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**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 04-2, July 2004). This revised policy modifies the method for deriving the interest differentials used to calculate the guarantee fee to provide a more transparent approach that better reflects market conditions. The revised policy applies to existing and new debt from 2010-11.

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Note

General inquiries concerning this document should be initially directed to the Commercial Policy Branch of NSW Treasury. Telephone: 9228 4422.

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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 perform comparably with private sector businesses of similar risk.

The *Government Guarantee Fee Policy* is specifically designed to improve the competitive neutrality of Government businesses. Government businesses are able to borrow funds at interest rates based on the credit rating of the State of New South Wales and so have a financial advantage over private sector businesses.

Guarantee fees serve to expose Government businesses to the risk-related cost of debt they would face 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
- are authorities, as defined in the *Public Authorities (Financial Arrangements) Act, 1987* or scheduled under any other Act that refers to the Treasurer's role in providing a guarantee.

An annual credit rating is required for Government businesses 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 borrowings a business has outstanding in any one financial year and the guarantee fee rate, which is the difference between a market interest rate for a business of similar risk and the cost of debt obtained from TCorp.

1. Introduction

The generic term 'Government business' includes:

- Public Trading Enterprises (or Public Non-financial Corporations under ABS classifications). This includes State Owned Corporations that are distinguished by their corporatised status
- Public Financial Enterprises (or Public Financial Corporations under ABS classifications)
- General Government businesses (or General Government agencies under ABS classifications), which are also non-Budget dependent and operate under the Commercial Policy Framework.

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
- replicate external market disciplines within the constraints of an administrative arrangement
- be relatively simple to administer
- be transparent in its application
- reflect current market conditions
- not distort businesses' borrowing behaviour.

The policy requires Government businesses to borrow at a cost reflective of their individual credit worthiness. This approach encourages businesses to recognise the 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 the amount they would have paid in the absence of a Government guarantee.

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.¹

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 - application to government businesses

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.

The ordinary debt of Government businesses is automatically guaranteed under the *PAFA Act*, provided that it has been obtained from TCorp.² Debt obtained from other lenders is not guaranteed, unless a specific debt has been explicitly guaranteed in writing by the Treasurer.

Each State Owned Corporation (SOC) to which the Government Guarantee Fee policy applies has in place an agreement that its TCorp debt is guaranteed. A statutory guarantee explicitly applies only when the board of the SOC and voting shareholders agree in writing, in accordance with section 22A(2) of the *PAFA Act* and 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.

¹ 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*.

² See section 22A *PAFA Act* and clause 54, *Public Authorities (Financial Arrangements) Regulation 2005*.

3. Application of Guarantee Fees

3.1 Criteria

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

- undertake commercial operations
- have borrowings greater than \$1 million
- have a credit rating lower than the State of New South Wales
- 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 public trading enterprises (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. The Treasurer, however, 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 guarantee fee rate
- the amount of debt held by businesses in each financial year.

4.1 Credit rating

All Government businesses subject to the guarantee fee must obtain a credit rating annually on a stand-alone basis. The stand-alone credit rating measures a business' financial standing independent of explicit or implicit financial support from the Government. This information is required to assess a business' level of competitive advantage from access to guaranteed borrowings.

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 current and forecast debt obligations.

4.2 Guarantee fee rate

The guarantee fee rate is the difference between a market interest rate for a business of similar risk and the cost of debt obtained from TCorp, which borrows using the State's credit rating. A rate is calculated based on short term lending rates (three month) and long term lending rates (five year).

The guarantee fee rates for all credit ratings are based on debt pricing measured by observed monthly average market bond rates, currently available for AAA, AA, A, BBB credit ratings. Where there is not an observed rate, rates will be imputed using a straight line projection from observed rates. Rates are collated by TCorp which calculates the applicable differential for each credit rating in consultation with NSW Treasury.

Guarantee fee rates that apply in any month are based on observations from the previous month. This allows the fee to be estimated and accrued by businesses during each year.

4.3 Single rate for short and long term debt

The guarantee fee will apply a single rate to all debt. The rate will be a weighted average of 90 percent of the long term interest differential and 10 percent of the short term interest differential, across the range of credit ratings.

This is intended to approximate a prudent debt mix based on operating requirements and asset profile. Businesses are expected to adopt prudential limits on short term debt that are consistent with operational risk, per the Treasury Management Policy (TPP 07-7, page 10). This will be monitored as this new Government Guarantee Fee policy is implemented.

4.4 Short and long term debt

As noted in Section 4.2 above, the guarantee fee rate for each month is derived from the prior month's market observations.

Short term debt is debt of less than 12 months' maturity. Each month the Government Guarantee Fee rate for that month will be applied to the average value of short term debt.

For long term debt, when a loan is arranged the guarantee fee will be charged at the rate for that month. This guarantee fee rate will apply to the loan until its maturity or a reset date elected by businesses at the time of establishment of each loan. Where a rate reset is agreed, the guarantee fee at the time of the reset will be that applicable for the credit rating of the business.

If a loan is repaid early, prior to agreed maturity date, the rate for that month will be applied to the amount repaid.

Guarantee fees are based on the face value of debt on the day of borrowing for guaranteed debt held by Government businesses in a financial year.

For Consumer Price Index (CPI) linked debt, where the face value increases by the CPI each quarter, the Government Guarantee Fee is applied to the indexed face value of the loan.

Loans will be classified according to the term of the funding not the term of the interest rate reset period. Accordingly, term floating rate loans will qualify as long term debt rather than short term debt.

The fee is applied to the loan portfolio of a business but is not applied to other outstanding liabilities (including derivatives).

For fixed forward contracts the guarantee fee rate will be set at the time the contract is entered into, using the government guarantee fee rate for that month. This replicates TCorp's effective lending rate for forward contracts and provides for simplicity of administration.

The new policy of applying a single guarantee fee rate to debt, regardless of whether short term or long term, means that there is no longer a need for businesses to provide information on derivatives that strategically lengthen the debt duration profile.

4.5 Calculation

To calculate the fee within the relevant financial year, at the end of each month NSW Treasury will obtain information from TCorp on average monthly short-term debt and the portfolio of long-term debt held by the business.

Where a Government business has 'own-name debt' (debt arranged external to TCorp) they are required to supply NSW Treasury annually with the details.

The method of calculating the guarantee fee involves the application of relevant guarantee fee rates to the individual loans comprising a Government business' total guaranteed debt. The guarantee fee will not include borrowing costs in relation to:

- financial accommodation other than borrowings
- establishment fees
- undrawn facility fees.

While this could be considered a departure from private sector lending practices, this approach reduces complexity and administrative costs while providing incentives for businesses to manage the cost of funds.

Where a business' credit rating changes no change will be made to the guarantee fee on historical borrowings.

4.6 Budget estimates

For preparation of estimates for the State Budget and Statements of Corporate Intent or Statements of Business Intent, businesses will be able to use a model supplied by Treasury.

- Treasury will provide the government guarantee fee rate for each credit rating to be used in budget estimates. This is likely to be the forecast government guarantee fee as a percentage of debt, on the assumption that a business' credit rating is unchanged. Businesses will be advised directly of the methodology and rates each year.
- Debt will be as per forward estimates provided by businesses to Treasury in the Budget context.

The model will provide transparency to businesses and Treasury on assumptions used in the guarantee fee estimates.

5. Administration and Transitional Provisions

The guarantee fee is to be paid in arrears, with the fee payment made in September of the following financial year. Treasury will invoice businesses in August.

Businesses may elect to self invoice using the Government Guarantee Fee model. These businesses are to provide an annual reconciliation to Treasury and include verification of the guarantee fee in the financial audit.

Transitional provisions for debt prior to June 2010

The new policy will apply to new borrowings and short term debt from 1 July 2010.

Debt drawn down before 30 June 2010 will be levied a Government Guarantee Fee using the bank panel rates that prevailed at the time each loan was drawn down. This rate will continue to apply for the term of that debt. As individual debt tranches mature or are repaid, refinanced debt will attract the prevailing market rates.

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

Variable	Timing
<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 the credit rating by April before the commencement of the financial year Y_1
<ul style="list-style-type: none"> ▪ Guarantee fee rates (the difference between a market interest rate and the cost of debt obtained from TCorp) 	<ul style="list-style-type: none"> • TCorp provides to Treasury on the first business day of each month • Treasury provides to Government businesses on the first or second business day of each month
<ul style="list-style-type: none"> ▪ Debt and guarantee fee rate resets 	<ul style="list-style-type: none"> • For each business, TCorp provides to Treasury each month of the financial year Y_1: <ul style="list-style-type: none"> • the average monthly face value of short-term debt • the portfolio of long-term loans and • any guarantee fee rate resets within the term of long term loans
<ul style="list-style-type: none"> ▪ Guarantee Fee for the financial year Y_1 	<ul style="list-style-type: none"> • GGF payable each month is shown in the GGF model • Businesses advise Treasury of 'own name' debt, where relevant • Treasury advises businesses in August of the total fee, & the fee is payable in September (of financial year Y_2) after end of the financial year Y_1
<ul style="list-style-type: none"> ▪ Budget and Half Year Review estimates 	<ul style="list-style-type: none"> • Businesses will estimate the fee payable using agreed guarantee fee rates (provided by Treasury) and debt as per forward estimates • The Government Guarantee Fee model will use these parameters to estimate the guarantee fee payable.

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
- selecting the credit rating agency to conduct the stand-alone credit rating of Government businesses
- advising Government businesses of their guarantee fee amounts and issuing invoices 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
- advising Treasury and businesses of applicable government guarantee fee rates
- providing information on businesses' borrowings with TCorp and any guarantee fee rate resets for long term loans, in order for Treasury to determine the guarantee fee and
- providing technical advice to Treasury where required.

Boards and management of Government businesses are responsible for:

- providing balances of TCorp and non-TCorp debt levels to Treasury at Budget and Half Year Review, and at other times upon request
- estimating current year and forecast guarantee fees payable using the Government Guarantee Fee model at Budget and Half Year Review, and at other times upon request
- obtaining a credit rating from the agency nominated by NSW Treasury and
- confirming invoiced amounts
- ensuring payment of the guarantee fee within the designated timeframe.

Further Information

General inquiries concerning this document should be initially directed to:

Commercial Policy Team
NSW Treasury
Telephone: (02) 9228 4422
Internet: www.treasury.nsw.gov.au

Appendix

Government Guarantee Fee Calculation – An Example

In this example, a business has a credit rating of BBB+ (Moody's scale) /Baa1 (Fitch scale) in the 2009-10 year and an improved rating of A (A2) in the 2010-11 year.

The Government Guarantee Fee rate that applies for borrowings in 2009-10 is 2.80%, based on bank panel rates for that year under the former Government Guarantee Fee policy (TPP 04-2). For new borrowings in 2010-11, the monthly rate varies with market rates. For July borrowings, the rate is 1.81% and for August borrowings it is 1.62%. In the example, this rate is held constant for the remainder of the year, whereas in practice, it will vary each month.

The business has chosen not to reset its Government Guarantee Fee rate before each loan matures. Each month, the Government Guarantee Fee charge is [(Short term debt average monthly balance) x (GGF rate applying that month/12)] + sum of [(Long Term loans) x (GGF rate that applied when each loan contract was arranged/12)].

Total Government Guarantee Fee payable in 2010-11 is
\$9,106,5475 = \$697,442 (July charge) + 11 x \$764,467 (August to June charge, same each month).

Government Guarantee Fee rate: example					Jun-10	Jul-10	Aug-10			FY 2010-11
Credit rating				Bloomberg differential to TCorp rate	BBB+	A	A			
Monthly GGF Rate					2.80%	1.81%	1.62%			
Reset within maturity?				No/Yes (months)	No	No	No			
Total Debt (has GGF applied)				Face value	\$203,000,000	\$353,000,000	\$403,000,000	\$0	\$0	\$403,000,000
Total GGF for month (Sum of 1,2,3,4)					\$473,667	\$697,442	\$764,467			\$9,106,575
Short-term debt (average monthly balance)					\$3,000,000	\$3,000,000	\$3,000,000			\$3,000,000
1 GGF on short term debt					\$7,000	\$4,525	\$4,050			\$49,075
Long term debt										
Borrowing date	Maturity date	Original Face Value		GGF fee monthly charge, LT debt	\$466,667	\$692,917	\$760,417			\$9,057,500
1/6/2010	1/8/2012	\$200,000,000	Debt outstanding has GGF applied		\$200,000,000	\$200,000,000	\$200,000,000			
			Nominal No. months until rate reset		N/A	N/A	N/A			
			GGF rate		2.80%	2.80%	2.80%			
2			GGF fee monthly charge		\$466,667	\$466,667	\$466,667			\$5,600,000
1/7/2010	1/8/2020	\$150,000,000	Debt outstanding has GGF applied			\$150,000,000	\$150,000,000			
			Nominal No. months until rate reset			N/A	N/A			
			GGF rate			1.81%	1.81%			
3			GGF fee monthly charge			\$226,250	\$226,250			\$2,715,000
1/8/2010	1/9/2025	\$50,000,000	Debt outstanding has GGF applied				\$50,000,000			
			Nominal No. months until rate reset				N/A			
			GGF rate				1.62%			
4			GGF fee monthly charge				\$67,500			\$742,500