



New South Wales
TREASURY

Office of Financial Management

COMMERCIAL POLICY FRAMEWORK

**FINANCIAL DISTRIBUTION POLICY
FOR GOVERNMENT BUSINESSES
(applies until 30 June 2010)**

Office of Financial Management

Policy &
Guidelines Paper

Preface

The *Financial Distribution 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 key purpose of the *Financial Distribution Policy* is to subject Government businesses to the discipline of making dividend payments, in recognition of the opportunity cost associated with the Government's equity. The policy also covers capital repayments, which may be used to achieve an appropriate capital structure.

The policy supersedes the previous NSW Treasury policy document on this matter, *A Financial Distribution Policy for NSW Government Trading Enterprises, August 1992*, and *Treasury Circular 1991/22*.

John Pierce
Secretary
NSW Treasury
June 2002

Treasury Ref: TPP02-3
ISBN: 0 7313 3171 0

General inquiries concerning this document should be initially directed to the Commercial Policy Section of NSW Treasury on (02) 9228 4095. This publication can be accessed from the Treasury's Office of Financial Management Internet site [<http://www.treasury.nsw.gov.au/>]. For printed copies contact the Publications Officer on Tel: 9228 4426.

Contents

	Page
Preface	i
Executive Summary	1
1. Introduction	3
2. Background	4
2.1 The Government as Shareholder	4
2.2 Purpose of the Policy	4
2.3 Definition of Terms	5
2.4 Legislative Provisions	6
2.5 Relationship to Other Policies	7
2.5.1 Capital Structure Policy for Government Businesses	7
2.5.2 Monitoring and Accountability	7
2.6 Application of the Policy	8
2.7 Transitional Arrangements	8
3. Finance Theory and Private Sector Practice	9
3.1 Dividend Policy and the Residual Approach	9
3.2 Observations of Private Sector Practice	9
3.3 A Modified Residual Approach for Government Businesses	11
4. Financial Distribution Policy for Government Businesses	12
4.1 Policy Statement	12
4.2 Guidance for Practical Application	13
5. Administration	15
6. Roles and Responsibilities	16
References	17

Executive Summary

Financial distributions comprise dividends and capital repayments. Dividends represent a return *on* the owners' equity investment in a firm, while capital repayments involve a return *of* owner's equity.

Policy Application and Objectives

Like the shareholders of publicly listed companies, the Government expects an appropriate return on the equity invested in its businesses. However, unlike publicly listed companies, ownership rights in Government businesses¹ are not readily tradeable, since they do not participate in share markets. This necessitates a policy mechanism to secure the interests of the Government as shareholder and to provide a strong incentive for boards/managers to focus on enhancing the value of Government businesses.

The *Financial Distribution Policy* applies to all Government businesses, although exemption may be permitted in exceptional circumstances. The objectives of the policy are to:

- recognise the opportunity cost associated with the Government's equity;
- enhance the transparency of, and accountability for, financial performance of Government businesses;
- ensure these businesses do not enjoy any special advantages over their private sector competitors; and
- support the initial determination and ongoing maintenance of each business' approved capital structure, in accordance with the *Capital Structure Policy for Government Businesses*.

Modified Residual Approach to Dividends

According to the residual approach to dividend policy, a firm would make a dividend payment only if there is cash left over, after using its retained earnings to fund all available value-adding investment opportunities. This approach is relevant to Government businesses, because it focuses on value creation and wealth maximisation.

For Government, however, realising a capital gain from its businesses is more difficult to achieve than for private sector shareholders, who are able to divest shares relatively easily. The Government's preference for dividends recognises that the time horizons for social returns in the General Government sector are not necessarily aligned with investment returns from Government businesses. Furthermore, dividend payments from Government businesses are an important source of funding for social services provided through the State Budget.

¹ The generic term 'Government business' includes:

- Public Trading Enterprises (or Public Non-Financial Corporations under ABS classifications). State Owned Corporations are included in this classification, but are distinguished by their corporatised status;
- Public Financial Enterprises (or Public Financial Corporations under ABS classifications); and
- General Government businesses (or General Government agencies under ABS classifications, which are also non-Budget dependent and operate under the Commercial Policy Framework).

The *Financial Distribution Policy* requires Government businesses to determine an appropriate distribution policy based on a ‘modified’ residual approach. This approach is necessary to take into account the Government’s strong preference for dividends over capital gain and for a reasonably stable stream of total dividends from its portfolio of businesses. In particular, the policy requires Government businesses to negotiate:

- dividend targets with reference to post-tax profits, underlying cash position, capital structure and the preferences of the shareholder; while
- capital repayments are used to achieve an appropriate capital structure.

Negotiation of Targets

Under the *Financial Distribution Policy*, dividend targets are negotiated annually between the shareholders and board/management of each Government business and agreed in writing in the Statement of Corporate Intent (for State Owned Corporations) or the Statement of Business Intent (for other Government businesses).

Targets are negotiated with reference to post-tax profits and through case-by-case consideration of the amount of residual cash available in a business, after allowing for working capital, the funding of acceptable investments and an appropriate contingency for financial flexibility. The preferences of the shareholder must also be considered.

The cash flow requirements of the business must be recognised and dividend payments must not knowingly place the business at financial risk. On the other hand, a business should not retain any cash or financial investments in excess of its requirements. Such funds should be returned to the shareholders because investment in financial assets is not part of the core operations of the business.

The Government views its businesses on a long-term, portfolio perspective. When individual businesses require higher levels of cash (and shareholders agree), this may be compensated for by negotiating changes in the timing of major capital expenditure from other businesses or by making equity injections. Negotiation of dividends therefore requires a balance between the funding needs of the business to secure long-term value creation and ensuring that the State’s revenue requirements are met.

Relationship to Capital Structure Policy

The *Financial Distribution Policy* and the *Capital Structure Policy* are inextricably linked. The expected level of normal dividend is a key input used in setting a business’ capital structure. This ensures that the dividend preferences of the shareholder over the long run are taken into account when determining the appropriate level of debt for a business. In addition, target and actual dividend payments are determined with reference to their impact on the business’ capital structure.

Capital repayments are a form of financial distribution and are used to achieve an appropriate capital structure, following a review under the *Capital Structure Policy*.

1. Introduction

In New South Wales, Government businesses are involved in delivering 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.

Since 1988, the *Commercial Policy Framework* has applied to Government businesses. The Framework consists of a suite of policies aimed at replicating, as far as possible, the disciplines and incentives that lead private sector businesses toward efficient commercial practices. The fundamental objective of the Framework is to maximise the wealth of the people of New South Wales, by requiring the boards/management of Government businesses to allocate resources efficiently and to be accountable for financial management.

The people of New South Wales are ultimately the shareholders of these businesses, however, the interests of the shareholders are represented by Ministers of State. The NSW Government has a number of distinct relationships with its businesses, arising from its role as shareholder, banker, tax collector and regulator. The *Financial Distribution Policy* deals with one of the key issues that arise from the Government's shareholder relationship with its businesses. In the same way as the shareholders of private sector companies, the Government expects an appropriate return on its equity investment.

This document explains the rationale behind the *Financial Distribution Policy* and sets out the principles to be applied when negotiating and determining the distributions of Government businesses.

2. Background

2.1 The Government as shareholder

The owners or shareholders of any business expect their investments to earn a return that rewards them for bearing risk. The level of reward is expected to be commensurate with the perceived riskiness of the investment.

There are many alternative vehicles for the investment of capital, so a particular investment can often be said to carry an ‘opportunity cost’. This is the difference between the actual return achieved and the potential return forgone from the alternative investment.

The Government’s equity in its businesses has accumulated over time, through the direct investment of capital and through indirect investment in the form of retained earnings. These investments have an associated opportunity cost and therefore it is reasonable that Government businesses achieve returns that are comparable to alternative commercial investments of similar risk.

Government businesses face many of the disciplines and incentives experienced by private sector businesses. They often operate in competitive markets, are monitored by equity holders (and to some extent, debt holders) and are required to borrow at a cost relative to their stand-alone credit ratings. Like their private sector counterparts, boards and managers of Government businesses are also concerned to protect their professional reputations.

Nevertheless, there is an important incentive faced by private sector companies that is generally not applicable to Government businesses. In the case of a company listed on a stock exchange, shareholders who are not satisfied with the performance of their investment are able to sell their shares and invest elsewhere. Ownership rights are readily tradeable and this provides a strong incentive for managers to focus on enhancing the value of the company.

Ownership rights in Government businesses are not readily tradeable, because they do not participate in share markets. While some Government businesses have been privatised, this is a complex process and there are usually strong reasons for retaining existing businesses under Government ownership.

The absence of tradeable ownership rights distinguishes Government businesses from their private sector counterparts and necessitates a policy mechanism to secure the interests of the Government as shareholder.

2.2 Purpose of the policy

The key purpose of the *Financial Distribution Policy* is to subject Government businesses to the discipline of making dividend payments, in recognition of the opportunity cost associated with the Government’s equity. The policy also covers capital repayments, as discussed below.

The setting of dividend targets under the policy provides greater certainty to these businesses regarding the Government’s expectations of their financial performance. At the same time, it enhances the transparency of, and accountability for, such performance.

Requiring dividends also ensures that Government businesses do not enjoy any special advantages over their private sector competitors. This concept of ‘competitive neutrality’ between Government and private sector businesses is a key principle underlying the *Commercial Policy Framework*.

Another driver of the policy is to support the practical application of the *Capital Structure Policy for Government Businesses* and, in particular, the initial determination and ongoing maintenance of each business’ approved capital structure. Capital repayments as defined under the *Financial Distribution Policy* may be used to achieve an appropriate capital structure, after a review in accordance with the *Capital Structure Policy*. The relationship between the two policies is further detailed later in this document.

2.3 Definition of terms

Financial Distributions

Financial distributions reduce the owners’ equity in a firm. They comprise dividends and capital repayments. Dividends represent a return *on* the owners’ equity investment. Capital repayments involve a return *of* the owner’s equity investment.

Interest payments on borrowings obtained from NSW Treasury Corporation, tax equivalent payments and Government guarantee fees do not constitute financial distributions. Instead, these payments are considered to be business expenses. Government guarantee fees and tax equivalent payments are subject to separate policies under the *Commercial Policy Framework* and the *National Tax Equivalent Regime* for Government businesses.

Dividends

This policy adopts the private sector definition of dividends, as provided by the *Corporations Act 2001*², whereby a dividend may only be paid out of the profits of a company. Case Law has established that profits include current year earnings, retained earnings and the asset revaluation reserve. Dividend payments from the asset revaluation reserve can only occur, however, where the reserve is based on a competent valuation, is not liable to short-term fluctuations and the firm’s constitution does not restrict the payment of dividends to trading profits only.³

For the purposes of *Financial Distribution Policy*, dividends are further categorised according to their source from the different elements of equity and whether or not they represent regular or ‘one-off’ payments, as follows:

- ‘normal dividends’ are payments from current year profits which are expected to be maintained in the foreseeable future; while
- ‘special dividends’ are additional, one-off payments made from retained earnings and/or the asset revaluation reserve.

² Section 254T ‘Dividends’, *Corporations Act 2001* (Cth).

³ *Marra Developments Limited v BW Rofe Pty Limited* (1977) 3 ACLR 185; *QBE Insurance Group Limited v ASC* (1992) 8 ACSR 631.

The distinction between normal and special dividends is necessary to assist the initial determination of capital structures for Government businesses. This issue is outlined later in this document and detailed in the *Capital Structure Policy*.

*Capital Repayments*⁴

Capital repayments represent a return of the Government's equity in a particular business. They are determined in accordance with the *Capital Structure Policy*, and are applied in order to achieve an appropriate capital structure.

Shareholders

In the context of Government businesses, the term 'shareholders' is used in this document to refer to Ministers of State who act as representatives of the people of New South Wales. For State Owned Corporations (SOCs), these Ministers are known as Voting Shareholders. There are two Voting Shareholders for every SOC. One is the Treasurer, while the other is a Minister nominated by the Premier. For other, non-corporatised Government businesses, the 'shareholder' role is shared by the Treasurer and relevant Portfolio Minister.

2.4 Legislative provisions

Legislative basis for obtaining payment

The *Public Finance and Audit Act 1983 (PF&A Act)* provides the legislative basis for financial distribution payments. Section 59B of the Act gives the Treasurer the power to require a prescribed statutory authority to pay an amount to the credit of the Consolidated Fund. Prescribed authorities include statutory SOCs and other, non-corporatised Government businesses.

Amounts payable under Section 59B may constitute either dividends or capital repayments, consistent with the definition of those terms used in this policy.

While the *PF&A Act* provides the legislative basis for obtaining these payments, the amount of any payment is determined in accordance with this *Financial Distribution Policy* (for dividends) and the *Capital Structure Policy* (for capital repayments).

Share Dividend Schemes for SOCs

The *State Owned Corporations Act 1989 (SOC Act)* requires a statutory SOC to have a share dividend scheme, as provided in the SOC's constitution, in a form approved by the Treasurer.⁵ For energy service SOCs, the share dividend scheme is to be determined by the Voting Shareholders in consultation with the board.⁶

⁴ Transfers to adjust an agency's capital structure are designated as 'contributions by owners' (i.e. capital adjustments) by *Treasury Circular NSWTC 01/11 'Contributions by Owners made to Wholly-Owned Public Sector Entities'*.

⁵ Section 20S(1), *State Owned Corporations Act 1989* (NSW)

⁶ Schedule 2 clause 4, *Energy Services Corporations Act 1995* (NSW)

The concept of share dividend schemes for statutory SOCs is simply a way of replicating the corporate form and processes of *Corporations Act 2001* companies, and nothing in the above provisions affects the operation of section 59B of the *PF&A Act*.

In the case of a company SOC, the *SOC Act* requires dividends to be agreed between the shareholders and the board.⁷ In the absence of such an agreement, dividends may be determined by the Voting Shareholders, by written notice, after consultation with the board.

2.5 Relationship to other policies

The *Financial Distribution Policy* operates together with a number of other policies within the *Commercial Policy Framework*.

2.5.1 Capital Structure Policy for Government businesses

Capital structure refers to the mix of debt and equity used to finance a firm's assets. In accordance with the *Capital Structure Policy*, a business' capital structure is set with regard to the debt capacity of the business, the funding requirements of its approved capital expenditure program, the need for working capital and an appropriate allowance for financial flexibility.

To allow a Government business to manage its debt through the peaks and troughs of the capital expenditure cycle and, at the same time, to maintain a relatively stable stream of dividends, fluctuation of its capital structure is permitted within an agreed range.

The expected level of normal dividends, as negotiated under the *Financial Distribution Policy*, is a key input used in setting a business' capital structure and the associated range. This ensures that the dividend preferences of the shareholder over the long run are taken into account.

Furthermore, targets for normal dividends and actual payments for both normal and special dividends are determined with reference to their impact on the business' capital structure. In this way, the *Financial Distribution Policy* and the *Capital Structure Policy* are inextricably linked.

Capital repayments are a form of financial distribution and are used to achieve an appropriate capital structure, following a review under the *Capital Structure Policy*.

2.5.2 Monitoring and accountability

The Government's relationship with its businesses can be compared to a private sector holding company, which controls a number of wholly owned subsidiaries. The subsidiaries are accountable to the holding company for their financial performance. This involves the holding company in the setting of performance targets and monitoring of results.

⁷ Schedule 2 clause 5, *State Owned Corporations Act 1989* (NSW)

The *Financial Distribution Policy* operates within the context of the monitoring and accountability regime for Government businesses.⁸ The regime is based on an annual written agreement between the shareholders and board/management of each business, known as a Statement of Corporate Intent (SCI) for a State Owned Corporation and a Statement of Business Intent (SBI) for a non-corporatised business. The purpose is to enhance accountability for performance and provide the business with certainty as to the shareholders' expectations of financial performance.

The Statement contains, amongst other key matters, financial performance targets and the capital program for a four year period, along with the business plan and projected financial statements over a ten year period. The normal dividend is one of the financial performance targets to be agreed in the Statement, in accordance with the *Financial Distribution Policy*.

2.6 Application of the policy

The *Financial Distribution Policy* applies to all Government businesses. Partial or total exemption from the policy is only permitted in exceptional circumstances. In any event, exemptions are restricted to non-corporatised Government businesses. A SOC cannot be granted an exemption because SOCs have been established on a strictly commercial basis, under legislation that explicitly provides for share dividend schemes.

Application for an exemption must be submitted to NSW Treasury for consideration by the Treasurer. The Treasurer will only grant an exemption where specific conditions warrant the business being classified as 'sub-commercial'.

Where an exemption is granted, the Treasurer and Portfolio Minister will need to determine whether the Government business is to be brought to full commercial status (and therefore become subject to the *Financial Distribution Policy*). If so, the business would be required to develop an implementation strategy and timeframe, to be agreed by the Treasurer and Portfolio Minister.

2.7 Transitional arrangements

For the purposes of transitional arrangements upon release of this policy:

- the setting of targets for 'normal dividends' will apply in respect of business performance from the 2003-04 financial year onwards. These targets will be negotiated in the context of the 2003-04 SCI/SBI for payment in 2004-2005; whereas
- there is no need for transitional arrangements regarding 'special dividends' or 'capital repayments', as these may be negotiated at any time, including outside the SCI/SBI process.

⁸ At the time of publication of this document, the *Monitoring Policy for NSW GTEs* is under review.

3. Finance Theory and Private Sector Practice

3.1 Dividend Policy and the residual approach

A private sector firm with after-tax profits has the choice of either using its profits to finance new investments or, alternatively, paying a dividend and then raising sufficient additional equity to undertake those same new investments. The choice between these alternatives is the subject of dividend policy, and its effect on the value of the firm has been the subject of much debate.

The Modigliani and Miller⁹ thesis is that, under the assumptions of a perfectly competitive market, the value of the firm is determined solely by the earning power of the firm's assets. The manner in which earnings might be retained or paid as dividends makes no difference. This is because, they argue, the market value of a share before payment of a dividend is precisely equal to the sum of the discounted share (after the issue of new equity) and of dividends paid.

In terms of maximising their wealth, shareholders are therefore likely to be indifferent to a choice between dividends or capital gains. Regardless of the firm's dividend policy, they could effectively transform the policy by either re-investing dividends paid or by selling shares, to meet their individual requirements.

The Modigliani and Miller thesis suggests a firm should adopt a residual approach to dividend policy. Under the residual approach, a dividend would be paid only if there were retained earnings left over after the firm has financed all investment projects capable of generating acceptable returns. The amount of dividend payout would fluctuate from period to period, according to the availability of such projects.

As long as the firm has acceptable investment opportunities, it will use retained earnings (and debt in proportion to its current capital structure) to finance these projects. If the total value of acceptable investments exceeded the amount of retained earnings plus sustainable debt, the firm would need to finance these opportunities with a combination of new equity and additional borrowing, or postpone some investment projects.

3.2 Observations of private sector practice

The Modigliani and Miller thesis is based on a number of restrictive assumptions that ignore taxes, transaction costs and other market imperfections. Further research¹⁰ has incorporated these factors and is based on observations of the commercial world. Two important considerations are the 'information content of dividends'^{11,12} and the 'clienteles effect'¹³.

⁹ Miller M H and Modigliani F, "Dividend Policy, Growth and the Valuation of Shares," *Journal of Business*, 34, 411-433, October 1961.

¹⁰ Brealey R A and Myers S C, *Principles of Corporate Finance*, Fourth Edition, McGraw-Hill, 1991.

¹¹ Bhattacharya S, "Imperfect Information, Dividend Policy and the Bird in the Hand Fallacy," *Bell Journal of Management Science*, 10, 259-270, Spring 1979.

¹² Miller M H and Rock K, "Dividend Policy under Asymmetric Information," *Journal of Finance*, 40, 1031-1052, September 1985.

¹³ Shefrin H and Statman M, "Explaining Investor Preference for Cash Dividends," *Journal of Financial Economics*, 13, 253-282, June 1984.

The significance of the ‘information content of dividends’ is displayed in the reaction of equity markets to changes in a company’s dividend payout. Dividends provide a signal regarding the sustainability of future earnings, cash flow and general prospects of the firm. An unexpected increase in dividends is viewed favourably, while a fall may lead to a reduced share price.

The ‘information content of dividends’ means that, despite arguments for the residual approach, boards and managers of firms tend to be reluctant to reduce dividends or reverse a previous increase. Observation of private sector practice¹⁴ confirms that dividend changes follow shifts in the sustainability of earnings over the long run. Transitory changes in earnings are unlikely to affect dividend payouts because managers act to ‘smooth’ dividends over time.

The ‘clientele effect’ states that different groups of investors are attracted to shares based on their particular dividend yield preference, which incorporates tax considerations. Those investors with a preference for dividends rather than capital gain will gravitate towards companies whose policies favour the distribution of profits via dividends. If a firm changes its dividend policy, it will simply attract a different clientele. According to the principle of supply and demand, once all clienteles are satisfied, changes to the firm’s dividend policy will have no impact on the firm’s share price.

These observations demonstrate that, when determining dividend policy, boards and managers of private sector companies consider the dividend preferences of shareholders and the reaction of equity markets to dividend decisions.

It is also useful to note private sector companies typically return excess funds to shareholders through special dividends or share re-purchases. The equity market creates a discipline for these companies to maximise the wealth of shareholders by either investing in value-adding opportunities or, where none are available, returning these funds to shareholders. The threat of a hostile takeover is also a deterrent to the accumulation of excess funds.

In the case of a holding company, subsidiaries are often required to make daily cash transfers to the parent company, which is responsible for managing the cash needs of the group as a whole. The subsidiaries then seek funds for capital expenditure from the parent company that considers, ranks and rations shareholder funds for new investments across the group as a whole. This approach is consistent with shareholder wealth maximisation and prevents subsidiaries accumulating funds that should be available for distribution to shareholders.

¹⁴ R.A. Brealey and S.C. Myers, *Principles of Corporate Finance*, Fourth Edition, McGraw-Hill, 1991.

3.3 A modified residual approach for Government businesses

Based on the private sector practices outlined above, it is appropriate that the shareholders of Government businesses have a central role in negotiating and determining dividends.

The residual approach to dividend policy is relevant to Government businesses because it focuses on value creation and wealth maximisation, by recognising the need to fund all available value-adding investment opportunities. However, given the unique circumstances for Government as the shareholder, the residual approach must be modified to take into account the Government's strong preference for dividends over capital gain and for a reasonably stable stream of total dividends from its portfolio of businesses.

For Government, realising a capital gain from its businesses is more difficult to achieve than for private sector shareholders, who are able to divest shares relatively easily. The Government's preference for dividends recognises that the time horizons for social returns in the General Government sector are not necessarily aligned with investment returns from Government businesses. Furthermore, a reasonably stable stream of total dividends on a long term, portfolio basis is preferred because these payments are an important source of funding for social services provided through the State Budget. The total funding requirement for such services tends to be either constant or increasing. Significant fluctuations in total dividends must therefore be avoided, if the services expected by the community are to be maintained regularly from year to year.

While the setting of dividends should consider the funding requirements of investment opportunities, the financial viability of such projects must nevertheless be assessed according to the Government's *Guidelines for Financial Appraisal* and other relevant requirements. The expenditure is reviewed and approved in the context of the SCI/SBI and, for Projects of State Significance, by the Cabinet Standing Committee on the Budget.

Private sector practice indicates that firms often 'smooth' dividend payments over time, by saving some funds in surplus years, for distribution in years where there would otherwise be limited or no capacity to pay a dividend. Government prefers that individual businesses do not smooth dividends in this way.

Instead, reflecting practice observed in the subsidiaries of private sector holding companies, excess cash accumulated by Government businesses should be returned to shareholders, as these funds are more efficiently managed by NSW Treasury. Excess cash is defined as any cash balances exceeding the business' requirements for working capital, the funding of acceptable investments and an appropriate contingency for financial flexibility.

4. Financial Distribution Policy for Government Businesses

4.1 Policy statement

The *Financial Distribution Policy* is based on a ‘modified’ residual approach and can be summarised by the following points:

- 1) Government businesses are expected to make dividend payments that are comparable to alternative commercial investments of similar risk.
- 2) Dividend targets and actual payments are set by negotiation between the shareholders and the boards/management of each business, with ultimate determination reserved for the shareholders.
- 3) Dividends are negotiated with reference to the post-tax profits of the business, in line with private sector practice and in recognition of the payment of income tax equivalents by Government businesses as a business expense.
- 4) A target dividend payout ratio is not applied, but instead there is case-by-case consideration of the amount of excess cash available in a business after allowing for:
 - a) working capital;
 - b) the funding of acceptable investments (those which project yields greater than the business’ Weighted Average Cost of Capital, except for capital expenditure which is required to fulfil regulatory requirements); and
 - c) an appropriate contingency for financial flexibility.
- 5) The above residual approach to dividends is further modified to take account of the shareholders’ preference for dividends rather than capital gains and for a reasonably stable stream of total dividends from its businesses.
- 6) The Government views its businesses on a long term, portfolio perspective. When individual businesses require higher levels of cash (and shareholders agree), this may be compensated for by negotiating changes in the timing of major capital expenditure from other businesses or by making equity injections.
- 7) Negotiation of dividends therefore requires a balance between the funding needs of the business to secure long-term value creation and ensuring that the State’s revenue requirements are met.
- 8) The *Financial Distribution Policy* operates together with the *Capital Structure Policy for Government Businesses* to ensure that a business’ capital structure is set with regard to the shareholders’ preferences for dividends over the long run and that dividend payments work to maintain capital structure within the agreed range.
- 9) Capital repayments are determined in accordance with the *Capital Structure Policy* and are distinguished from dividends because they represent a return of the Government’s equity in a business, in order to achieve an appropriate capital structure.

4.2 Guidance for practical application

Negotiation of Dividend Targets

- 1) Dividend targets are negotiated with reference to post-tax profits, underlying cash position, capital structure and the preferences of the shareholder.
- 2) Dividend targets are negotiated between the shareholders and board/management of each business. The expected dividend payments over four years are agreed in writing in the SCI/SBI. NSW Treasury acts as the financial adviser to the shareholders during this negotiation process.
- 3) Dividend targets must recognise the cash flow requirements of the business and must not knowingly place the business at financial risk. The business must have sufficient cash to meet its operational needs, as well as to make the agreed dividend payments.

Sometimes, increases in reported profits may not be supported by increased cash flow. For example, an actuarial adjustment of superannuation liabilities may result in an increase in reported profits but not cash, since the adjustment is a non-cash item. Similarly, an increase in the asset revaluation reserve may not be realisable if it does not reflect the revenue generating capacity of the asset base.

- 4) A business should not retain any cash or financial investments in excess of its requirements for working capital and the funding of the capital expenditure program, with an appropriate level of financial flexibility for contingencies. Funds in excess of these requirements should be returned to the shareholders because investment in financial assets is not part of the core operations of the business. NSW Treasury more efficiently manages such funds at the 'holding company' level.
- 5) The expected level of normal dividends is used as a constraint in setting the business' capital structure, ensuring that the shareholders' preferences for dividends over the long run are taken into account when determining the debt capacity of the business.
- 6) A business may retain cash for proposed capital expenditure in future years, provided that retention does not move the business' capital structure outside the approved range and the expenditure meets all relevant requirements such as those of the Government's *Guidelines for Financial Appraisal*. The capital expenditure program of a business is assessed during the SCI/SBI process and monitored by NSW Treasury on a quarterly basis.
- 7) Dividend targets are determined after allowance for the provision of any agreed Community Service Obligations. A return is not required on State Budget funding for social programs.

Monitoring of Performance and Determination of Actual Payments

- 1) A business is expected to maintain a reasonably stable stream of dividends, as agreed in its SCI/SBI.
- 2) The actual dividend payments made during a particular financial year relate to the business' performance during the previous year. These payments will be based on actual financial results, allowing the final dividend amount to be revised in light of performance and any other relevant considerations.

Further negotiation may be necessary where the board/management of a business proposes to make actual dividend payments that vary significantly from agreed targets or where the shareholders need to revise their dividend preferences.

- 3) The peaks and troughs of the investment cycle (and the consequent demand for funds) should be managed by the business as far as possible through the flexibility of the approved capital structure range, without affecting agreed dividend levels.
- 4) Where there are significant variations to revenues and/or capital expenditure requirements, lower dividends may be accepted (or higher dividends required) but always with regard to the shareholders' preferences and within the strict constraint of ensuring that capital structure stays within the approved range.

Where dividends above or below targets are indicated, negotiation between the shareholders and board/management will be required on the relative commercial merits of changes to dividends, debt levels or the timing and funding of the capital expenditure program. A key factor will be the current point within the capital structure range and hence the business' capacity to move up or down within the range. The shareholders' preferences regarding dividends must also be considered.

- 5) Where there is a significant revision of dividend expectations over the long term, or where a business is showing excess cash accumulation over the long term, it may be necessary for its capital structure to be reviewed.

5. Administration

Normal dividends are paid in arrears. The following table summarises the administration of normal dividend payments using the financial year ended 30 June Year₀ for illustrative purposes. Treasury will advise Government businesses of any changes in timing in the context of the annual updates to the *Reporting Calendars*.

Item	Timing
<ul style="list-style-type: none"> ▪ Negotiation of target financial distributions in the context of the SCI/SBI process. 	<ul style="list-style-type: none"> ▪ Draft SCI/SBI to be provided to Treasury, on behalf of Shareholding Ministers/Treasurer and Portfolio Minister in the first week of April Year₀. ▪ Final SCI/SBI endorsed prior to 31 August Year₁.
<ul style="list-style-type: none"> ▪ Interim dividend, comprising 50% of target dividend payment based on Year₀ <i>target</i> after-tax profits. 	<ul style="list-style-type: none"> ▪ Payable on a date to be determined by the Shareholding Ministers/Treasurer, but prior to 1 August Year₁.
<ul style="list-style-type: none"> ▪ Negotiation of final dividend. 	<ul style="list-style-type: none"> ▪ Board final dividend recommendation to be provided to Treasury, on behalf of Shareholding Ministers/Treasurer by the third week of August Year₁. ▪ Final dividend recommendation to be agreed by Shareholding Ministers/Treasurer prior to the first week of October Year₁.
<ul style="list-style-type: none"> ▪ Final dividend, comprising balance of total dividend payment based on Year₀ <i>actual</i> after-tax profits. 	<ul style="list-style-type: none"> ▪ Payable on a date to be determined by the Shareholding Ministers/Treasurer, but prior to 1 December Year₁.

Special dividend payments and capital repayments may be made at any time, as negotiated between shareholders and the board.

6. Roles and Responsibilities

Boards and management of Government businesses perform a stewardship role and are responsible for developing businesses' strategies and operational management. This involves:

- negotiating target and final financial distributions with shareholders;
- ensuring the target financial distribution is met;
- reporting movements in target financial distributions and negotiating actual payments, upon finalisation of the annual accounts by providing a recommendation to shareholders; and
- advising shareholders on an exceptions basis of significant revisions to profitability and their associated impact on financial distributions.

NSW Treasury is responsible for the development of the *Financial Distribution 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 financial distributions involves exercising strategic control consistent with shareholders' accountability to Parliament. This involves Treasury analysts, on behalf of shareholders:

- negotiating with boards and management target and final financial distributions;
- monitoring financial distribution levels and the maintenance of agreed targets;
- reporting movements in target financial distributions upon finalisation of the annual accounts and associated reasons in quarterly exception reports; and
- ensuring that *Financial Distribution Policy* is applied as a mechanism to maintain the approved capital structure.

Further Information

General inquiries concerning this document should be initially directed to:

Commercial Policy Section
NSW Treasury
Telephone: (02) 9228 4095
Internet: www.treasury.nsw.gov.au.

References

- Australian Taxation Office, *Manual for the National Tax Equivalent Regime*, October 2001.
- Bhattacharya S, “Imperfect Information, Dividend Policy and the Bird in the Hand Fallacy,” *Bell Journal of Management Science*, 10, 259-270, Spring 1979.
- Brealey R A and Myers S C, *Principles of Corporate Finance*, Fourth Edition, McGraw-Hill, 1991.
- Miller M H and Modigliani F, “Dividend Policy, Growth and the Valuation of Shares,” *Journal of Business*, 34, 411-433, October 1961.
- Miller M H, “Behavioural Rationality in Finance: The Case of Dividends,” *Journal of Business*, 59, S451-S468, October 1986.
- Miller M H and Rock K, “Dividend Policy under Asymmetric Information,” *Journal of Finance*, 40, 1031-1052, September 1985.
- NSW Treasury, *A Tax Equivalent Regime for NSW GTEs*, June 1994.
- NSW Treasury, *Capital Structure Policy for Government Businesses*, 2002.
- NSW Treasury, *Government Guarantee Fee Policy for Government Businesses*, 2002.
- NSW Treasury, *Guidelines for Financial Appraisal*, July 1997.
- NSW Government, *Monitoring Policy for NSW GTEs*, October 1992.
- NSW Government, *A Social Program Policy for NSW GTEs*, July 1994.
- Shefrin H and Statman M, “Explaining Investor Preference for Cash Dividends,” *Journal of Financial Economics*, 13, 253-282, June 1984.