Guarantee Fee Policy* is specifically designed to improve the competitive neutrality of Government businesses. Government businesses that hold debt guaranteed by the State of New South Wales have a financial advantage over private sector businesses by being able to borrow at interest rates based on the credit rating of the State.

Guarantee fees serve to expose Government businesses to the risk-related cost of debt they would have faced if they were required to borrow funds based on their stand-alone credit rating.

A guarantee fee is levied on the outstanding debt of Government businesses which:

- undertake commercial operations;
- have borrowings greater than \$1 million;
- have a credit rating lower than that of the State of New South Wales; and
- hold debt that is guaranteed by the NSW Government.

For each Government business with guaranteed debt, an annual credit rating is required in order to assess the ability of the business to meet its future debt obligations without the financial support of the NSW Government.

Guarantee fees are based on the average amount of both short-term and long-term debt a business has outstanding in any one financial year and the interest differentials associated with its particular credit rating. These differentials are revised annually and reflect the current interest rates payable on bank loans.

The fee for short-term debt is determined by multiplying the average short-term debt for the assessable period with the relevant interest differential. For long-term debt, a more sophisticated methodology is applied with consideration of the average maturity profile of the debt.

1. Introduction

The term ‘Government business’ is a generic term used in this policy paper for convenience and includes:

- Public Trading Enterprises;¹
- Public Financial Enterprises;² and
- General Government businesses (ie General Government non-Budget dependent agencies to which the Commercial Policy Framework applies).

The term Public Trading Enterprises (PTEs) encompasses State Owned Corporations (SOCs) that are distinguished by their corporatised status.

A government guarantee is an undertaking by the Government to cover the liability of a Government business in the event the business is unable to meet its debt servicing or other obligations.

The *Government Guarantee Fee Policy* is designed to ensure competitive neutrality between Government businesses and their private sector counterparts.

The policy requires Government businesses to borrow at a cost reflective of their individual credit worthiness. This approach encourages businesses to realise their full cost of debt and therefore develop appropriate debt management practices.

Government businesses are able to borrow funds at interest rates based on the credit rating of the State of New South Wales. A guarantee fee ensures that the businesses are subject to a rate of interest or cost of debt based on their own credit rating. The guarantee fee represents an extra charge to make up the difference between the interest paid by Government businesses and what they would have paid in the absence of a Government guarantee.

¹ or “Public Non-Financial Corporations” under Australian Bureau of Statistics (ABS) classification.

² or “Public Financial Corporations” under ABS classification.

2. Legislative Framework

The *Public Authorities (Financial Arrangements) Act, 1987* ('PAFA Act') provides the legislative basis for administering guarantee fees.

2.1 Borrowing requirements

Sections 7 and 8 of the *PAFA Act* provide that Government businesses, which are declared to be authorities for the purposes of the Act, can obtain financial accommodation subject to approval from the Treasurer and the Governor.³

Under section 10 of the *PAFA Act*, Government businesses are required to obtain all financial accommodation from NSW Treasury Corporation (TCorp), unless the Treasurer grants an exemption.

2.2 Guaranteed debt and guarantee fees

Section 22A of the *PAFA Act* provides for the automatic granting of a Government guarantee of *certain types* of financial accommodation. Section 22A only applies to financial accommodation obtained within/outside of Australia by an authority pursuant to part 2 of the *PAFA Act* and:

- by the issue of debentures, bonds, inscribed or registered stock, discounted securities or promissory notes (section 22A(1)(a)); or
- as consideration for an authority's assumption of liability for any obligation (section 22A(1)(b)); or
- as prescribed by the regulations, whether or not involving the issue of securities of any kind (section 22A(1)(c)).

The type of obligation referred to in section 22A(1)(b) is not merely an obligation to repay financial accommodation. Instead it refers to situations where financial accommodation is obtained for the purposes of entering into, or meeting, obligations owed by an authority to a third party. This means ordinary debt is *not* automatically guaranteed under section 22A(1)(b) merely because there is an obligation to repay it.

Section 22A(1)(c) provides for other forms of financial accommodation to be guaranteed, as prescribed by regulation. Clause 58 of the *Public Authorities (Financial Arrangements) Regulation 2000* prescribes any form of financial accommodation (not already specified under section 22A(1)(a) or (b) of the *PAFA Act*) obtained by an authority from TCorp.

³ Financial accommodation as defined in the *PAFA Act* typically includes debt instruments such as loans, promissory notes, debentures, bonds and discounted securities. For a full definition, refer to section 4 of the *PAFA Act*.

This means that the ordinary debt of Government businesses is automatically guaranteed, provided that it has been obtained from TCorp. Debt obtained from other lenders is not guaranteed, unless a specific debt has been explicitly guaranteed in writing by the Treasurer or is otherwise debt which has been obtained as consideration for an authority's assumption of liability for any obligation under section 22A(1)(b).

In accordance with section 22D of the *PAFA Act*, the Treasurer may charge Government businesses a fee in respect of debt guaranteed by the NSW Government. The Treasurer determines the amount and the timing of the fee.

2.3 Application to State Owned Corporations

For State Owned Corporations (SOCs), a statutory guarantee applies only to the extent that the board of the SOC and voting shareholders agree in writing, in accordance with sections 16 or 20U of the *State Owned Corporations (SOC) Act 1989*.

The same sections of the *SOC Act* provide that guarantee fees for SOCs may be separately fixed by the voting shareholders, in consultation with the board, at times determined by the Treasurer.

3. Application of Guarantee Fees

3.1 Criteria

A Government guarantee fee applies to Government businesses that satisfy all of the following criteria:

- undertake commercial operations;
- have an aggregate total of short-term and long-term Government guaranteed debt greater than \$1 million;
- have a credit rating lower than the State of New South Wales; and
- are authorities, as defined in the *PAFA Act* or scheduled under any other Act that refers to the Treasurer's role in providing a guarantee.

3.2 Exemptions

Government businesses with a credit rating equal to or above that of the State of New South Wales are not subject to a guarantee fee, as they pose no additional financial risk to the NSW Government.

The guarantee fee does not apply to authorities that receive a significant subsidy from the Consolidated Fund for day-to-day operating revenue, including non-commercial PTEs. The premise is that Government businesses that require significant Government assistance to supplement their operating revenues are not sufficiently commercial to warrant inclusion in the guarantee fee scheme. However, the Treasurer has the discretion to levy a guarantee fee on any authority with respect to a guarantee given for specific borrowings.

TCorp is not subject to guarantee fees since it acts as an intermediary and is not a primary borrower.

Special exemptions from the guarantee fee or reductions in the guarantee fee may be granted from time to time in exceptional circumstances to suit the specific situation of a Government business. Such exemptions or reductions should be applied for through NSW Treasury for consideration by the Treasurer. Any special exemption or reduction given will be for a fixed term.

4. Method to Determine Guarantee Fees

Guarantee fees are based on the following variables:

- the stand-alone credit rating of a Government business in relation to the credit rating of the State of New South Wales;
- the interest differentials associated with the business' credit rating;
- the amount of short-term and long-term debt held by businesses in any one financial year; and
- the average term to maturity of a business' guaranteed long-term debt.

4.1 Credit rating

All Government businesses with guaranteed debt levels greater than \$1 million, and not subject to an exemption, must obtain a credit rating annually on a stand-alone basis. The stand-alone credit rating measures a business's financial standing independent of explicit or implicit financial support from the Government. This information is required to assess a business' level of competitive advantage.

Government businesses pay for their individual rating assessments. NSW Treasury selects the credit rating agency on the basis of a competitive tender. This requirement ensures that there is a consistent and unbiased approach to the assessment and allocation of credit ratings. The use of an independent rating agency also ensures that the NSW Government is separate from the rating process. This separation is necessary given that the NSW Government holds the dual role of owner and provider of debt finance.

Government businesses with a total guaranteed debt level exceeding \$10 million must obtain a rating from the agency nominated by NSW Treasury. Those businesses with a total guaranteed debt between \$1 million and \$10 million have the option of obtaining an estimate of their stand-alone credit rating from the rating agency or NSW Treasury. This threshold is set because the cost of the rating assessment would be relatively high for Government businesses with low debt levels.

Credit rating agencies undertake assessments that are forward looking and therefore a credit rating of a Government business is an assessment of its ability to meet its obligations regarding its debt in the future.

4.2 Interest differentials

Each interest differential provides an estimate of average interest rates paid by borrowers with associated credit ratings. The differential is used to price the difference between the actual borrowing costs of a business and the borrowing cost that would apply in the absence of a government guarantee.

The interest differentials for all credit ratings are based on debt pricing determined by a panel of commercial banks appointed by NSW Treasury. The panel prices short-term and long-term debt for each credit rating assuming generic bank lending terms. Prices are collated by the nominated credit rating agent who calculates the applicable differential for each credit rating in consultation with NSW Treasury.

Interest differentials are based on an average of prices received in the previous financial year (Year₀) of the year in which the fee is applied (Year₁)⁴. Although the fee is payable based on debt held in Year₁ the use of differentials sourced from Year₀ allows the fee to be estimated and accrued by businesses in their budgets for Year₁.

The differentials are revised each year to capture the changing conditions in lending markets that affect the interest differential margins for different levels of risk. Separate rates are determined for short-term debt and long-term debt, based on an average life of one year and five years respectively.

4.3 Short-term and long-term debt

Guarantee fees are based on the book value of the average amount of guaranteed debt held by Government businesses in any one financial year.

The fee is applied to the loan portfolio of a business but is not applied to other outstanding liabilities (including derivatives). To recognise the lower credit risk associated with short-term borrowings, short-term and long-term debts are classified separately in the guarantee fee:

- long-term debt is defined as borrowings held for more than one year from the original date the debt was obtained. Debt obtained by issuing short-term debt through the use of derivatives is also classified as long-term debt; and
- short-term debt is defined as borrowings, which once obtained, are held for a maximum duration of one year. Short-term debt also includes long-term debt that is subject to a floating rate of interest.

NSW Treasury obtains information from TCorp and the relevant Government business on the outstanding amount of both short-term and long-term debt held by the business at the end of each month for the relevant financial year. Government businesses are required to supply NSW Treasury with the details, where short-term debt matures before the end of any month and where a business still has 'own-name debt' (debt arranged external to TCorp) outstanding.

⁴ Generally, pricing from the bank panel will be collected twice per year in September and March. However, prices may be collected more or less frequently depending on volatility or unusual credit events.

4.4 Term to maturity

The average term to maturity of long-term debt is considered to ensure the guarantee fee is priced appropriately. The simple weighted averaging method used is described below.

- Step 1:** Each tranche of long-term debt held at year-end on 30 June is multiplied by its corresponding term to maturity.
- Step 2:** The sum of the above is divided by the business' total long-term debt.
- Step 3:** The result is rounded to the nearest year to arrive at the average term to maturity for long-term debt.

TCorp and Government businesses provide Treasury with the average term to maturity information for guaranteed debt arranged through TCorp ('TCorp debt') and through external financiers ('own-name debt').

4.5 Calculation

The method of calculating the guarantee fee broadly involves the application of relevant interest differentials to a Government business' total guaranteed debt. The calculation aims to give an approximation of commercial reality while ensuring administrative simplicity.

Short-term debt

The guarantee fee in respect of short-term debt is determined by multiplying the average short-term debt in the relevant year by the interest differential corresponding to a business' credit rating. This result is then added to the fee for long-term debt to achieve the total guarantee fee payable.

The following example shows how the guarantee fee would apply to the short-term debt of an 'A' rated business in Year₁:

$$\text{Guarantee Fee (short-term debt)} = \text{Short-term debt} \times \text{Interest differential}$$

Year	Stand-alone credit rating	Interest differential for 'A' credit rating <i>(example only)</i>	Short-term debt	Fee for short-term debt in Year₁
Year ₁	A	0.5%	\$25 million	0.005 x 25.0 = \$0.125 million

Long-term debt

For long-term debt, an alternative method is applied to account for the fixed rate nature of this debt category. In the private sector, fixed rate debt is priced at the time of issue whereby the interest rate remains unchanged to maturity. Therefore, in contrast to short-term debt, the guarantee fee calculation somewhat insulates long-term debt from the impact of changing interest differentials.

This outcome is achieved by breaking down the average long-term debt into different maturity segments that creates an amortisation schedule. Each maturity segment represents a portion of debt that bears the original interest differential over successive years. Each maturity segment is then multiplied by the relevant differential and finally added together to determine the fee in respect of long-term debt.

For example, if the average term to maturity of a business' debt were four years, only one quarter of the total debt would be subject to the latest differential and so, only a fraction of the debt is assumed to be refinanced each year. After four years, all of that debt is assumed to be repaid or refinanced.

This is illustrated in the following the amortisation schedule for an average long-term debt of \$100 million with an average term to maturity of four years.

		Maturity segments of long-term debt (\$m)							
		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8
Applicable interest differential (%)	Year 1 1.0%	100.0	75.0	50.0	25.0				
	Year 2 2.0%		25.0	18.75	12.50	6.25			
	Year 3 2.5%			31.25	23.44	15.63	7.81		
	Year 4 2.3%				39.06	29.30	19.53	9.77	

Only debt maturing in a given financial year will be subject to the interest differential for that year, including any debt prepaid or refinanced prior to maturity.

The guarantee fee for long-term debt is determined by multiplying each segment of debt by its corresponding interest differential. The fee equals the sum of these amounts in any given year. The following example illustrates this, using the above schedule information.

Given	Result
<ul style="list-style-type: none"> Long-term debt = \$100 million Average term to maturity = four years Interest differential for long-term debt in Year 1 = 1.0 % Interest differential for long-term debt in Year 2 = 2.0 % 	Guarantee Fee for long-term debt in Year 2 $= (75.0 \times 0.01) + (25.0 \times 0.02)$ $= 0.75 + 0.5$ $= \$1.25 \text{ million}$

Should additional debt be obtained and the average term to maturity lengthened to five years in Year 3, the increased amount would factor into the row for Year 3 and a fifth maturity segment would carry over into the column for Year 7. Where there is a reduction in fixed rate debt then the guarantee fee reduction will be based on the average interest differential applying to the previous year.

A spreadsheet has been developed to automatically calculate the guarantee fee. It can be obtained upon request from the Commercial Policy Section in NSW Treasury. The spreadsheet incorporates the amortisation schedule showing how each maturity segment of long-term debt is amortised over successive years. It also allows businesses to estimate fees payable in the following year.

Derivatives

As indicated earlier, where a Government business agency uses derivatives to strategically lengthen its debt maturity profile, the amount of short-term debt involved will need to have the interest differential for long-term debt applied to that debt. To enable this calculation to be performed, businesses will need to advise NSW Treasury at the end of each financial year of details of all of their interest rate swap exposures.

These details are: face value; maturity date; fixed rate; floating rate basis and whether the business is the fixed payer or receiver.

For the purposes of simplicity, the guarantee fee calculation will only be adjusted where the interest rate swaps have the effect of lengthening the average maturity of the debt portfolio by more than $\frac{1}{4}$ of a year. If that is the case, then the fee calculated by the methodology described here will be adjusted by reducing the amount of debt subject to the short-term interest rate differential and increasing the amount of debt subject to the long-term interest rate differential.

5. Administration

The guarantee fee is paid in arrears, with the fee payment made in September of the following financial year.

NSW Treasury advises Government businesses of the applicable interest differentials in April before the relevant financial year. This timing allows businesses to estimate the fee in their budgets.

The following table summarises the administration of guarantee fees for a given financial year (Y_1).

Variable	Timing ⁵
<ul style="list-style-type: none"> Interest differentials 	<ul style="list-style-type: none"> Bank Panel to submit prices in September and March of prior financial year (Y_0) to nominated credit rating agency Nominated credit rating agency to submit average differentials to apply in Y_1 by end of March of Y_0
<ul style="list-style-type: none"> Interest differentials applicable for the financial year Y_1 	<ul style="list-style-type: none"> Treasury provides to Government businesses in April before the commencement of the financial year Y_1
<ul style="list-style-type: none"> Business' credit rating for the financial year Y_1 	<ul style="list-style-type: none"> Nominated credit rating agency provides by April before the commencement of the financial year Y_1
<ul style="list-style-type: none"> Interest rate swap details as at 30 June of the financial year Y_1 	<ul style="list-style-type: none"> Government businesses provide in July after end of the financial year Y_1
<ul style="list-style-type: none"> Average monthly closing balances of short-term and long-term debt 	<ul style="list-style-type: none"> Businesses and TCorp provide in July after end of the financial year Y_1
<ul style="list-style-type: none"> Guarantee Fee for the financial year Y_1 	<ul style="list-style-type: none"> Treasury advises businesses in August & fee is payable in September (of financial year Y_2) after end of the financial year Y_1

⁵ As a transition year, this timetable will not apply for interest differentials for 2004-05.

6. Roles and Responsibilities

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

- developing, promulgating and promoting the policy;
- engaging stakeholders in consultative processes; and
- updating and revising the policy where necessary.

The administration of the guarantee fee involves:

- collecting the necessary information to calculate the guarantee fee payable including management of the panel of banks;
- selecting the credit rating agency to conduct the stand-alone credit rating of Government businesses;
- advising Government businesses of their guarantee fee amounts; and
- processing the receipt of the guarantee fee payments.

NSW Treasury Corporation (TCorp) is responsible for:

- providing funds for the borrowing program of Government businesses;
- providing information on businesses' borrowings with TCorp and the average term to maturity of the borrowings in order for Treasury to determine the guarantee fee; and
- offering technical advice to Treasury where required.

Boards and management of Government businesses are responsible for:

- providing monthly balances of TCorp and non-TCorp debt levels to Treasury upon request;
- obtaining a credit rating from the agency nominated by NSW Treasury; and
- ensuring payment of the guarantee fee within the designated timeframe.

Further Information

General inquiries concerning this document should be initially directed to:

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

Appendix

Government Guarantee Fee Calculation – An Example

The example below uses notional figures to demonstrate how the fee is calculated. Note the difference between i) the interest differential for long-term debt and ii) the average fee percentage for long-term debt, because the fee takes into account the term to maturity.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6																																																							
Agency Stand-Alone Credit Rating	A	A	A	A	A	A																																																							
Interest differentials ⁶ :																																																													
Long-term debt	0.50%	0.60%	0.70%	0.80%	0.70%	0.60%																																																							
Short-term debt	0.20%	0.30%	0.40%	0.40%	0.30%	0.30%																																																							
Average life of long-term debt, rounded to nearest year	4	4	4	4	4	4																																																							
Average debt levels:																																																													
Long-term \$m	100	100	100	100	100	100																																																							
Short-term \$m	10	10	10	10	10	10																																																							
Government Guarantee Fee:																																																													
Long-term debt \$'000	500.00	525.00	581.25	676.56	723.05	683.50																																																							
Short-term debt \$'000	20.00	30.00	40.00	40.00	30.00	30.00																																																							
Total fee \$'000	520.00	555.00	621.25	716.56	753.05	713.50																																																							
Average Guarantee Fee percentage (long-term debt)																																																													
	0.50%	0.53%	0.58%	0.68%	0.72%	0.68%																																																							
<table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th></th> <th style="text-align: center;">Year 1</th> <th style="text-align: center;">Year 2</th> <th style="text-align: center;">Year 3</th> <th style="text-align: center;">Year 4</th> <th style="text-align: center;">Year 5</th> <th style="text-align: center;">Year 6</th> </tr> <tr> <th></th> <th style="text-align: center;">\$m</th> <th style="text-align: center;">\$m</th> <th style="text-align: center;">\$m</th> <th style="text-align: center;">\$m</th> <th style="text-align: center;">\$m</th> <th style="text-align: center;">\$m</th> </tr> </thead> <tbody> <tr> <td rowspan="6" style="vertical-align: top;"><i>This section calculates the maturity segments of long-term debt which are charged at a particular year's interest differential (\$m)</i></td> <td style="text-align: center;">Year 1</td> <td style="text-align: center;">100.00</td> <td style="text-align: center;">75.00</td> <td style="text-align: center;">50.00</td> <td style="text-align: center;">25.00</td> <td></td> </tr> <tr> <td style="text-align: center;">Year 2</td> <td></td> <td style="text-align: center;">25.00</td> <td style="text-align: center;">18.75</td> <td style="text-align: center;">12.50</td> <td style="text-align: center;">6.25</td> </tr> <tr> <td style="text-align: center;">Year 3</td> <td></td> <td></td> <td style="text-align: center;">31.25</td> <td style="text-align: center;">23.44</td> <td style="text-align: center;">15.63</td> <td style="text-align: center;">7.81</td> </tr> <tr> <td style="text-align: center;">Year 4</td> <td></td> <td></td> <td></td> <td style="text-align: center;">39.06</td> <td style="text-align: center;">29.30</td> <td style="text-align: center;">19.53</td> </tr> <tr> <td style="text-align: center;">Year 5</td> <td></td> <td></td> <td></td> <td></td> <td style="text-align: center;">48.83</td> <td style="text-align: center;">36.62</td> </tr> <tr> <td style="text-align: center;">Year 6</td> <td></td> <td></td> <td></td> <td></td> <td></td> <td style="text-align: center;">36.04</td> </tr> </tbody> </table>								Year 1	Year 2	Year 3	Year 4	Year 5	Year 6		\$m	\$m	\$m	\$m	\$m	\$m	<i>This section calculates the maturity segments of long-term debt which are charged at a particular year's interest differential (\$m)</i>	Year 1	100.00	75.00	50.00	25.00		Year 2		25.00	18.75	12.50	6.25	Year 3			31.25	23.44	15.63	7.81	Year 4				39.06	29.30	19.53	Year 5					48.83	36.62	Year 6						36.04
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6																																																							
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⁶ Interest differentials are updated annually and the latest figures may be obtained from NSW Treasury.