State Onlending Policy Guidance Note

Prepared by the Department of Treasury

31st May 2024

1. Background

1.1. Following the revision to the 2011 Onlending Policy, the Department of Treasury (DoT) through the Financial Management Division (FMD) updated the 'Policy' to be referred to as 2023 State Onlending Policy, as approved by the National Executive Council (NEC[1]) on 31st day of May 2024. The overall objective of the State Onlending Policy ensures that all requests received by Government for onlending meet the following key criteria:

a) Protect public finances whilst also supporting economic development;
b) Ensure transparency and accountability in the analytical and decision-making process;
c) Any onlending application, either accepted or rejected are done based on sound justifications; and
d) Justification and documentation for the original borrowing and onlending application is available for review and evaluation.

1.2. In accordance with clauses 4.2.2 and 7.2 of the 2024 State Onlending Policy, the DoT through the FMD has prepared this Guidance Note to:

a) assist the requesting onlending Party understand the onlending proposal assessment process;
b) set out how the credit risk assessment will be conducted by FMD; and
c) specify the reporting requirements of each onlending Party.

2. Assessment of Onlending Proposals

2.1. FMD will, with the assistance from Structural Policy Division (SPD) of the DoT when requested, will complete the following tasks:

1. undertake an appraisal of the technical aspects of the investment project or program to ensure that all the necessary requirements are met, and the project or program complies with all the legal and regulatory requirements related to the technical aspects.
2. undertake an appraisal of the financial plan for the investment project or program to ensure that all the necessary requirements are met including:
   - analysis of cash inflows (net revenue) and outflows (operational expenses, depreciation, taxes, interest costs, and other payables);
   - analysis of capacity to service debt obligations (principal, interest and fees/ expenses);
   - analysis of economic internal rate of return (IRR) against government criteria;
   - sensitivity analysis for fluctuations in (i) exchange and interest rates, (ii) revenue, and (iii) production/operational costs.
3. Undertake an appraisal of the onlending Party covering:
   - appraisal of data in order to formulate a base case scenario;
   - appraisal of investment capital which specifies (i) sources of investment capital (including owner capital, borrow capital); (ii) capacity to repay the obligations of the project;

[1] NEC is the body which, in most countries with a "Westminster" System of Government, is known as the 'cabinet' and it is often referred to as the 'cabinet' in PNG.

- appraisal of the audited financial reports for the last three years.

4. undertake a credit risk assessment including the terms and conditions for provision of onlending as set out in Section 3 below.

5. finalise the risk assessment, agree on the provision of onlending, and prepare the necessary documentation for consideration by all parties.

6. submit a report to the Minister for Treasury (the Treasurer) as required under clause 5.2.2 of the 2024 State Onlending Policy.

3. Assessment of Credit Risks

3.1. Given the lack of any local rating agency or presence of an international rating agency with a physical presence in PNG, a simplified approach is to be used. The Policy will apply a credit scoring approach with simple rating factors and risk weightings that are appropriate to PNG. In assessing each onlending Party or entity, business risks and financial risks will be evaluated according to the indicators and sub-indicators as set out in Table A1, along with the weights that are set for each category. These will be determined and assessed by the FMD (with assistance from the SPD) to agree on the categories and weights. The indicators and criteria will be reviewed annually.

Table A1: Indicators and Weightings

Financial Risk (70%)		**Business Risk (30%)**	
Indicator	**Weighting**	**Indicator**	**Weighting**
Financial Position/Solvency • Debt/Equity (10%) • Debt Service Cover Ratio (10%) • Cash Balance (10%) • Current Ratio (10%)	**40%**	Regulatory Framework • Legal Framework (1%) • Government Support (5%) • Independence (2%) • Rate Setting (5%) • Sufficiency of Rates (2%)	**15%**
Performance/Profitability • Net Profit After Tax (5%) • EBITDA Margin (5%) • Return on Equity (10%)	**20%**	Management Quality • Board and Governance (5%) • Compliance (with all statutory and regulatory obligations) (3%) • Reporting (2%)	**10%**
Impact from the Onlending • Impact on Debt/Equity (5%) • Impact on Profit (5%)	**10%**	Industry Environment • Market Share (3%) • Input Sources (1%) • Income Sources (1%)	**5%**

3.2 Each indicator will be scored on a scale from A (low risk) to C (high risk), noting that each sub-indicator will be assessed with an equal weighting to generate the overall rating for each indicator. The credit rating and assessment scores assigned for indicators and sub-indicators are listed in Table A2. Table A3 sets out the criteria to be used in rating each financial risk indicator. Table A4 sets out the criteria to be used in rating each business risk indicator. Although both risk categories are relevant, the financial risk indicator is assigned a 70% weighting as it focuses more on the short to long term performance of the entity and hence is more likely to determine the entities credit worthiness.

Table A2: Credit Rating and Assessment

Rating	Assessment Score
A rating (low risk)	1
B rating (moderate risk)	2
C rating (high risk)	3

3.3. The overall rating will then determine the credit risk rating as follows:

A. High Credit Quality / Low Risk of Default: equivalent to what would be the effective local currency credit rating of A with a weighted score of >2.5;

B. Medium Credit Quality / Moderate Risk of Default: equivalent to what would be the effective local currency credit rating of B with weighted score of between 1.5 and 2.5; and

C. Low Credit Quality /High Risk of Default: equivalent to what would be the effective local currency credit rating of C with weighted score of <1.5.

Table A3: Financial Risk Indicators and Assessment

Indicator	A (low risk)	B (moderate risk)	C (high risk)
Financial Risk			
Financial Position/Solvency (as at end of last financial year)			
1(a). Debt/Equity	<40/60	40/60 to 60/40	>60/40
1(b). Debt Service Cover Ratio (operating income to annual debt service)	>2	1 to 2	<1
1(c). Cash Balance	>6 months debt service payments	>3–6 months debt service payments	<3 months debt service payments
1(d). Current Ratio	>5	2 to 5	<2
Performance/Profitability (as at end of last financial year)			
2(a). Net Profit After Tax Ratio (% of Revenue)	>10%	0% to 10%	<0%
2(b). EBITDA (% of Revenue)	>15%	5% to 15%	<5%
2(c). Return on Equity	>10%	0% to 10%	<0%
Impact from the Onlending (on the ratio and profit above)			

3(a). Impact on Debt/Equity	Ratio increases by less than 5%	Ratio increases by 5% to 10%	Ratio increases by more than 10%
3(b). Impact on Profit	Profit decreases by less than 5%	Profit decreases by 5% to 10%	Profit decreases by more than 10%

Notes (Financial Risk Indicators):

Financial Position/Solvency

To assess the ability of an entity to meet its long-term debt obligations and to accomplish long-term growth and expansion. It indicates an entity's ability to continue operations into the foreseeable future. The key sub-factors considered are:

- 1(a). Debt/Equity measures the proportion of the entity's total debt to equity that is used to finance its total assets. An entity that is heavily financed by debt may pose a greater risk to investors; and
- 1(b). Debt Service Coverage Ratio measures the ability of the entity's projected cash flow to meet its debt obligations. It is used in assessing the entity's ability to generate enough cash to cover its debt payments;
- 1(c). Cash Balance measures the period of debt service obligations that are covered by the cash position; and
- 1(d). Current Ratio (sometimes referred to as working capital ratio) is a liquidity ratio that measures the entity's ability to pay short-term obligations or those due within one year.

Performance/Profitability

To evaluate the entity's revenue generation ability, in net terms, from its operations, the key variables of interest include:

- 2(a). Net Profit After Tax Ratio (as a % of Revenue) is a financial measure that shows how well the entity has performed through its core operations, net of taxes;
- 2(b). EBITDA (earnings before interest, taxes, depreciation and amortization) margin (as a % of Revenue) assesses the entity's operating profitability and cash flow, and may be used as a proxy for the earning potential of a business. Higher EBITDA margin is associated with smaller operating expenses in relation to total revenue, leading to a more profitable operation; and
- 2(c). Return on Equity (ROE) is a measure of financial performance calculated by dividing net income by shareholders' equity. Because shareholders' equity is equal to a company's assets minus its debt, ROE is considered the return on net assets. ROE is considered a measure of the profitability of the entity in relation to shareholders' equity.

Impact from the Onlending

It assesses the extent to which the onlending will have an impact on the debt/equity ratio and on profit. Factors considered here include:

- 3(a). Percentage change on the Debt/Equity ratio; and
- 3(b). Percentage fall in the Net Profit After Tax Ratio.

Table A4: Business Risk Indicators and Assessment

Indicator	A (low risk)	B (moderate risk)	C (high risk)
Business Risk			
Regulatory Framework			
1(a). Legal Framework	Own onlending Entity law	Falls under PFMA	Does not come under PFMA
1(b). Government Support	No support in past 5 years	Support provided in past 5 years	Support is being provided currently
1(c). Independence	Board operates independently	Board operates under instructions from the Minister(s)	Board is fully controlled by Ministers
1(d). Rate Setting Flexibility	Fees and tariffs are freely set by the board	Fees and tariffs are set with approval by the Minister(s)	Fees and tariffs are set frequently by Minister(s)
1(e). Sufficiency of Rates	Rates cover full recovery of costs plus return	Rates cover full recovery of costs	Rates do not cover full recovery of costs
Management Quality			
2(a). Governance	Board meets at least quarterly	Board meets at least annually	No board in place
2(b). Compliance (with all statutory and regulatory obligations)	Full compliance	Partial or delayed compliance	Little or no compliance
2(c). Reporting	Complete reporting and audits	Partial or delayed reporting and audits	Little or no reporting or audits
Industry Environment			
3(a). Market Share	50%-100%	25% to 50%	<25%
3(b). Input Sources			
3(c). Income Sources	>5 sources	1 to 5 sources	Single source

Notes (Business Risk Indicators):

Regulatory Framework

Under this indicator, key issues to be considered include the:

- legislation governing the entity's operations;
- level of Government support;
- level of independence of the entity from the Government;
- flexibility with the adjustment of rates (fees and tariffs); and
- sufficiency of the rates (fees and tariffs) to help the entity cover its capital and operating costs.

1a. Legal Framework	
Risk	**Criteria / Requirements**
A	Existing regulation is largely adequate for the entity to effectively carry out its mandate (e.g. the entity has its own law). The regulations are predictable and do not present unnecessary or unforeseen shocks to the entity's operations. The established regulations are up to date and allow for pursuing business strategy opportunities. The regulations are flexible, and not restrictive; they are designed to protect the entity, as well as the end-user.
B	Regulations governing the entity's operations are generally adequate to enable it to carry out its mandate (e.g. the entity is covered under PFM law). The regulations are largely predictable, although they may pose some unforeseen shocks to the entity's operations. The established regulations are current and provide opportunities for the entity to pursue new business strategies. The regulations are mostly not restrictive and largely seek to protect both the entity and the end-user.
C	Existing regulation is inadequate to enable the entity successfully to carry out its mandate (e.g. the entity is not covered in law). The regulations are highly unpredictable and may pose some unforeseen shocks to the entity's operations. The established regulations are obsolete and do not provide opportunities for the entity to pursue new business strategies. The regulations are restrictive and are observed to be more protective of the end-user than of the entity.

1b. Government Support	
Risk	**Criteria / Requirements**
A	The Government has not provided any budget or other support or subsidies to the entity over the past five years.
B	The Government has provided some budget or other support or subsidies to the entity over the past five years.
C	The Government is currently providing budget or other support or subsidies to the entity.

1c. Independence	
Risk	**Criteria / Requirements**
A	The regulator is largely supportive of the entity, and its decisions are not influenced by political pressure.
B	The regulator generally shows support of the entity in the decisions it makes, and its decisions are generally free of political interference.
C	The regulator often makes decisions that are politically biased and are not in the best interests of the entity.

1d. Rate Setting Flexibility	
Risk	**Criteria / Requirements**
A	Rates (fees and tariffs) are often adjusted to reflect changes in external factors. Process for the approval of rates largely is transparent, prompt and not cumbersome. Rate cases are efficient and permit the inclusion of forward-looking costs.
B	Rates (fees and tariffs) are generally adjusted to reflect changes in external factors but may be subject to delays in the approval process. The process for the approval of rates is generally seen to be transparent and prompt, although there may be instances that indicate otherwise. Rate cases may sometimes be seen not to be efficient or may not permit inclusion of forward-looking costs.

C	Rates (fees and tariffs) are not adjusted to reflect changes in external factors. When they do get adjusted, there are lags and delays in the process of approving rates on the part of the regulator or political interference. Rate cases are largely not efficient and do not permit the inclusion of forward-looking costs.

1e. Sufficiency of Rates	
Risk	**Criteria / Requirements**
A	The rates (fees and tariffs) charged by the entity are timely enough to enable recovery of its costs, especially in periods of rising costs. Rates are set at sufficient levels that permit full recovery of costs and a fair return on investments, with minimal challenges to its operations.
B	Rates (fees and tariffs) are set at levels that generally provide recovery of most operating costs and are generally sufficient to earn returns and attract capital.
C	Rates (fees and tariffs) are set at levels that often fail to provide recovery of costs. Rates are set at levels that largely do not permit full recovery of costs and a fair return on investments.

Management Quality

Under this indicator, key issues to be considered include the:

- experience of the Board members of the entity (particularly the relevance of their experience to the industry in which the entity operates) and the composition of the Board;
- mode in which management of the entity is appointed and how significant political affiliation is in the process;
- presence of committees on the Board and the frequency and minutes of their meetings; and
- audit of the entity by reputable auditing firms.

2a. Governance	
Risk	**Criteria / Requirements**
A	The entity has a mixed skill set of staff. Management and Board of the entity are experienced in various areas of expertise needed in its operations. The Board meets at least quarterly. The entity has a well-defined governance structure to facilitate its operations. There is largely no political influence in decision making.
B	The entity has a somewhat mixed skill set of staff. Management and Board of the entity have some experience in the various areas of expertise needed in its operations. The Board meets at least annually. The entity is seen to have a fairly well-defined governance structure to facilitate its operations. There is generally no political influence in decision making, although there may be occasional cases that indicate otherwise.
C	Entity’s staff is not seen to have a diverse set of skills. Decisions of Management of entity demonstrate a lack of or inadequate experience in the areas of expertise needed in its operations. The entity does not have a Board. The entity is largely not seen to have a well-defined governance structure to facilitate its operations. Entity’s operations and decision-making are influenced by political pressures.

2b. Compliance	
Risk	**Criteria / Requirements**
A	Management of the entity largely enforces compliance and adherence to established regulations. The entity is seen achieving its mandates and objectives, and its management sees to the execution of its operational and financial strategies.
B	Management of the entity is generally seen enforcing compliance and adherence to established regulations. The entity is mostly able to achieve its mandates and objectives, and its management is generally able to execute its operational and financial strategies.
C	Management of the entity is not seen to be enforcing and adhering to established regulations. The entity is unable to achieve its mandates and objectives, and its management is not able to execute its operational and financial strategies.

2c. Reporting	
Risk	**Criteria / Requirements**
A	The entity has timely and concise reports and audited financial statements, which are in line with International Financial Reporting Standards (IFRS standards) and contain an independent auditor's report. Reports on the entity are published annually and easily accessible on the entity's website.
B	The entity's reports and financial statements partially meet the International Financial Reporting Standards (IFRS standards). Reports on the entity are sometimes not published annually or on a timely basis and may not be easily accessed.
C	The entity's reports and audited financial statements largely do not meet the International Financial Reporting Standards (IFRS standards). Reports on the entity are not published annually on a timely basis and cannot be easily accessed.

Industry Environment

Under this indicator, key issues to be considered include the entity's:

- ability to take advantage of opportunities within new markets;
- capacity to allow for expansion in new markets;
- having a competitive advantage over its competitors and diversified customer base;
- ability to maintain or increase its market share over time and generate revenue from sources; and
- ability to generate its product from sources and generate revenue from non-core activities.

3a. Market Share	
Risk	**Criteria / Requirements**
A	An entity controls a greater share of the market in which it operates and is largely seen consistently increasing the size of its share of the market. The entity operates in a stable market with little volatility, and in more densely populated geographical locations which provide it with a larger customer base.
B	The entity is seen accounting for a reasonably large proportion of the market in which it operates, although the size of its share of the market may be seen fluctuating over time. The entity operates in a generally stable market with some volatility.
C	The entity is not seen to be controlling a greater share of the market in which it operates. The entity is largely seen unable to increase the size of its share of the market. The entity is

	seen operating in a largely unstable market. The entity operates in a largely sparsely populated geographical area, which reduces its customer base.

3b. Input Sources	
Risk	**Criteria / Requirements**
A	The entity does not depend on any particular supplier(s) which cannot easily be replaced in order to generate its output. Its production/service centres are diversified across several locations to ensure regular supply of its product/service.
B	The entity is not overly dependent on any particular supplier(s) that it cannot easily replace. It has generally well-diversified production/service centres are across several locations.
C	The entity depends on a particular supplier or group of suppliers which it cannot easily replace without incurring high switching costs.

3c. Income Sources	
Risk	**Criteria / Requirements**
A	The entity does not depend on a single local or regional market. The entity derives its revenues and profits from a broader set of products/services. It does not rely on a particular customer(s), and where it does the customer possesses a high credit quality and/or the entity and the customer is highly interdependent.
B	The entity has a broad range of products/services and does not depend on a particular product/service for the majority of its revenues and profits. It does not depend excessively on a single local or regional market. The entity has a generally large customer base, such that the loss of a top customer is unlikely to pose a high risk to its business stability.
C	The entity's products/services line up is somewhat limited, and it derives its profits from a narrow group of products/services. The entity relies heavily on a particular customer or small group of customers and demand for its product/service is low.

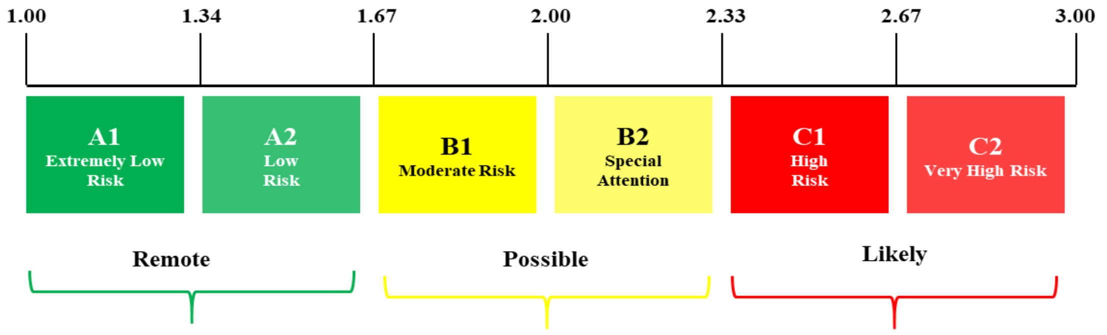
3.4. The weighted score of each individual risk indicator is calculated as the weight (W) multiplied by its score (S) as shown in the example in Table A 5. This is then summed up to attain the overall risk rating of the entity.

Table A5: Risk Rating Scorecard Example

Indicators	Weights (W)	Score (S)	Weighted Score
Financial Indicators	**70%**		
Financial Position/Solvency			
1a. Debt/Equity	10%	1	0.10
1b. Debt Service Cover Ratio	10%	2	0.20
1c. Cash Balance	10%	2	0.20
1d. Current Ratio	10%	3	0.30
Performance/Profitability			
2a. Net Profit After Tax Ratio (% of Revenue)	5%	2	0.10
2b. EBITDA (% of Revenue)	5%	1	0.05
2c. Return on Equity	10%	2	0.20
Impact from the Onlending			
3a. Impact on Debt/Equity	5%	2	0.10
3b. Impact on Profit	5%	1	0.05
Indicators	**Weights (W)**	**Score (S)**	**Weighted Score**
Business Indicators	**30%**		
Regulatory Framework			
1a. Legal Framework	1%	1	0.01
1b. Government Support	5%	2	0.10
1c. Independence	2%	1	0.02
1d. Rate Setting Flexibility	5%	2	0.10
1e. Sufficiency of Rates	2%	2	0.04
Management Quality			
2a. Governance	5%	1	0.05
2b. Compliance	3%	2	0.06
2c. Reporting	2%	1	0.02
Industry Environment			
3a. Market Share	3%	2	0.06
3b. Input Sources	1%	2	0.02
3c. Income Sources	1%	2	0.02
TOTAL			**1.80**

3.5. The overall weighted score is mapped to an alphabetical rating as shown in in the figure below, with A1 signifying extremely low risk and C2 implying very high risk. The figure also shows the likelihood of the risk materializing (i.e. the entity may default on the payment of its debt obligations). For the example in TableA5 with a weighted score of 1.80, the assessment shows there is a moderate risk of default and a credit rating of B1.

Overall Rating/Extent of Exposure and Likelihood of its Materialization



4. Onlending Fees and Setting of the Interest Rate

4.1. The 2023 State Onlending Policy stipulates that the Government will charge a service fee and set the interest rate based on the probability of default, with the higher the probability of default the higher the interest rate. A risk-based fee calculated from the probability of default recognizes that not all onlending is equally risky; therefore, riskier projects and onlending should invite higher interest rate.

4.2. The methodology to be applied under the 2023 State Onlending Policy is an interest rate adjustment added to the primary loan interest rate as a credit risk premium. This methodology involves taking the six risk categories from the overall risk rating (as shown in the chart above) with each category having a standard predetermined fee. The Standard and Poor's Sovereign Foreign Currency Cumulative Average Default Rates Without Rating Modifiers (1975-2020) have been selected for calculating the probability of default. A subsidy of 50% is applied to the fee and the minimum fee is set at 0.25%.

4.3. The interest rate payable either semi-annually or annually on the interest payment dates of the primary loan will be according to the following table:

Credit Rating	Risk Assessment	< 1 year	1-5 years	5-10 years	> 10 years
AAA	A1	0.25%	0.25%	0.25%	0.25%
AA	A2	0.25%	0.25%	0.25%	0.25%
A	B1	0.25%	0.48%	1.58%	2.35%
BBB	B2	0.25%	0.70%	1.83%	2.40%
BB	C1	0.35%	1.28%	4.05%	5.90%
B	C2	1.45%	4.98%	11.45%	14.40%

4.4. The onlending interest rate will be calculated when the subsidiary loan agreement is finalised and will apply for the duration of the onlending.

Example: Calculation of the Onlending Interest Rate	
Credit Assessment of the Onlending Party (SOE)	B1
Average Amount of Loan Outstanding	PGK 120,000,000
Remaining Term of the Loan	7 years
Onlending Rate	Primary Loan rate + 1.58% per annum

4.5. If the onlending entity does not comply with the requirements of its payment obligations or does not report in accordance with Section 5 below, FMD will bring this to the attention of the Auditor General as non-compliance with the 2023 State Onlending Policy and Guidance Note.

5. Reporting by Onlending Entities

5.1. The onlending Entity is required to provide FMD and SPD with the following reports:

1. Audited financial statements on an annual basis within six (6) months from the end of the financial year of the onlending Party. The financial statements should include:
    - Total Revenue
    - Total Expenditure
    - Net Profit after Tax
    - Net Profit % Revenue
    - Return on Equity (ROE)
    - Current Ratio
    - Cash Flow Ending Balance
2. Project reports every quarter within thirty (30) calendar days from the end of quarter during the construction period for each project covering the status of project implementation including the date and value of each disbursement and loan payment, and the amount outstanding that is covered by the onlending.
3. A quarterly report within thirty (30) calendar days from the end of quarter on the financial status of the onlending Entity and the ability to meet all its loan and other obligations together with an indication of the risk of the onlending Entity body needing to meet its payment obligations.
4. Annual business plan and other strategy documents that are submitted to the Board and/or the relevant Minister
5. Any other reports as required by FMD.

5.2. A template has been set up on the Department of Treasury website (https://www.treasury.gov.pg) where the reports and documents required by FMD can be uploaded through a web portal.

5.3. FMD will be responsible for the regular supervision and monitoring of each onlending Entity and each project that has onlending.

5.4. As stipulated in Section 9 of the 2023 Onlending Policy, "The Department of Treasury through the Financial Management Division shall report the onlending under the category of Public Financial Assets. These will be reported in the Final Budget Outcome (at the end of March), Annual Public Debt Bulletin (at the end of April), the Mid-Year Economic and Fiscal Outlook (MYEFO) (at the end of July), and the Budget under the Chapter on Financing and Debt Management Strategy (in November).