Guidelines for Tasmanian Government Businesses

Capital Investment

November 2016

Tasmania
Explore the possibilities

Department of Treasury and Finance

Published by the Department of Treasury and Finance
GPO Box 147
HOBART TAS 7000

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Capital Investment Guideline

1. Purpose

The boards of Government businesses are responsible for making capital investment decisions and are accountable to the Shareholding Ministers for those decisions. This Capital Investment Guideline establishes the Shareholding Ministers' expectations of boards when making capital investment decisions and defines a process that will enable the Shareholding Ministers to be satisfied that capital investments are based on sound commercial practice and enhance Shareholder value.

The key objectives of this Guideline are to:

- clearly set out the expectations, priorities and risk concerns of Shareholding Ministers, without diminishing the responsibility and accountability of the board of the Government business;
- ensure Government businesses have in place rigorous assessment and approval processes to ensure major capital investment decisions are soundly based and to hold boards accountable for their investment decisions;
- ensure major capital investment decisions by Government businesses appropriately balance the commercial interests of the business against the interests of the State as a whole;
- ensure that when assessing the risks of any major capital investment decisions, Government businesses are cognisant of the Government's risk appetite as a risk averse investor; and
- ensure that Government businesses monitor and report to Shareholding Ministers on their major investment decisions.

This Guideline does not relate to financial investments which are covered by the financial policies of the businesses in line with Treasurer's Instruction GBE 07-44-01.

This Guideline is in addition to the businesses' current requirements for continuous disclosure and regular reporting obligations to the Shareholding Ministers.

2. Application of Guideline

This Guideline applies to all Government Business Enterprises and State-owned Companies.

This Guideline supersedes the previous version (November 2012) and takes effect from the day it is issued.

3. The Fiscal Strategy

In accordance with the Government's Fiscal Strategy, Government businesses are required to deliver services to Tasmanians at the lowest sustainable cost, while also providing an appropriate financial return to the Government.

As part of the current Fiscal Strategy, boards and management of Government businesses are accountable for business performance and for delivering value for taxpayers and the community. To achieve this, the Government is focused on enhancing the financial transparency of

Government businesses and ensuring that all businesses are reporting regularly against clear and measurable goals.

Any major capital investment is likely to impact on the debt level of the business. The Government has a close focus on Government business debt levels, particularly given that Government businesses comprise a significant share of Total State Net Financial Liabilities. (TSNFL). This is particularly important given that the level of TSNFL is an important consideration of the Credit Rating Agencies.

Similarly, the Shareholding Ministers have a strong expectation that all Government businesses focus on their core business, as set out in enabling legislation and relevant governance documents, including Ministerial Charters, Constitutions and Members' Statements of Expectations. The Shareholding Ministers expect that Government businesses operate consistently within the bounds established by these governance documents.

On this basis, this Guideline establishes a process for proper scrutiny of capital investment proposals, to ensure that:

- investment proposals are focussed on the core business of the Government business and the expectations of Shareholding Ministers;
- returns to Government will be maximised; and
- Government business debt levels are sustainable and will not adversely impact on the State.

4. Capital Investment Decisions

There is an expectation that each Government business has in place a rigorous and robust decision making process to support the planning and approval of all capital investment proposals. This process is likely to include different provisions and requirements for analysis depending on the size and complexity of each proposal. While the board of the Government business is responsible for all investment decisions made by the business, it is also likely that responsibility for the approval of smaller, simpler proposals will have been delegated to the senior management team.

The decision making process for capital investments is to be clearly prescribed in a board-approved policy and should include unambiguous delegation thresholds.

The Shareholder Ministers expect that, for major capital investment decisions, the following issues will be considered by the board:

- how the proposed investment aligns with the business's long-term strategies set out in the Corporate Plan;
- whether an investment proposal is focussed on, or complements, core business as set out in the Members' Statement of Expectations or Ministerial Charter for the business;
- any alternative options that have been considered and why these have been discounted;
- potential risks inherent to the proposed investment, and strategies that will be put in place to mitigate these risks;

- the expected investment rate of return, how this reflects the level of risk associated with the investment, and how this compares to industry benchmarks, where relevant;
- the ability of the business to deliver on the proposal and the impact on resourcing, including the need to use outside contractors, or joint venture or partnership arrangements;
- the ability of the business to undertake the proposed major capital investment within its financial capabilities, without seeking additional funding; and
- specific policy directives issued by the Government including, for example, limits on geographical expansion outside Tasmania without shareholder approval.

5. Shareholding Ministers' Expectations

While the boards of Government businesses are ultimately accountable for capital investment decisions, it is appropriate that the business advises the Government on any proposed major capital investments prior to the implementation of the board approved business case, as the Government has a strategic State-wide view that may not exist within each individual Government business.

Capital investment may be funded by debt, equity, or a combination of the two. From a financial viewpoint, a Government business that utilises debt to fund major capital investment is taking on future obligations and costs in the form of interest and principal repayments. This also impacts on the debt position of the total State sector. Alternatively, utilising equity is the investment of cash reserves which has an opportunity cost and could be invested elsewhere by the Government.

With debt funded capital investment in particular, the Government may wish to limit the total level of debt within the Government business sector, given its flow-on effect to the achievement of Fiscal Strategy targets and Rating Agency assessments.

From an accounting perspective, while the majority of costs associated with major capital investments will be capital expenditure, it is to be expected that certain proposals will involve costs that are categorised as operational expenditure. Such proposals will still be wholly considered under this Guideline.

The Shareholding Ministers have an obligation to question if an investment is strategically sound, or whether it will meet the rate of return threshold normally used by the Government business. Investment in inappropriate projects, in both a financial and strategic sense, is likely to erode shareholder value over time.

The Shareholding Ministers will not ordinarily have a role in the decision-making process for investment decisions by Government businesses. However, Government businesses must demonstrate that they have conducted an appropriate level of due diligence and rigour when considering new capital investments and the Shareholding Ministers must also be satisfied that the decision by the board is robust and that any investment appropriately balances the commercial interests of the business against the interests of the State as a whole.

Government businesses should consult with the Shareholding Ministers and Treasury from the outset of any proposed major capital investment. This will enable the Shareholding Ministers to raise any Government policy considerations relating to a proposal prior to it being approved by the Board.

Ultimately the Shareholding Ministers will reserve their right to oppose proposed major capital investments that, in their opinion, are considered to be commercially unsound, or, as is more likely the case, may be in the best interests of the Government business, but may not be seen as being in the overall interest of the Government and ultimately the Tasmanian community when taking into account the broader strategic view, including the nature of Government as a risk-averse investor.

6. Proposed Major Capital Investments

The term "proposed major capital investment" in the context of this Guideline covers non-financial investments. Proposed major capital investments include not only new ventures but also the replacement or refurbishment of existing capital equipment. Any proposed project that satisfies **at least one** of the following criteria is deemed to be a major capital investment project to which this Guideline applies:

- it does not meet the standard rate of return threshold used by the Government business, but is considered by the business to address whole-of-State outcomes;
- it is located interstate or overseas except where a business presence has previously been approved;
- it includes the involvement of the private sector, such as joint ventures and co-operative alliances, including the provision of additional equity to a joint venture;
- a finance lease arrangement with a total cost in excess of the threshold set out in table 6.1 below;
- it is complex with significant risks in terms of viability or Government commitment; or
- it has a total project value in excess of the following threshold:

Table 6.1 ***Capital Investment Thresholds***	
Business	**($m)**
Hydro Tasmania (excluding projects included in the asset management strategy)	10
Tasmanian Networks Pty Ltd (excluding AER approved capital investment)	10
Tasmanian Ports Corporation Pty Ltd	5
Tasmanian Railway Pty Ltd	5
TT-Line Company Pty Ltd	5
Forestry Tasmania	5
Metro Tasmania Pty Ltd	5
Aurora Energy Pty Ltd	2
Tasracing Pty Ltd	2
Tasmanian Irrigation Pty Ltd (excluding new irrigation schemes)	2
Public Trustee	2
Port Arthur Historic Site Management Authority (excluding conservation works)	2
Tascorp	2
Motor Accidents Insurance Board	2

The above thresholds reflect the relative size and risk profile of the businesses within the Government's overall portfolio of businesses.

For the purpose of the thresholds, the total value of a capital investment project includes:

- the value of both debt, equity and other financing such as finance leases;

- an estimate of future capital cost obligations associated with the initial investment (for example, an asset acquisition that requires substantial refurbishment or any other attendant future commitments);
- contingency allowance for potential increases in the cost of the capital investment proposal; and
- the total value of multi-staged investments. Such investments are to be treated as a single investment for the purpose of this Guideline.

Formation of subsidiary companies, joint ventures and similar arrangements are also the subject to *Guidelines for Tasmanian Businesses - Subsidiary Companies and Joint Ventures*.

7. Board Consideration of Major Capital Investment Proposals and Advice to Shareholding Ministers

Government businesses should inform the Shareholding Ministers in writing of any proposed major capital investment as early as practicable. The business must provide supporting documentation to justify the investment, including:

- the business case that covers, as a minimum, the issues detailed in section 4;
- measurable targets and goals for the investment, which will be monitored by the board and reported to the Shareholding Ministers;
- exit strategies (where appropriate), as discussed in section 7.1;
- the benefits of the investment to Tasmania, as discussed in section 7.2; and
- the alignment with the Shareholding Ministers' expectations on risk and returns, as discussed in section 7.3.

Where the proposed major capital investment is in information technology systems, the supporting documentation provided to the Shareholding Ministers should also provide the additional information required by section 7.4.

Where the proposed major capital investment is a replacement or refurbishment of existing capital items, the supporting documentation provided to the Shareholding Ministers should also provide the additional information required by section 7.5.

7.1 Exit Strategies

Major capital investment proposals which involve entering into new ventures or business activities, including the formation of joint ventures, should include triggers to activate an exit strategy if the investment performance does not fulfil expectations after a reasonable period of time. The exit strategy should include:

- the key triggers for exiting;
- an assessment of the likely impact on any third party partners; and
- available options based on potential risks.

7.2 Benefits to Tasmania

The board of a Government business has an obligation to make recommendations and decisions that are in the best commercial interests of the business, after taking into account the interests of the State as advised by the Shareholding Ministers. As the Government has the overall responsibility to appropriately balance the commercial interests of the business against the broader interests of the State as a whole, wider considerations are appropriate along with the more narrow financial considerations.

Any investment involves risk that may lead to increased volatility in earnings and requirements for additional capital. In circumstances where the proposed major capital investment does not realise expectations, the Government may suffer a loss of equity in the business.

Therefore, the board of a Government business has a responsibility to also assess whether the major capital investment proposal will lead to:

- growth in the State's economy;
- increased employment opportunities; and/or
- increased financial returns to Government.

7.3 Risk and Return Assessment

All major capital investment proposals should include a thorough assessment of the rate of return and projects should generally only proceed if they are shown to exceed the rate of return threshold established by the Government business. The underlying assumptions relied upon for assessments considered by the boards of Government businesses should be shared with the Shareholding Ministers.

The return provided from a major capital investment should be commensurate with its perceived level of risk. However, Government businesses may consider projects where the assessed rate of return is less than the standard rate of return threshold used if the Government can be satisfied that the investment facilitates outcomes which provide measurable whole of State benefits.

The board of the Government Business is accountable for the actual performance of the major capital investment compared with the projected performance.

The Shareholding Ministers must be satisfied that the stated rate of return on the proposed major capital investment can be achieved and that adequate returns will flow back to the Shareholders, in view of the general principle that the Shareholding Ministers prefer reliable dividend streams to capital growth.

As a general rule, major capital investments should return positive cash flows within the medium term (that is, three years from the commencement of operations) and provide a tangible dividend within that timeframe.

Major capital investments associated with risk mitigation are exceptions to the return assessment, as they may not generate a return but are required for operational or other purposes. For the purpose of such investments, the rate of return expectations may be disregarded, however the proposed investment must still meet all other requirements outlined in this Guideline.

Government businesses should identify significant risk exposures associated with the proposed major capital investment. Identification of new risks once a project has commenced, and the ability of the business to manage all identified risks must be clearly articulated. Businesses should assess the extent of any risk and identify risk mitigation measures that are warranted from a cost/benefit perspective.

In assessing the risk of the proposed major capital investment, Government businesses should be cognisant that the Government is a risk averse investor and must take into account any risks that have the potential to impact on the State and its balance sheet.

7.4 Investments in Information Systems

The Government is mindful that investments in information technology can be complex processes and there can be a risk of significant cost overrun where there are not proper controls in place.

Therefore, where a proposed major capital investment is for information technology systems, in addition to the general requirements, the board of the Government business should be satisfied that it has been provided with the following additional information:

- a description of the controls that are in place to prevent increases in project scope and cost-overruns;
- a description of the proposed information technology provider and the due diligence on the provider that has been conducted by the business;
- the complexity of the proposed system and associated implementation risk;
- the forecast cost of ongoing system support;
- a description of the system's functionality and the ability to integrate with existing system architecture; and
- a description of the division of financial and operational risks borne by the systems provider and those risks retained by the business.

The board of a Government business must conduct a thorough due diligence on any proposed information technology provider(s) that are selected to provide services related to any information technology major capital investment project.

7.5 Replacement or Refurbishment of Existing Capital Equipment

Where a proposed major capital investment is the replacement or refurbishment of existing capital equipment, the investment proposal should also include the following:

- a description of the asset to be replaced, including its purpose and strategic fit with core business;
- clear justification for replacing the asset, including the risks associated with non-replacement;
- analysis of alternative replacement options that have been considered, such as new, second hand and asset refurbishment options;
- the forecast financial impacts of the replacement, such as the expected rate of return, projected cash flows and annual profits, including the estimated impact on depreciation, interest and maintenance expenses;

- an assessment of the risks inherent in the proposed asset replacement or refurbishment; and
- whether there are likely to be any broader policy or industry impacts.

8. Investments in Non-core Business

A Government business should not undertake non-core business activities, especially those that result in a business presence outside the state. It is unlikely that at-risk equity invested in such non-core business activities would be the best strategic use of those funds for the community.

If the board of a Government business has identified a compelling case to make such a capital investment, it must not make the investment without the prior written approval of its Shareholding Ministers.

When seeking the approval of its Shareholding Ministers to invest in such an activity, the proposal from the Government business should include detailed information to justify why the board considers that the activity is appropriate, in addition to the information that is required to support the investment itself.

This recognises that investing in such non-core business activities would effectively broaden the scope of Government activities. Therefore, it is crucial that any expansion of business activities is clearly supported by the Shareholding Ministers before it is progressed.

This requirement applies to all proposed investments that are outside the scope of core business of the Government businesses or outside of the State, whether they are major capital investments or otherwise.

9. Role of Treasury

It is the role of Treasury to provide advice to the Shareholding Ministers in regard to compliance with this guideline and as to whether the Government business has the appropriate processes in place to enable the Shareholding Ministers to have sufficient comfort that appropriate due diligence has been undertaken by the board of the Government business.

Government businesses need to ensure that their Shareholding Ministers are provided with sufficient time to provide input into the capital investment proposal. This needs to include time for Treasury to provide any advice in regard to:

- establishing that the capital investment proposal has been formulated in a commercially sound manner in line with the board's approved decision making process;
- ensuring that the proposed investment is consistent with the Government's strategic direction for the business;
- any implications for financial returns to the Government arising from the proposed project, as well as the extent of any new borrowings;
- ensuring that all identifiable risks have been documented and considered, and that appropriate mitigation strategies are in place;
- the appropriateness of the exit strategy and the implications if the proposal does not meet its required rate of return; and

- whether the proposed capital investment gives rise to any broader public policy issues for Government.

At any stage, further information may be sought from the Government businesses by Treasury.

10. Ongoing Reporting and Monitoring

Shareholding Ministers expect ongoing information on the commercial effectiveness and financial viability of major capital investment projects to be provided as a part of the Government business reporting cycle.

To this end, each business must monitor and report the performance of its major capital investments against the agreed targets, on a regular basis. The performance indicators will differ for each major capital investment. However, at a minimum they should include a comparison of actual performance against the benchmarks provided in the business case. This should include:

- return on investment;
- internal rate of return;
- capital expenditure;
- performance against budget and project implementation timeframes;
- project cash flows; and
- borrowings.

In addition, a post implementation review on major capital investments is to be undertaken by or on behalf of the Government business and a copy of that review provided to the Shareholding Ministers.

Reporting should continue into the post-implementation phase, particularly where a major capital investment has been approved by the board of a Government business on the basis of the expected realisation of benefits over an extended period. The extent of post-implementation reporting and analysis should be discussed and agreed with the Shareholding Ministers on a case-by-case basis.

Should it become evident to the Government business that its major capital investment is performing poorly or well below expectations, or has produced risks not originally foreseen, the Shareholding Ministers are to be informed immediately, along with proposals for remedial action to mitigate those risks or strategies to exit from the investment.

The Shareholding Ministers will hold boards of Government businesses accountable for the outcomes of major capital investment decisions.

Guidelines

All major capital investment proposals that qualify under Section 6 must meet all the requirements outlined below.

Major Capital Investments	
(a)	Must be considered against any alternatives and note why they have been discounted.
(b)	Must be subject to consultation with the Shareholding Ministers prior to the implementation of the board approved business case to enable feedback on any Government policy considerations and provide the business case, target and goals, exit strategies, benefits to Tasmania and risk and return evaluation as early as practicable.
(c)	Must be presented to the Board through a business case covering all relevant issues outlined in the Guidelines plus the additional information if the investment is in information technology or a replacement/refurbishment of existing capital equipment.
(d)	Include all the costs (if multi-staged) as a single investment.
(e)	Have gone through a rigorous internal assessment and approval process that will subsequently hold the Board accountable.
(f)	Have been formulated in a commercially sound manner in line with the core business functions as set out in enabling legislation and relevant governance documents or, if outside this scope, seek approval from Shareholding Ministers.
(g)	Be consistent with the Government's strategic direction.
(h)	Forecast any implications for future returns to Government and notify the Shareholding Ministers of any change.
(i)	Be within the current financial capabilities of the business.
(j)	Be funded (through equity, debt or finance leases) in a way that reduces opportunity costs, including minimising the contribution to the overall debt levels of the Government.
(k)	Have a contingency/exit plan developed if the proposal does not meet the expected rate of return or requires further funding, and inform the Shareholding Ministers immediately if either occur.
(l)	Meet the standard rate of return required for capital investment decisions that is commensurate with the perceived level of risk (excluding investments associated with risk mitigation).
(m)	Return positive cash flows in the medium term (excluding investments associated with risk mitigation).
(n)	Align with the risk averse appetite of the Government.
(o)	Monitor and report the investment against agreed targets in the business case.
(p)	Include a post-implementation review of the investment to be provided to the Shareholding Ministers.
(q)	Receive prior approval by the Shareholding Ministers if any new investment is in non-core business activities.

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