8. COMMERCIAL PERFORMANCE IN THE BROADER PUBLIC SECTOR

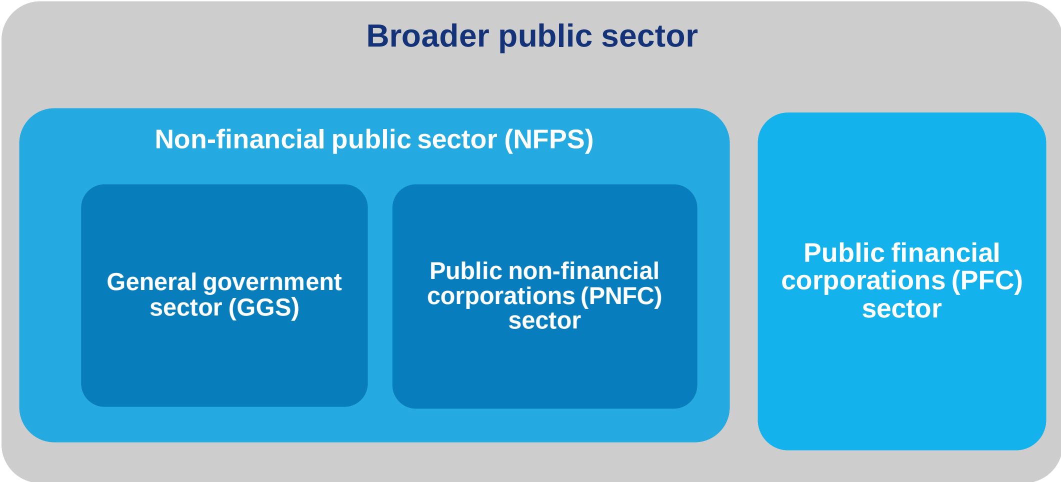
- The broader public sector comprises the total state government in New South Wales and includes the general government sector (GGS), the public non-financial corporations (PNFC) sector and public financial corporations (PFC) sector.
- The PNFC and PFC sector are guided by a Commercial Policy Framework (CPF), which applies the disciplines and drivers of private businesses to government businesses to support them operating effectively and in the best interest of consumers. The Government continues to review the CPF to align it with best practice.
- The non-financial public sector (which comprises the GGS and PNFC) net operating balance is forecast to be $2.7 billion for 2016-17, $1.3 billion more than forecast in the 2016-17 Budget. This is due to a stronger than expected result for both the GGS and PNFC sectors. Within the PNFC sector, the main drivers of the upward revision are stronger results in the property sector and increased demand and improved efficiency in water and energy sectors.
- The total dividends and tax equivalent payments received by the GGS from the PNFC and PFC sectors in 2016-17 are $1.1 billion, which is $67.0 million lower than estimated at the 2016-17 Budget. This is a result of lower dividends and tax receipts from the energy sector, partially offset by higher dividends and tax receipts mainly from the water sector.
- Over the budget and forward estimates, dividends and tax equivalent payments are forecast to be $6.0 billion, $1.7 billion higher than forecast at the 2016-17 Budget. This is mainly due to State-owned Corporations forecasting higher dividend payments as a result of aligning with the updated Financial Distribution Policy for Government Businesses.

8.1 Introduction

The broader public sector is made up of entities within the public financial corporations (PFC) sector and non-financial public sector (NFPS). The NFPS is comprised of the general government sector (GGS) and the public non-financial corporations (PNFC) sector:

- entities within the GGS are funded mainly by taxation revenue and provide services such as health, education and emergency services
- entities within the PNFC sector operate on a more commercial basis and are able to recover most of their costs by charging consumers for services such as transport, water and electricity distribution
- the PFC sector provides financial management services to the government and insurance services to the people of New South Wales
- entities in the PNFC and PFC sectors include State Owned Corporations (SOCs) set up under the *State Owned Corporations Act 1989* to operate with a greater degree of commerciality and autonomy than entities in the GGS.

A full list of NSW public sector entities according to their classification as a GGS, PNFC or PFC entity is provided at Appendix A3 of this *Budget Statement*.



8.2 Reform of government businesses

Review of the Commercial Policy Framework

The Commercial Policy Framework (CPF) is a suite of policies that set expectations for government businesses in the PNFC and PFC sectors. The CPF aims to replicate in government businesses the disciplines and drivers of efficient private sector businesses.

The Government continuously reviews and updates the CPF to ensure it reflects commercial best practice and to incorporate changes in government priorities and the regulatory environment. Treasury is currently reviewing policies designed to improve the efficiency of government businesses by:

- supporting the delivery of services at lower cost
- adopting private sector governance principles that are practical to apply
- strengthening assurance and monitoring of major capital investments
- ensuring that commercial objectives are balanced with improved customer outcomes.

The reforms to the CPF will enable government businesses to perform comparably with efficient private sector businesses, putting downward pressure on cost of living expenses and helping benefit the NSW economy.

At the same time, government businesses maintain transparency through public reporting obligations.

Changes to the CPF in 2015-16 included enhanced guidance on setting and reporting key performance indicators and changes to the capital structure and distribution policies (see Box 8.1). In 2017-18, revisions to the CPF will include implementing a stronger assurance and monitoring process for major capital investments and updating the board governance guidelines. These changes will strengthen the ability of government businesses to deliver the best outcomes for the people of New South Wales.

Box 8.1: Capital efficiency reforms and dividends policy

As part of the process of updating the CPF, in mid-2016 NSW Treasury released the updated Capital Structure Policy for Government Businesses and the updated Financial Distribution Policy for Government Businesses.

The new Capital Structure Policy requires businesses to move to an efficient capital structure while maintaining an investment grade credit rating (a Baa2 credit rating on the Moody's rating scale unless otherwise agreed by Treasury).

Since the release of the updated policy, SOCs have reviewed their gearing levels and capital structures. In order to move to an efficient capital structure, SOCs have committed to increase their dividend payments or return surplus capital to the State, where appropriate. For example, Water NSW will return more than $650.0 million in surplus capital in 2017-18, and the Port Authority of NSW will increase their 2017-18 dividend payment from $53.6 million as forecast in the 2016-17 Budget to $200.0 million.

These changes will move a number of the price-regulated SOCs to more closely align with the regulatory levels of gearing as determined by the Independent Pricing and Regulatory Tribunal (IPART). For the non-regulated SOCs it will move the businesses to gearing levels that more closely align with comparable public and private sector businesses.

These changes to the capital efficiency of SOCs are freeing up capital for the State to reinvest for the benefit of the people of New South Wales.

The Government ensures that dividend payments and capital returns do not impact on consumer prices, capital investment or service delivery. Payment of dividends and capital returns are subject to a number of conditions including confirmation of financial capacity to pay, a satisfactory test of solvency and maintaining an investment grade credit rating. The broader CPF encourages more efficient government businesses, putting downward pressure on consumer prices.

The Government will continue to monitor and review the dividend payout ratio and capital structure of government businesses to balance the outcomes for both consumers and tax payers.

Reforming water

Over recent years, the Government has delivered a program of reform aimed at achieving greater efficiency in water services and improvements in customer experience.

In 2016, a realignment of functions across the Department of Primary Industries (DPI) Water and Water NSW resulted in a number of operational and field based functions moving from DPI Water to Water NSW. As a result, DPI Water is now focused on providing strategic water policy and planning advice, and developing and enhancing water regulation and reporting frameworks. This supports productive and sustainable management of the State's water resources.

Water NSW is now focused on:

- providing a single point of contact for rural water customers
- developing infrastructure solutions for water supply security and reliability
- planning, building, operating and maintaining water supply infrastructure
- promoting improvements in achievable water quality standards, and protecting public health and the environment through enhanced catchment protection practices in declared catchments.

In November 2016 the Government issued a direction to Water NSW to secure the water supply of Broken Hill through building, owning and operating a 270 kilometre pipeline from the

River Murray at Wentworth to Essential Water's filtration plant in Broken Hill. Water NSW has begun planning and procurement and is on track to deliver the pipeline by December 2018.

Sydney Water is investing $156.0 million in its information technology project CxP. CxP will be a single enterprise solution for customer interactions that is quicker and more reliable than the current system. It will also deliver a new billing and customer management system. The new system will provide a platform for future customer service enhancements and more efficient processes.

Reforms in the non-regulated sector

The businesses in the non-regulated sector have also undergone significant reforms to their operating models over recent years, driving efficiencies and savings for consumers.

In February 2017, the Forestry Corporation of New South Wales (FCNSW) acquired the Lyall estate, which comprises 7,000 hectares of pine plantation and plantable land near the timber towns of Oberon, Tumut, and Tumbarumba in regional New South Wales. This acquisition offers synergies through its proximity to FCNSW's existing plantation resources and timber processing hubs. The acquisition will help boost softwood production and drive industry growth. Substantial improvements in FCNSW's productivity since corporatisation in 2013 made the acquisition possible without requiring any additional capital from the State.

The Port Authority of New South Wales (PANSW) has committed to developing Sydney Harbour as a premier cruise destination. A Cruise Development Plan (CDP) to address infrastructure and capacity issues in Sydney Harbour and support the growth in the cruise sector is being developed by the Department of Industry in consultation with Transport for NSW (TfNSW), PANSW and the cruise industry. The Government expects to release the CDP later in the year.

An independent review of Landcom (trading as UrbanGrowth NSW) undertaken in 2016 recommended separating the business' major urban transformation projects (MUTPs) from its greenfield activities. In July 2017, oversight for the MUTPs will be transferred to the Premier and Cabinet Cluster to implement the review's recommendations, with the Bays Precinct, Parramatta North, Anzac Parade South and Central to Eveleigh projects to be transferred to the UrbanGrowth NSW Development Corporation, and the Newcastle Urban Transformation and Transport Program to be transferred to the Hunter Development Corporation. Landcom will remain as a SOC, focusing on greenfield development and housing affordability.

These changes will allow better coordination across the whole-of-government for the MUTPs while enabling Landcom to focus on its core business, including meeting the Government's target of delivering 20,000 home sites by March 2019.

The Government is also reforming the delivery of public transport services. In 2011, TfNSW was established to be responsible for delivery of transport services in New South Wales. In 2012, RailCorp was reformed and Sydney Trains and NSW Trains were established as government owned operators to deliver services under contract to TfNSW and drive customer service improvements. In the 2015-16 Budget, the Government built on these reforms and announced that the Transport Asset Holding Entity (TAHE) would be established. On 12 April 2017, a bill to make TAHE a dedicated transport asset manager was passed by Parliament. The legislation marks another important milestone in the staged approach to amending the *Transport Administration Act 1988* to deliver improved asset management and customer services.

TAHE will optimise the existing transport asset base to enable a more effective, efficient and commercial approach to the asset management.

Reforms in the energy sector

On 24 May 2017, a Federal Court decision on the pricing regime for network distributors including Essential Energy will likely result in the Australian Energy Regulator (AER) remaking its revenue determination for Essential Energy's 2014-19 regulatory period.

The Federal Court decision comes more than two years after the AER issued Essential Energy's 2014-19 regulatory determination, which resulted in the average 2016-17 network charges for customers in the Essential Energy area being reduced by almost 26 per cent, or $289 per year, compared to their 2014-15 network charges. There is an agreement with the regulator that charges will not increase by more than inflation for the remainder of the determination period to 2019.

Essential Energy's objective continues to be to transition to a more streamlined, cost-effective business model while delivering a safe, reliable and efficient electricity network to its customers.

Snowy Hydro Corporation has commenced a feasibility study into Snowy 2.0, a pumped hydro storage project. This study is due to be completed by the end of the 2017 calendar year.

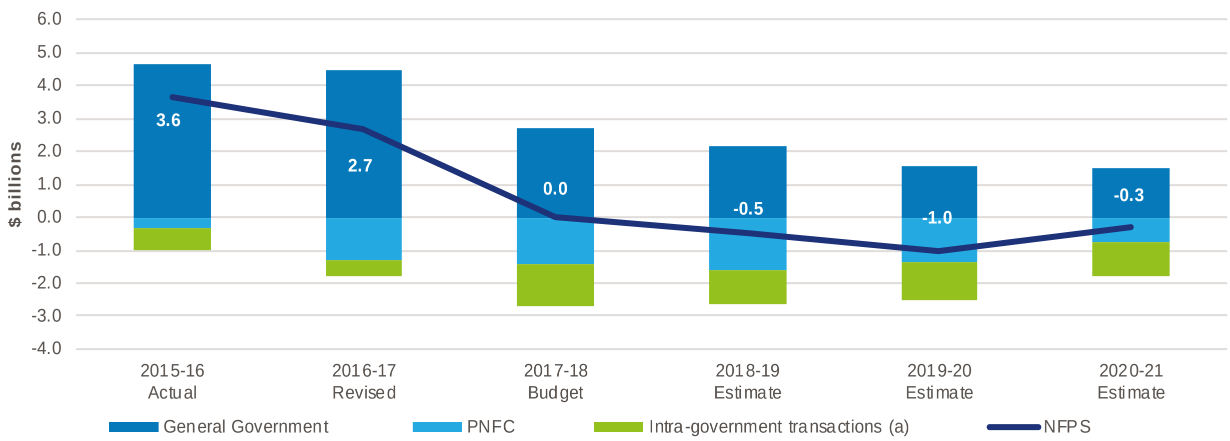
The New South Wales and Victorian governments are in discussions with the Commonwealth Government regarding the Commonwealth's possible purchase of New South Wales' 58 per cent and Victoria's 29 per cent shareholdings in Snowy Hydro Corporation.

8.3 Non-financial public sector

The $2.7 billion net operating balance for the NFPS in 2016-17 is higher than forecast in the 2016-17 Budget (Chart 8.1). The upward revision is due to a stronger net operating balance for both the GGS and PNFC sectors. Within the PNFC sector, this was driven by stronger residential land sales, and increased demand and improved efficiency in water and energy, partially offset by a decline in revenues as a result of the partial long-term leases of Ausgrid and Endeavour Energy. The net operating balance for the NFPS over the forward estimates is higher relative to the 2016-17 Budget forecast, primarily driven by revenue growth exceeding expense growth in the GGS.

Further details on the performance of the GGS are set out in Chapters 5 and 6 of this *Budget Statement*.

Chart 8.1: Components of the non-financial public sector net operating balance



(a) Intra-government transactions refer to payments between State entities, such as dividends paid from PNFCs to GGS.

Dividends and tax equivalent payments

Dividends received by the GGS from PNFCs and PFCs are based on the operating performance of those businesses. To ensure competitive neutrality with private sector businesses, PNFCs and PFCs also make tax equivalent payments and pay debt neutrality charges (government guarantee fees). In 2016-17, the dividend and tax equivalent payments are forecast to be $1.1 billion, and government guarantee fees are forecast to be $395.5 million. Over the budget and forward estimates, dividends and tax equivalent payments are forecast to be $6.0 billion.

Dividends and tax equivalent payments from the electricity sector over the budget and forward estimates are forecast to be $1.2 billion lower than estimated at the 2016-17 Budget, primarily due to the asset recycling initiatives that saw the partial long-term leases of Ausgrid and Endeavour during the 2016-17 financial year. The impact of these transactions is to decrease dividends and tax equivalent payments by $0.8 billion between 2017-18 and 2019-20.

This reduction in dividends is offset by distributions from the retained interests of Ausgrid and Endeavour Energy, which are accounted for as distributions from equity investments and so fall within the GGS.

PNFCs in the water sector have increased their dividends by $1.5 billion between 2017-18 and 2019-20 when compared to the forecast in the 2016-17 Budget. This improvement is a result of moving to more efficient capital structures in line with the updated Capital Structure and Distributions Policies (see Box 8.1). In some cases, the move to a more efficient capital structure has allowed the water businesses to return excess capital to the State.

Dividends and tax receipts have increased from the property and resources sector mainly due to the reform of Landcom's operations, which will enable it to pay dividends over the forward estimates. Landcom had previously retained 100 per cent of earnings to fund the delivery of the MUTPs.

PANSW has increased its forecast dividends over the forward estimates to move in line with the updated Capital Structure and Distribution Policies, thereby improving capital efficiency and returns to the Government.

Table 8.1 shows the dividend and tax equivalent payments of the PNFC and PFC sectors over the period 2016-17 to 2020-21.

Table 8.1: Dividends and tax equivalent payments from public non-financial corporations and public financial corporations

	2016-17	2017-18	2018-19	2019-20	2020-21
	Revised	Budget		Forward Estimates	
	$m	$m	$m	$m	$m
Electricity	275	47	54	75	112
Water	576	966	923	1,088	814
Property and Resources	124	328	297	305	249
Ports	8	202	36	40	36
Transport	...	...	...	...	102
Public Financial Corporations	122	77	78	86	92
Total Dividends and Tax Equivalent Payments	1,106	1,620	1,388	1,594	1,405

Capital expenditure

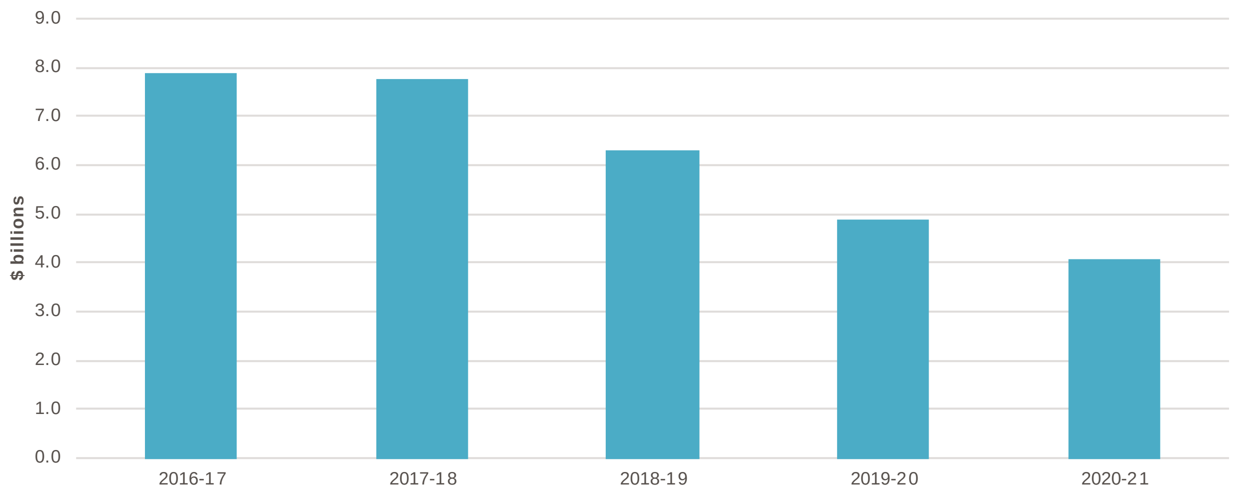
In 2016-17, capital expenditure within the PNFC sector is forecast at $7.9 billion, $1.4 billion lower than forecast at the 2016-17 Budget. This result was driven by the partial long-term leases of Ausgrid and Endeavour and lower capital spend by Rail Corporation New South Wales and Sydney Motorway Corporation.

Capital expenditure within the PNFC sector over the budget and forward estimates will be $23.0 billion. This is $5.7 billion lower than forecast in the 2016-17 Budget due to the capital expenditure programs from Ausgrid and Endeavour Energy no longer being included. These reductions are slightly offset by higher spend by Sydney Water and Water NSW.

Chart 8.2 shows capital expenditure in the PNFC sector from 2016-17 to 2020-21. Box 8.2 provides information on the Government's plan to fund the final stage of the $16.8 billion WestConnex project.

Further details on the Government's capital expenditure strategy are provided in Budget Paper No. 2 *Infrastructure Statement*.

Chart 8.2: Capital expenditure of the public non-financial corporations sector



Capital expenditure falls from a high of $7.9 billion in 2016-17 to $4.1 billion in 2020-21 reflecting completion of stages one and two of the WestConnex project and the Sydney International Convention Exhibition and Entertainment Precinct.

Box 8.2: Funding and financing WestConnex

WestConnex is the largest road project in Australia, providing 33 kilometres of motorway, two thirds of which will be underground. It will create 10,000 direct and indirect jobs during construction and delivery, and deliver more than $20 billion in economic benefits to New South Wales.

On 12 May 2017, the Government announced its plan to help fund the final stage of WestConnex – the critical M4-M5 Link connecting two of Sydney's busiest motorways and the Iron Cove Link and Rozelle Interchange – by the sale of a majority stake in Sydney Motorway Corporation (SMC), the company delivering WestConnex. The Government also announced a one month toll free period for the M4 Widening.

The Government will launch a competitive trade sale later this year, calling for expressions of interest in at least 51 per cent of SMC and its subsidiaries, which hold the toll road concessions for WestConnex. The Government expects this transaction to receive substantial interest from local and international investors. The transaction is targeted to close in mid-2018.

The transaction forms part of the Government's core strategy to maintain strong budgets while delivering a once-in-a-generation infrastructure pipeline that creates jobs and drives economic growth.

8.4 Public financial corporations sector

The public financial corporations (PFC) sector includes New South Wales Treasury Corporation (TCorp) and Insurance and Care NSW (icare).

TCorp is the central borrowing authority for the State, and the State's central provider of funds management services. As a top ten Australian fund manager, TCorp currently has over $79.3 billion in funds under management (as at 31 May 2017). This includes managing funds on behalf of icare, State Super and the NSW Infrastructure Future Fund (NIFF). TCorp's total funds under management have increased from $66.6 billion to $79.3 billion over the year to 31 May 2017 largely as a result of the new NIFF investment mandate.

Strong investor demand for NSW triple-A rated securities, combined with TCorp's economies of scale, mean that TCorp is able to achieve a low cost of borrowing for the State. TCorp has been able to achieve economies of scale through the funds amalgamation initiative, which saw the State's core funds management activities in icare and State Super successfully amalgamated within TCorp. As part of the funds amalgamation initiative, a single custodian has been appointed to manage all financial investments managed by TCorp. In December 2016, the Government announced that JP Morgan was selected as preferred custodian of the combined investment funds for three Government agencies, TCorp, icare and State Super, achieving significant savings for the State.

icare delivers insurance and care services to the people of New South Wales through the Workers Insurance, Dust Diseases Care, Lifetime Care, Self Insurance, Building Insurers' Guarantee and Sporting Injuries Insurance schemes. In April 2017, icare was moved to the Treasury Cluster.

As a centre of excellence for insurance and care needs, icare puts customers at the heart of its endeavours with its goal to protect, insure and care for the people, businesses and assets of New South Wales.

Since it was created in September 2015, icare has introduced a range of initiatives that have benefited the people of New South Wales. icare has:

- halved the average processing times for people who have a workplace related dust disease and met the new two day target for considering and approving claims (once processed) in 100 per cent of cases
- finalised a direct funding pilot which enabled lifetime care participants to enhance their quality of life by giving them the ability to adjust their care services to suit their lifestyle
- linked workers insurance premiums to good claims performance and in 2015-16 allocated $188.0 million to be returned in premium discounts to employers with safety and return to work records above the NSW Workers Compensation Scheme average
- launched the icare Foundation, which will invest $100 million over five years, in programs, research and partnerships focused on prevention and post injury care that will make a difference to the mental and physical wellbeing of our community.