

Public sector insights

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Dear friends

Welcome to the second edition of *Public sector insights*. Since the last edition, the global economy has experienced a shift in dynamics as governments are taking a lead role in the financial services sector and stimulating activity across borders.

Ernst & Young's Global Government & Public Sector leader, Philippe Peuch-Lestrade visited Australia on 28 January. During his visit, he was interviewed by Skygroup Business on his reflections of the current economic crisis. Philippe commented on the government's more active involvement in managing banks and financial services. Governments will also face an additional challenge over the next five years as they balance increasing budget deficits with the need to invest in key services and infrastructure to stimulate their economies.

Governments in Australia and New Zealand are not immune to this change.

Our headline article focuses on the government's changing face in these uncertain times. I would like to leave you with these words from John F Kennedy, "The Chinese use two brush strokes to write the word crisis. One brush stroke stands for danger; the other for opportunity. In a crisis, be aware of the danger - but recognise the opportunity."

I hope this edition of *Public sector insights* will provide you with ideas and inspiration. Feel free to contact me directly any time.

Best regards



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'Government is back'

With the announcement of the Federal government's second economic stimulus package in early February, the financial crisis continues to put unforeseen pressures on the public sector. Both here and internationally, governments are resuming responsibility for areas of the economy that have been progressively privatised since the 1980s. In the UK, the USA and Europe, public servants are now in charge of large portions of the banking sector.

"... now, with the financial crisis, there is huge pressure from citizens to have the government back in charge."

Philippe Peuch-Lestrade

In Australia, the proposed investment vehicle to support the commercial property sector will see the government stepping in as foreign banks withdraw from the Australian market. We are seeing, here and elsewhere, guaranteeing of private market transactions, liquidity and capital support of 'critical' institutions, currency and interbank market support, as well as general monetary and fiscal stimuli.

Ernst & Young's global leader for Government & Public Sector, Philippe Peuch-Lestrade, visited Australia recently. Interviewed on Sky Business, Philippe provided a number of insights from his dealings with governments internationally. "In a short sentence," Philippe said, "government is back. Since the 80s a lot of governments supported privatisation ... but now, with the financial crisis, there is huge pressure from citizens to have the government back in charge." This responsibility has been forced upon governments. "Across the government arena, broadly speaking, nobody was ready" said Philippe.

Nor do today's government workers have an in-depth understanding of the financial services industry as they would have done pre-privatisation: "It is a totally new generation in government and in the public sector". Philippe explained that governments across the world are taking a variety of roles in the financial services sector including providing guarantees, taking shareholdings and purchasing assets including bad debt portfolios. Few of their employees have deep familiarity with these complex arrangements and their potential consequences for the public at large. Consequently, public servants internationally are seeking support and advice to cope with their new responsibilities.

In Australia, the \$42 billion Nation Building and Jobs Plan sees investment pouring into infrastructure including transport and education. These major development and multi-billion dollar spending programs will put additional strain on already stretched departments. And while none of our banks currently face part or total nationalisation, setting up complex financial arrangements and investment vehicles, such as the commercial property fund, will see bureaucrats facing new challenges and responsibilities.

Adding to this burden is the increasing demand from the public that government initiatives deliver real results for the economy, driven by concerns around budget deficits. Not just confined to Australia, as Philippe states, "Government initiatives around the world must be accountable, transparent and still perform".

This is, of course, a tall order. It is clear from our engagement with clients trying to cope with the turbulence, and governments and regulatory agencies formulating policy responses, that no one has all the answers. However, Ernst & Young has advised both the UK and USA governments on their responses to the financial crisis. We are supporting the Office of Financial Stability in the USA, which was established to administer the Troubled Asset Relief Program (TARP) and, in the UK, we are involved in the Icelandic banking rescue. We understand the specific challenges the public sector now faces in managing a range of new responsibilities that it was ill-prepared for.

Across the world, governments have had no choice but to get involved in their ailing banking sectors. As Philippe concluded: "If the bank stops, everything stops". While this presents a myriad of challenges for public sector workers, with appropriate support and a collaborative approach from both public and private sectors, governments will contribute to building the stability and confidence that the markets and public need to move out of the recessionary cycle.

Feel free to contact Uschi Schreiber or any of our public sector leaders (listed on the back page) for further information.

A stimulating brief

Navigating the implementation of the plan

On 3 February 2009 the Prime Minister Kevin Rudd and the Treasurer Wayne Swan announced the \$42 billion Nation Building and Jobs Plan to stimulate the economy in response to deteriorating global economic conditions. The Plan aims to deliver a fiscal stimulus package of about 2% of GDP in 2009 and support and sustain 90,000 jobs throughout 2009 and 2010.

There is acknowledgement that the Australian government has acted swiftly and mobilized quickly to take advantage of Australia's strong economic position. In addition to allocating the resources, it needs to be done responsibly and transparently.

This plan is a first in a generation for employees in governments and will be a significant test for the Rudd's government 'new Federalism' agenda.

There is acknowledgement that the Australian government has acted swiftly and mobilized quickly to take advantage of Australia's strong economic position. The challenge will be in the implementation over the next six to twelve months.

The issues for governments across the country will be to manage the funding, ensure effective project implementation and measure its effectiveness in stimulating the economy. The challenge will be in bringing along industry to respond to the opportunity across the building and construction sectors.

In addition to allocating the resources, it needs to be done responsibly and transparently. Our observation of what needs to be achieved over the next six to twelve months are:

► **Accountability**

The accountability for the outcomes needs to be clarified across jurisdictions and departments. Accountabilities and responsibilities need to be mapped at a detailed level so that milestones can be achieved and job creation performance outcomes realised.

► **Reporting**

Investment in reporting is required to ensure the progress and outcomes can be accurately identified and properly communicated. It is critical that Federal and State governments understand what has been achieved and where the potential blockages may occur. This will also be critical to ensuring that governments' have the data to provide evidence that the \$42 billion investment has been worthwhile.

► **Program management and milestones**

Both Federal and State governments will benefit from an integrated project plan. It needs to be actively managed over the life of the program to ensure there is no slippage and the stimulus is spent in the most efficient and effective way.

► **Risk management**

While individual programs can identify and manage their program specific risks, someone needs to take responsibility for consolidating and then re-calibrating individual risk profiles. For example, if each of the Nation Building programs (housing, environment, education and transport) separately identifies industry capability as a medium level risk, when you take a whole of program view, the risk might actually be very high. There needs to be a coordinated approach to risk management to ensure there are no gaps in the implementation.

The stimulus package roadmap over the next six to twelve months is a complex process. While the plan is a great start to protecting Australia's economy, implementation is the real test of success. Now is the time to increase the focus on program management. Then clarity around accountability, reporting with a robust program management plan and risk management plan will lead to a smoother implementation.

The plan has been set to protect Australia from the global recession. The implementation is yet to be realised as we navigate through the uncertainty over the next year.

For further information on the Nation Building and Jobs Plan, please contact Bill Banks or Uschi Schreiber.

Delivery excellence

Better outcomes, lower costs

Governments will be under increasing political pressure to demonstrate results, and departments and agencies will need to adjust rapidly to deal with these issues.

The public sector is under mounting pressure as it faces a new and complex set of issues broadly grouped into four common issues:

1. Increased accountability for delivering improved, valuable and measurable outcomes.
2. Reduced budgets as governments balance the need for delivering economic stimulus packages with significantly reduced revenues.
3. Increased need for transparency, speed and rigour in decision making and resource allocation.
4. Rapidly developing policy directions and the introduction of transformational initiatives, including new modes of policy implementation which require significant refocussing of resources.

The implications for departments and agencies are clear. The effectiveness and efficiency of how they deliver services and outcomes will need to improve:

1. Improve accountability

To consistently deliver valuable and measurable outcomes, departments will need to improve accountability throughout the organisation. This requires agencies to redesign their performance measurement, management and reporting processes and systems, which will make it easier for management to identify and respond to under-performance. Improving accountability typically requires redesigning some roles and ensuring appropriate capability (such as good forecasting of service demand), supported by a change management program.

2. Rationalise programs and manage costs

To manage the pressure on budgets and to improve outcomes, agencies will need to increase their focus on cost management and rationalise programs that are not aligned to policy or social outcomes, or are not being effectively delivered. This requires agencies to have clarity on the value of each set of activities undertaken, the respective costs and the value-for-money. In short, a "core business review" is required, with the aim being to focus resources and management attention on doing the right things efficiently and effectively, and minimising non-essential activities.

3. Introduce output-focused decision making

To increase transparency, speed and rigour in resource allocation and decision making, departments and agencies will need to ensure criteria for all decision making is clear and completely aligned to desired outputs.

This requires strengthening capabilities in analysis, business case development and investment decision making. It also requires efficient processes.

4. Introduce outcome oriented program management

To respond to transformational initiatives and achieve the expected benefits from them, agencies will require a rethinking of how projects and programs are designed and managed. One of the key changes that could be introduced is a concept such as goal-directed program management - which focuses attention on the delivery of milestones leading to tangible goals, rather than the functional activities that need to be completed. The other key change should be an increased focus on ensuring that the benefits are delivered and KPIs achieved and reported to stakeholders.

Many departments and agencies have obstacles to overcome. These include a lack of transparency about costs, activities and performance; poorly defined, overly complex and often conflicting accountabilities; and culture and internal mechanisms that do not support performance improvement or change. However, addressing these issues in the manner described should enable agencies to be more performance focused and effective resulting in reduced costs.

If you have questions about improving the delivery performance of your department or agency, please contact Kevin Jarvie +61 3 9655 2695, Mithran Doraisamy +61 3 9655 2660 or +61 2 6246 1590, Maria Storti +61 2 6246 1525.

Building the case

Shared services in the public sector

The business case for shared services in the public sector is typically compelling. The key driver is not just cost reduction: other drivers include the desire for better customer service, improved financial management and increased professional development opportunities for staff who provide the shared services.

However the track record of shared services in the public sector shows that successful implementation of shared services has been more difficult. Based on interviews with key senior stakeholders involved in planning and delivering shared services across a range of public sector agencies, Ernst & Young identified that successful implementations consistently follow five vital Rules of Engagement.

1. Benefits for all stakeholders

A centrally driven push for cost reduction is often insufficient incentive for most stakeholders to accept and commit to shared services. Successful shared services programs identify potential benefits for all stakeholders. Business cases must be strategic, offer a clear plan and provide incentives for stakeholders beyond aggregate cost reductions. e.g., improved service levels, retained savings for their business/ agency. High level business cases that do not recognise and address the different drivers for individual stakeholders are more likely to fail.

2. Strong leadership and support

A shared services strategy must have active high-level support and sponsorship from senior departmental executives and politicians. Equally, parties affected by the transformation need to understand its rationale, its benefits and, where appropriate, receive adequate support during its implementation. Successful implementations include provision for appropriate consultation and participation, while avoiding the trap of 'death by committee'.

3. Align timelines to capacity to implement

There is a natural tendency to 'want to do it all now', reflected in tight timelines and high initial financial savings targets. This tendency often results in overly ambitious implementation plans which are not achieved, resulting in budget overruns and missed milestones. Implementation strategies must be credible and provide certainty around the benefits they deliver - even if these benefits come in stages, over a number of years.

4. Strong change management and transition skills

Successful execution requires strong change and transition management to prevent cost blow-outs, to deliver on customer needs and ensure stakeholder satisfaction. And this means change management at both the central and line agency levels, conducted by a high calibre transition team that understands change management and goes beyond communication and focuses on instilling a service and continuous improvement culture.

5. Get the governance right

A good governance model within the public sector requires a clear delineation of roles and responsibilities between the purchaser and provider of shared services. The role of the central agency must also be clearly articulated to drive the change agenda, set the parameters and often act as 'banker/ funder' of the shared services initiative across government.

Based on the views and comments provided by the interview group and Ernst & Young's own experience in the field, the likelihood of a successful shared services implementation will be enhanced by adherence to these Rules of Engagement.

The Future

While governments across Australia and New Zealand have made significant progress and understand the potential benefits associated with shared services strategies, the public sector remains on a learning curve. Shared services implementation is akin to changing the wings while the plane is flying along - a clever trick, which requires resources ... and focus!

Perhaps the most important message the public sector needs to understand is the time taken for shared services to become fully embedded and deliver to its full potential. Shared services implementations require enough time to ensure meticulous planning and execution.

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Spinning their wheels

Why isn't simplified infrastructure taxation accelerating the PPP financial close?

Tax legislation, Division 250 was enacted to prevent Public Private Partnership (PPP) negotiations being dragged out by lengthy tax rulings. More than a year after the Federal government introduced this potential accelerant, projects have yet to cut down their time to financial close. While many blame the credit crunch, Ernst & Young looks beyond the market conditions to the real issues keeping the brakes on.

On 25 September 2007, the Federal government removed two scourges of PPP delivery efficiency, the so-called 'terrible twins' - Section 51AD and Division 16D - that had unintentionally slowed delivery of private sector investment in public infrastructure to a crawl.

The measures were originally introduced in 1982 to prevent large scale tax avoidance through tax benefit transfer deals between tax exempt and taxpaying parties, involving for example, power stations and passenger aircrafts. Section 51AD left the taxpayer subject to income tax on the gross assessable income derived from the subject property.

Division 16D denied deductions for capital allowances attributable to tax ownership of the subject property but with allowance for deductions such as those for financing costs. Division 16D also re-characterised assessable income derived by the taxpayer as having an interest component, which is included in assessable income, and a principal component, which is not.

This was not a particularly big deal, per se, for finance lease arrangements, where the risk to the financial investors was limited to the credit risk of the public sector or the foreign lessee. However, when Australia began to need 'genuine private sector investment' in public infrastructure, the ramifications for the new PPP arrangements were catastrophic. The impact of the application of section 51AD was so severe that it could annihilate the taxpayer through insolvency!

Understandably, before committing to a PPP project, private investors were keen to make sure Section 51AD would not be applied. The potential downside tax risks were so great that private investors required certainty - of the sort you only get from a binding individual ruling from the Commissioner of Taxation - in advance.

Thus, no PPP could reach a financial close until it received a private ruling. The complexity of these and the inherent delays in the private rulings system, had the potential to extend a PPP's financial close by 18 months or more.

Division 250 oils the gears

Following a sustained chorus of demands for reform from both the taxpaying and tax exempt sectors, the hoped for cavalry arrived in the form of Division 250. Division 250 effectively switches off the potential for Section 51AD and Division 16D to apply to PPPs. Instead, it seeks to determine the tax treatment of a PPP arrangement depending on whether the private sector or the tax exempt sector has the predominant economic interest, as defined, in the infrastructure asset.

Where the taxpayer has insufficient economic interest, Division 250 moves the tax treatment from the traditional one of an ownership (gross income less capital allowances) to treatment as one of a notional loan (where a net interest like return is recognised). In broad terms it changes the risk profile from Armageddon to one of timing. Total taxable income and total tax over the project theoretically stay the same - but the timing of tax payments is accelerated. This is not to say that the new Division 250 legislation has removed complexity.

With such a critical aspect of economic development as public infrastructure, a degree of complexity of the applicable tax law is inevitable, necessary and appropriate (refer to the capture test on this page). Division 250 brings with it new concepts like 'tax preferred use' and 'predominant economic interest'.

Moreover, it significantly increases the role in the tax law of other, still relatively new, terms such as 'financial benefit'. Beyond

Capture tests

Put simply, Division 250 will apply to a taxpayer and an asset where:

1. The asset is put to a 'tax preferred use';
2. For a period greater than 12 months;
3. The 'financial benefits' in relation to the tax preferred use are provided by a 'tax preferred entity';
4. The taxpayer would otherwise be entitled to a capital allowance in relation to the asset's decline in value or expenditure; or
5. The taxpayer does not have a 'predominant economic interest' in the asset.

the rulings there are also five possible exclusions to Division 250, with one of these exclusions using eight exceptions!

There remain a number of issues for planning in projects, including the optimal approaches to allocation of financial benefits across assets and services, the determination of discount rates, and the vexed question of the treatment of lifecycle costs.

Far from certain

With the introduction of Division 250, private investors gain more certainty around after-tax cash flows and base case financial models - theoretically, reducing or even eliminating the need for private rulings. And yet, a year down the track, we have yet to see PPPs reaching a financial close more swiftly. Certainly the global financial crisis is having an impact here, but this is not why the full impact of Division 250 has yet to come through.

The fact is, while Division 250 does indeed remove much of the tax risk to project viability, it is still a fairly complex law to all but those familiar with its terms and the many nuances in its development and drafting. And a thorough understanding of both the breadths and the boundaries of Division 250 can make a real difference to the delivery cost of the infrastructure.

Project sponsors and investors should not hold their breath waiting for public guidance from Federal Treasury or the Australian Tax Office; it could be a long time coming given new and increasing priorities in the tax arena. Instead, PPP investors should put themselves in experienced hands for tax advice on Division 250 to help accelerate projects to a successful financial close.

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