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Capital Structure Policy for Government Businesses

Policy & Guidelines Paper

Preface

The *Capital Structure Policy for Government Businesses (Capital Structure Policy*) is a component of the NSW Government's Commercial Policy Framework. The Framework's suite of policies aims to replicate in Government businesses the disciplines and incentives that lead private sector businesses toward efficient commercial practices.

The purpose of the *Capital Structure Policy* is to outline the Government's expectations for the mix of debt and equity used to fund the capital needs of a Government business. The policy has been updated to determine the efficient capital structure for State Owned Corporations (SOCs) and other Government businesses.

The Government has a significant investment in a portfolio of Government businesses, including SOCs. This equity investment has accumulated over time through the direct investment of capital and indirectly in the form of retained earnings. The Government seeks to ensure its capital is efficiently allocated.

Government businesses are to establish and maintain an efficient capital structure based on an investment grade Target Credit Rating that is consistent with the Government's risk appetite. Businesses are expected to use debt where possible in order to reduce the overall cost of capital, balanced against the need to meet obligations and to withstand shocks.

The *Capital Structure Policy for Government Businesses*, 2016 edition, supersedes the previously issued TPP02-7. This revised policy applies to Government businesses from 1 July 2017, i.e. in relation to Statements of Corporate Intent for 2017-18 and financial years thereafter.

The revised *Capital Structure Policy* supports the Government's broader policy goals, in particular, maintaining the State's triple-A credit rating.

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Secretary
NSW Treasury
August 2016

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Note
General inquiries concerning this document should be initially directed to your relevant Government business' Treasury contact or the Commercial Assets section.
Email: contact@treasury.nsw.gov.au (please add topic in email subject)

This publication can be accessed from the Treasury's website www.treasury.nsw.gov.au.

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Purpose of the policy

The *Capital Structure Policy for Government Businesses (Capital Structure Policy*) is a component of the NSW Government's Commercial Policy Framework. The Framework's suite of policies aims to replicate in Government businesses the disciplines and incentives that lead private sector businesses toward efficient commercial practices.

The key objective of the *Capital Structure Policy* is to ensure that Government businesses maintain an efficient capital structure. This policy seeks to:

- ensure that the Government's equity investment in a Government business is allocated efficiently and more consistent with private sector best practice
- recognise the opportunity cost associated with the Government's equity investment
- maintain financial flexibility for the Government business to meet its financial commitments, including operating costs, capital expenditure and debt commitments
- enhance the transparency of, and accountability for, financial performance of Government businesses
- limit any special advantage or disadvantage a Government business may have over non-government competitors where applicable, in accordance with competitive neutrality principles.

Application of the policy

This policy applies to State Owned Corporations (SOCs) and other Government businesses as described in Appendix 1.

The *Capital Structure Policy* operates together with other policies within the Commercial Policy Framework, in particular the *Financial Distributions* and *Reporting and Monitoring* policies for Government businesses. Appendix 2 provides further details.

Capital structure for Government businesses

Capital Structure

The capital funding for a Government business may be provided from two sources – debt and shareholder equity. Capital structure refers to the mix of debt and equity held by the Government business.

To promote an efficient capital structure for our Government businesses, a Target Credit Rating will be set against which their capital structure is to be established and maintained. This will ensure that the Government's risk tolerance is balanced with its expectations for commercial returns on its investment. The Government and Treasury take a whole of portfolio approach when managing financial risk.

Target Credit Rating

A credit rating of a business reflects a range of factors, including: the competitive and regulatory environment, the business' operational characteristics, its capital programmes and its overall financial situation.

Government businesses are expected to maintain an investment grade stand-alone credit rating that is consistent with the Government's risk appetite.

The Target Credit Rating for Government businesses has been set at Baa2/BBB (Moody's/Standard & Poor's) under this policy.

Treasury may determine an alternative Target Credit Rating, after consulting with the Government business.

Treasury arranges a stand-alone credit rating assessment for applicable Government businesses each year. This rating is compared with the business' Target Credit Rating. Where there is a misalignment between the target and actual credit ratings, the capital structure of the business will be reviewed.

Setting the Target Capital Structure

Government businesses are expected to establish and maintain a capital structure consistent with the Target Credit Rating i.e. their Target Capital Structure. The Target Capital Structure will be negotiated between Shareholders and the business as part of the SCI process or as required. Where agreement cannot be reached, the Target Capital Structure will be determined by the Shareholders. Where the Government business' existing capital structure differs from the Target Capital Structure, the transition to the target may necessitate redistribution.

Accordingly, where the credit rating outlook is:

- higher than the Target Credit Rating there is capacity for the Government business to take on more debt and it may be required to distribute excess capital in the form of:
  - dividends as determined under the Financial Distributions policy; and/or
  - capital repayments as determined under the Financial Distributions policy.
- below the Target Credit Rating, Shareholders and the business will agree to a course of action and time frame to move the Government business to the Target Credit Rating and Target Capital Structure and in limited circumstances may consider:
  - reduced dividends as determined under the Financial Distributions policy; and/or
  - a capital injection as approved by Shareholders within a timeframe approved by the Treasurer in consultation with the Government business.

Other reforms may also be considered to address underlying factors affecting the Government business' credit rating, including changes in its strategic direction and the competitive or regulatory environment (refer to section following on Adapting to changes in circumstances).

The Target Capital Structure will be set to maintain a level of debt and liquidity appropriate to retain the Target Credit Rating. The Target Capital Structure will ordinarily be expressed as a minimum to maximum range for debt. This target will be used to inform financial distributions by the Government business under the *Financial Distributions Policy*. These financial distributions are to also be reflected in the Government business' SCI.

Appendix 3 provides further details regarding the roles and responsibilities for this process.

Adapting to changes in circumstances

The operating environment for Government businesses may change due to either or both business specific and external factors. These changes in the operating environment may lead to a revised credit rating outlook which may trigger a (further) review of the business' capital structure.

The Shareholders' capital structure expectation allows for a level of flexibility where circumstances change, e.g. where operating targets are missed or there is a change in the legislative or regulatory environment. It is envisaged that the actual capital structure of a business may fluctuate within its limits and may even breach the range on a short term basis, provided there is an expectation that its credit rating outlook will return to target.

Such changes in circumstances should be brought to the early attention of Treasury.

Appendix 1: Application of the policy

Statutory State Owned Corporations listed in Schedule 5 of the *State Owned Corporations Act 1989* are to apply the full aspects of the *Capital Structure Policy for Government Businesses*.

Companies wholly owned by the Government and established under the *Corporations Act 2001* (Cth) will be included under a Target Capital Structure regime based on an assessment of each business by Treasury.

Non-corporatised Public Trading/Finance Enterprises (PTEs/PFEs) will be assessed on a case-by-case basis by Treasury to determine if capital needs could be funded by a mix of Government equity and debt. The adoption of a Target Capital Structure regime will be determined based on various criteria including the capital intensity of the business' operations, the riskiness of its operating revenues and expenses, and Government policy.

General Government Businesses will be assessed on a case-by-case basis by Treasury to determine if capital needs could be funded by a mix of Government equity and debt. Their capital investment and funding decisions are subject to the approval process of the Budget and are in the main funded by means of capital grants from the Budget. The application of a Target Capital Structure approach to a general Government business will depend on the nature of the capital investment and the characteristics of its business activities.

Appendix 2: Relationship with other commercial policies

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

Financial Distribution Policy

The *Capital Structure Policy* and the *Financial Distributions Policy for Government Businesses (Financial Distributions Policy)* are inextricably linked. The key objective of the *Financial Distributions Policy* is for the Government to receive an appropriate return on its equity in Government businesses. Financial distributions transfer a share of the owner's equity in a business to the owner and comprise:

- 'dividends' which represent a return on the owner's equity investment; and/or
- 'capital repayments' which involve a return of the owner's equity investment.

Where a Target Capital Structure has been determined, it will operate as a constraint on dividends. The dividend scheme and forecast dividend profile will reflect the requirement to target a capital structure that will provide a Target Credit Rating. In this way, actual dividend payments may be used to maintain the business' capital structure within the approved minimum to maximum range.

Financial distributions in the form of capital repayments may be used where it has been determined that the Government's equity in a business should be reduced.

Reporting and Monitoring Policy

The effective monitoring of Government businesses is a key element of the Commercial Policy Framework. The R*eporting and Monitoring Policy for Government Businesses* aims to enhance accountability in the management and control of Government businesses and provide clarity on reporting and monitoring requirements. It requires Government businesses to agree with Shareholders a Statement of Corporate Intent (SCI), which includes agreement of the Target Capital Structure, and provide regular reports on performance against targets agreed in their SCI. Further, it requires continuous disclosure of any information which may materially impact the operational and financial standing of the business.

Appendix 3: Roles and responsibilities

Timing (Note 1)	**Role** (Note 2)	**Responsibility**
Before February	Obtain annual credit rating to inform the SCI.	Management (within Treasury contract)
As required	Determine the Target Credit Rating (TCR) if other than Baa2/BBB (Moody's/Standard & Poor's).	Treasury in consultation with business
February - April	Confirm existing or negotiate revised Target Capital Structure with minimum-to-maximum debt range as part of the SCI process. Where credit rating does not align with TCR: ▪ Consider options to move to TCR ▪ Model credit rating impact of options ▪ Agree the approach and timing to move to TCR ▪ Agree the Target Capital Structure	Shareholders and Board with support from Treasury and Management
June	Submit SCI and Business Plan (which incorporate business' TCR and Target Capital Structure) to Treasury for signing by Shareholders	Board / Management
Ongoing	▪ Ensure the agreed capital structure is established and maintained. ▪ Report movements in capital structure and the associated reasons in quarterly and half yearly reports to the Shareholders or earlier where relevant (refer to Reporting and Monitoring Policy). ▪ Advise Treasury of material changes in the operating environment that may warrant a capital structure review. ▪ Comply with relevant legislative requirements e.g. in obtaining financial accommodation.	Board / Management
Ongoing	▪ Monitor debt levels and the maintenance of agreed capital structure. ▪ Institute capital structure reviews as appropriate. ▪ Submit financial accommodation requests etc. for Treasurer approval.	Treasury

1. Or another time advised by Treasury e.g. to coincide with Budget submissions.
2. The Statement of Corporate Intent Guidelines released by Treasury annually will provide more detailed guidance.

Glossary

Board: the governing board as provided in the business' enabling legislation or the *State Owned Corporations Act 1989*; or where the Government business does not have a governing board, the Chief Executive Officer/Managing Director undertakes the role of the Board.

Credit rating: aggregate estimation of a business entity's capacity to service and repay debt, as it falls due.

Credit outlook: indicates the potential direction of a rating over the medium term e.g. a positive outlook means that a rating may be raised; negative means that a rating may be lowered; stable means that a rating is not likely to change; and developing (or evolving) means that a rating may be raised or lowered.

Government businesses in New South Wales include:

- Public Trading Enterprises (PTE) or Public Non-financial Corporations under Australian Bureau of Statistics (ABS) classification;
- Public Financial Enterprises (PFE) or Public Financial Corporations under ABS classification; and
- General Government (under ABS classification) agencies or business units of an agency that supply market goods and services, do not receive significant Budget funding and have been identified by Treasury as a Government business.

Shareholders for:

- State Owned Corporations: the Treasurer and another Minister nominated by the Premier as a voting shareholder under the *State Owned Corporations Act 1989*.
- Non-corporatised Government businesses: the Treasurer and the relevant Portfolio Minister undertake the role of shareholders.
- Companies established under the *Corporations Act 2001* (Cth): Minister(s), typically the Treasurer, holding shares for and on behalf of the Crown.

State Owned Corporation (SOC): Government business (PTE or PFE) distinguished by its corporatised status having been listed in Schedule 5 of, and subject to, the *State Owned Corporations Act 1989.*

Statement of Corporate Intent (SCI): an agreement under the *State Owned Corporations Act 1989* between the SOC Board and Shareholders that holds the Board accountable for performance to the Shareholders and Parliament. The SCI is supported by a Business Plan. Where a Government business is not corporatised, it is required to provide Treasury with a **Statement of Business Intent (SBI)** and a Business Plan, under the Commercial Policy Framework, which is an agreement between the business and the Treasurer and Portfolio Minister (or their representatives). The term SCI in this policy is used to refer to the applicable Government business agreement be that either SCI or SBI.

Target Credit Rating: stand-alone credit rating of Baa2/BBB (Moody's/ Standard & Poor's) or an alternative Target Credit Rating as determined by Treasury in consultation with the Government business under this policy.