REPUBLIC OF NAURU

2020-21 BUDGET

BUDGET PAPER NO 2
STATE OWNED ENTERPRISES EXTRACT

CIRCULATED BY

THE HON MARTIN HUNT MP

MINISTER FOR FINANCE OF THE REPUBLIC OF NAURU

ON THE OCCASION OF THE BUDGET 2020-21

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Conventions used in this document:

- All amounts are expressed in Australian dollars, unless otherwise stated
- Due to rounding, there may be minor discrepancies in the totals shown in tables
- Exchange rate conversions assume USD1=AUD1.6 unless otherwise stated.

2020-21 Budget
Budget Paper No 2

Budget Paper No 2 provides more detail on the economic outlook, economic statistics, State Owned Enterprises (SOEs) and the National Sustainable Development Strategy (NSDS). This extract covers SOEs.

The performance of the State owned enterprise (SOE) sector is expected to improve over 2020-21, with the implementation of the new *Public Enterprise Act 2019*, and Community Service Obligation (CSO) regime. Management changes at the SOEs following the 2019 election are mostly complete, and the new management teams are focussed on improving corporate planning and performance. The future of the RPC remains a key risk for all these businesses.

Consistent with the global aviation industry world-wide, travel restrictions related to Covid-19 are expected to have a significant impact on Nauru Airlines' performance. Government cash flow support through the new CSO to cover revenue foregone to keep air-freight services available and affordable, and to invest in the aircraft freighter conversion should support income earnt from freight services. Further investments in replacement aircraft for the ageing fleet are also being considered.

The performance of those SOEs not exposed to the travel industry is expected to continue to improve, as they build and grow their businesses with new investment and improved governance.

Part 3: State Owned Enterprises

The performance of the State owned enterprise (SOE) sector is expected to improve over 2020-21. Management changes at the SOEs following the 2019 election are mainly complete, and the new management teams are focussed on improving corporate planning and performance.

Given the uncertain economic outlook, the need to improve the resilience of Nauru's economy, and the significant Government investment in SOEs, it is important that SOEs are as efficient and effective as possible in providing goods and services to the community. Inefficient SOEs act as a drag on economic growth, reducing resources that might be put to better use in other activities that increase the overall productive capacity of the economy, and increase national wealth. The opportunity cost of investment in SOEs is very high.

Accordingly, the 2020-21 Budget includes measures to improve the efficiency of SOEs. They include the implementation of the *Public Enterprise Act 2019* (PEA) and the introduction of a new Community Service Obligation (CSO) framework, to improve the competitive neutrality of government owned businesses.

It is also expected that the process of resolving outstanding arrears between SOEs will continue. For all SOEs the Government is recommending a pre-pay arrangement of provision of all services to ensure that they are able to generate sufficient cash flow and meet financial performance objectives.

Public Enterprise Act 2019

The *Public Enterprise Act 2019* (PEA) came into effect in June 2019. It provides a modern framework for governing SOEs consistent with international better practice.

The Act includes five principles for the governance of a public enterprise, as follows:

1. Prudent and efficient management according to which an SOE must operate on a commercial basis that is efficient and profitable
2. Measurable performance according to which a public enterprise must identify it business goals
3. Responsible management according to which the management of a public enterprise must be competent, honest and accountable
4. Transparent performance according to which a public enterprise must report its performance fully, publicly and timeously
5. Monitored performance, according to which a public enterprise must be subject to rigorous monitoring, approval and review.

Importantly, the PEA makes clear that the primary objective of a SOE is to be a successful business (section 22(1)), and it must conduct its business and operations with a view to being a successful business (section 22(3)). A SOE is considered a successful business if:

a) It is at least as profitable and efficient as comparable businesses in the private sector; and
b) Generates each financial year, a net operating profit after tax that is not less than its weighted average cost of capital prescribed as a percentage.

The PEA provides for the circumstance where the achievement of social objectives might undermine the ability of a SOE to achieve the primary objective. The requirements for a Community Service Obligation (CSO) are covered in sections 25 and 26 of the PEA.

Community Service Obligations

Consistent with international better practice, the Government has established a CSO framework that acknowledges Government sometimes asks some SOEs to pursue social objectives that undermines the SOE's ability to be fully commercial, and to generate sufficient revenue to comply with the primary objective to be a successful business.

CSO's are a mechanism used by other jurisdictions to be transparent about government's directives to SOEs to pursue the delivery of social obligations that undermine the ability of SOEs to operate commercially. The pursuit of social objectives often results in inefficient cross-subsidies and compromises the financial performance of the business, leading to ad hoc requests for Government support.

The SOEs receive the CSO in acknowledgement of the cost of the non-commercial activity, so that overall the SOE's are able to earn sufficient revenue to be commercial. It also has the benefit of enabling the SOE to compete with private businesses on a more level playing field.

Governments generally accept the principle that the costs of CSOs need to be made transparent for reasons of public accountability and scrutiny, and in order to better assess the financial performance of SOEs. The payment of the CSO enables the SOE to reduce cross-subsidies and improves overall allocative efficiency and national wealth.

To be considered a CSO, the following conditions must be in place:

- There must be a specific request from Government to the SOE to pursue the activity – the CSO must be negotiated between Government and the SOE
- The outcome would not be pursued if the SOE were operating on a purely commercial basis
- There is a specified social objective
- The CSO is costed at 'avoidable cost' (that is, marginal cost of service)
- Funding is from the budget.

The Government of Nauru's CSO Policy Framework 2020 provides for the Government to negotiate a CSO in the following areas:

- provision of essential services at affordable cost
- mitigation of risks to food and supply security
- alleviating cost of living pressures or price rises for all residents.

The policy framework provides that to be considered a CSO, the following principles must be met:

i. Only the Government can request that an SOE pursue a social objective funded through a CSO – the request must come from Government
ii. The CSO agreement would be negotiated with the SOE at the Government's request with details agreed between the SOE and Minister for Finance and approved by Cabinet

iii. The CSO objective is to be clearly specified, and conditions for the CSO, including key performance indicators are to be documented
iv. The objective would not be pursued if the SOE was operating on a purely commercial basis
v. The CSO is costed at 'avoidable cost' (that is, marginal cost of service), and this costing is based in evidence
vi. Agreements are to be annual, and funded in the budget
vii. Agreements are to be periodically reviewed to ensure that the social objective remains relevant, and that the CSO remains appropriate, efficient and effective in achieving the objective.

In the 2020-21 Budget, three CSOs are proposed to be negotiated as follows:

- Nauru Utilities Corporation (NUC) to provide affordable electricity through a pre-pay lifeline tariff for up to 200kw/hr of power. The lifeline tariff covers the minimum monthly electricity requirement for a household. The revenue from the CSO will underpin reductions in residential tariff rates. NUC will also develop options for household energy efficiency measures.
- Nauru Airlines Corporation (NAC) to provide regular and affordable air freight services with a once weekly freighter service from Brisbane or Fiji at pre-Covid-19 rates. This CSO will cover the empty return journey for freight services, to ensure the service continues to be provided for the rest of the year.
- Nauru Port and Maritime Authority (NMPA) to ensure affordable Port charges, by holding Stevedoring and Wharf charges at current rates. The CSO will cover the difference between the current rate and the '2019 gazetted rate' that has been set to ensure that NMPA can generate sufficient revenue to cover its costs and operate commercially. The revenue from the CSO will ensure that NMPA does not need to increase its charges beyond the current pre-Covid-19 rates, and still cover all its costs.
    - This additional revenue for NMPA is expected to meet the Government obligation under the Port Project Agreement with the ADB to ensure that the Port is able to generate sufficient revenue to be fully commercial.

The following sections cover in more detail the performance of the most significant SOEs.

Nauru Airlines Corporation

Nauru Airlines (NAC) is the National Carrier of Nauru. It has the regulatory and route right allocations on the bi-lateral agreements between Australia and Fiji to Nauru. It provides passenger and air freight services.

NAC's objective is to connect Nauru to Australia and neighbouring Pacific Island nations and provide safe and sustainable passenger and air freight services to facilitate trade, tourism and functioning of Government.

Operating an airline is capital intensive, requires a very high level of specialised skill and the industry is highly regulated.

NAC's performance in 2019-20 was mixed. Improvements in cost control and operational performance were severely impacted by the coronavirus pandemic. In April 2020, IATA data indicated that year on year, the number of world-wide flights was down by 80 percent[1]. For NAC, the Government's travel restrictions reduced passenger services between Nauru and Brisbane to once a fortnight and freight to once a week. Charter services continued to operate.

The Government provided support to NAC in 2019-20 to undertake C-checks on some of its engines, and cash flow support in light of the Covid-19 outbreak. In 2020-21 Government will provide cash flow support through the CSO to ensure weekly air freight services and fund the freighter conversion.

In 2020-21 NAC expects that its income will reduce by at least a third. RPC related activity is expected to contribute around 42 per cent of revenues.

Table 3.1: NAC revenue and expenses

NAC	2018-19 Actual $	2019-20 Forecast $	2020-21 Budget $
Revenue	62,763	62,478	42,102
Expense	64,861	64,041	41,050
Operating profit before tax	(2,098)	(1,563)	1,052

In 2020-21, NAC's business plan includes the following elements:

- Maintain core services, with a focus on cost reduction and overheads, workforce right-sizing and reducing operations in light of Covid-19 restrictions. A new solution to replace the Zapways system will also be progressed.
- Freighter expansion, continuing existing services with support of additional revenue from the CSO, as well as expanding freight charter work. An existing aircraft will be converted to a freighter and the door of the existing freighter will be modified to meet safety requirements.
- Aircraft replacement program, NAC is considering replacing aging aircraft with support from Taiwan. This will support the airline to be more competitive with reduce maintenance and fuel costs, and potentially open up more route and service opportunities.
- Australian Border Force and RPC dependency, early planning for any change in business continuity.

Nauru Utilities Corporation

NUC provides electricity and water services to Nauru. Its energy supply comprises a mix of diesel and solar powered generation, and water is sourced from a desalination plant and trucked to the end user.

2019-20 has been a challenging year for NUC, due to continued high diesel fuel prices (until new fuel arrived in May 2020) and freight charges. With electricity tariffs being held constant, NUC has been financially stressed. Government support to resolve outstanding accounts receivable arrears boosted cash flow through the year. Progress was made on improving the quality and reliability of services, by replacing poles and wires. The EU solar farm was completed and land clearing commenced for the ADB solar project.

[1] IATA Covid-19 Updated Impact Assessment 14 April 2020

The outlook for 2020-21 is mixed, with lower refugee numbers and wind down of the RPC expected to impact both water and electricity demand. The new CSO for the pre-pay lifeline residential tariff will increase revenue certainty, and enable NUC to reduce its residential tariff lines as follows:

- residential lifeline pre-pay rate of the tariff will be reduced from 25c to 22c
- residential pre-pay tariff will be reduced from 50c per kw/hr to 47c
- residential post-pay tariff will be reduced from 50c to 48c.

All other tariffs will remain the same. NUC will also explore opportunities to support households improve energy efficiency.

Overall, NUC is expecting to at least break even in 2020-21. It will continue to progress the ADB Solar Farm Project and continue to improve energy reliability.

Total revenue from the provision of electricity and water is expected to be $18.9 million, with total expenses (excluding depreciation and tax) of $18.8 million.

Table 3.2: NUC revenue and expenses

NUC	2018-19 Actual $	2019-20 Forecast $	2020-21 Budget $
Total Income	19,293,616	18,048,608	18,866,276
Total Expense	22,278,198	16,685,194	18,808,902
EBITDA	**(2,984,582)**	**1,363,414**	**57,374**

Eigigu Holdings Corporation

Eigigu Holdings Corporation (EHC) is the main commercial arm of Government and has the following subsidiaries: Eigigu Supermarket, Menen Hotel, Enigin, Eigigu Transport, Eigigu Enterprise, Eigigu Civic Centre and Eigigu Solutions Corporation (ESC). EHC also has the Eastern Gateway hotel in Majuro, Marshal Island which remains subject to disputation.

The 2019-20 consolidated budget expected the group to earn $26.4 million in revenue and $24.6 million in expenses resulting in an operating profit before income tax of $1.9 million. Actual performance to March 2020 showed operating revenue of $17.4 million and expenses of $14.5 million and an operating profit before income tax of $2.9 million. The key expenditure items were personnel costs and cost of sales. ECH expects to earn a full year profit in 2019-20 and contribute a $250,000 dividend to the Government.

During 2019-20, EHC commenced a project to reconstruct historic financial statements, and address accounts receivable. Government provided support through the year to settle outstanding arrears with NUC and other suppliers.

EHC expects to achieve a more modest financial performance in 2020-21. Total revenue is expected to be $23.0 million, and total expenses of $18.7 million, with an operating profit before income tax of $3.6 million. It expects to provide a $250,000 dividend to Government.

The Menen Hotel and Eigigu Transport are the best performers in the group, and are highly dependent on patronage from ongoing RPC operations.

A summary of the operating profit before tax for the key subsidiaries is in the table below.

Table 3.3: EHC consolidated operating profit before tax to March 2020

Operating profit before tax	2018-19 Actual $	2019-20 Budget $	2019-20 Actual $	2019-20 Forecast $	2020-21 Budget $
Menen Hotel	2,051,016	1,291,712	2,217,921	2,957,228	2,116,086
Eigigu Supermarket	(54,718)	487,246	216,089	288,119	465,785
Eigigu Civic Centre	(8,484)	100,184	165,014	111,604	21,145
Enigin	111,987	171,647	100,097	133,462	128,934
Eigigu Enterprise	(146,662)	87,677	(22,867)	(30,490)	91,414
Eigigu Transport	523,562	530,737	257,196	342,928	681,839
Eastern Gateway Hotel	(39,562)	3,522	(2,076)	(2,768)	6,232
Other	276,594	(787,071)	(53,429)	(137,215)	47,225
Consolidated	2,713,733	1,885,654	2,877,945	3,662,868	3,558,660

NAURU POST OFFICE

The Nauru Post Office has been revitalised over 2019-20, with actual year to date performance exceeding expectations. It paid a $100,000 dividend in 2019-20. Budgeted and actual performance is in the table below.

The Post Office expects to continue to expand its business over 2020-21.

Table 3.4: Post Office revenue and expenses

Post Office	2019-20 Budget $	2019-20 Actual Feb 20 $	2020-21 Budget $
Revenue	908,800	2,129,137	4,322,000
Expense	880,592	2,229,772	4,062,911
Operating profit before tax	28,208	(100,635)	259,089

NAURU PORT AND MARITIME AUTHORITY

The Port Authority of Nauru became an SOE in 2019-20, consistent with the arrangements for Port reform in the Port Project. It established its own bank account, and the government appropriation and revenue streams were transferred to it.

The key activities for NPMA in 2020-21 include the business as usual running of the Port, completion of the Port Project and a new project to arrange a wet lease of a ship for a cargo freight service to Nauru to mitigate sea-freight supply risks.

The new CSO payment will support NPMA to earn sufficient revenue to fully cover its costs.

Table 3.5: NMPA revenue and expenses

NMPA	2019-20 Budget $	2019-20 Actual May 20 $	2020-21 Budget $
Revenue from operations	2,150,527	2,040,091	2,259,162
CSO revenue	-	-	1,183,500
Expense	4,296,053	2,164,056	3,277,777
Operating profit before tax	(2,145,526)	(123,966)	164,885

Nauru Rehabilitation Corporation

Nauru Rehabilitation Corporation (NRC) produces armour rock and aggregate supplies used in construction and provides waste collection, plant hire, land clearing and rehabilitation services. It has a mandate to rehabilitate land for use as residential, renewable energy, agriculture, aquaculture, sports, parks and natural reserves.

The key projects for NRC in 2019-20 included the supply of armour rock and aggregate to the Port Project, export of armour rock, as well as land clearing for the ADB sponsored Solar Farm Project and rehabilitation projects. NRC also undertook road maintenance for the RPC.

There were issues with machinery during the year that impacted on land clearing, rock and aggregate production. These are expected to be resolved in 2020-21 with the arrival of new rock crushing and other equipment purchased for NRC by the Government and through the Port Project. The Government has also supported technical assistance to ensure that machines continue to operate at the required capacity to meet the Government-in-kind rock and aggregate supply commitments to the Port Project.

Table 3.6: NRC revenue and expenses

NRC	2019-20 Budget $	2019-20 Actual Apr 20 $	2020-21 Budget $
Revenue	15,513,497	6,562,414	16,125,899
Expense	7,156,729	4,838,704	8,820,724
Operating profit before tax	8,356,768	1,723,710	7,305,175

In 2019-20, NRC expected to receive $15.5 million in income, but actual performance was significantly less. This reflected that the planned export of armour rock did not occur, and land clearing revenue was only a third of what had been expected. NRC has also accumulated significant accounts receivable arrears, which has also undermined revenue performance.

Operational expenditure in 2019-20 was budgeted at $7.2 million, and actual performance to April 2020 was $4.8 million. Capital expenditure was estimated at $3.7 million and actual performance to April 2020 was $3.6 million. A net operating profit of $8.4 million was budgeted, and actual performance to April 2020 was $1.7 million.

For 2020-21, NRC is budgeting for similar revenues and expenditure as 2019-20, with $16.1 million revenue, operational expenditure of $8.8 million and capital expenditure of $1.1 million. A net operating profit to $7.3 million is predicted. NRC indicates that $4.6 million of this will be transferred to an asset replacement fund.

Key activity for 2020-21 is expected to be production of armour rock and aggregate for the Port Project, continuation of land clearing for the Solar Farm Project and other rehabilitation projects, including the pilot residential land clearing project sponsored by the Government. NRC also expect to export armour rock during the year.

In 2020-21 NRC will take a three-pronged business approach:

- BAUi (business as usual) - rock and aggregate production, engineering projects (solar farm and pilot residential land project), and plant hire services, accounting for 90 per cent of business
- ReDI (research and development and investment) – dolomite, armour rock and aggregate exports, public private partnerships to explore export opportunities
- HiGI (higher ground initiative) – working with development partners to address climate change/sea level rise, and develop a land use plan to underpin future land clearing and development opportunities.