

THE PREMIER - FOR CABINET TO NOTE

LEASING GUIDELINES

1. PROPOSAL

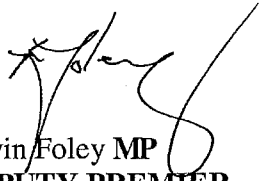
- 1.1 That Cabinet note that the Treasurer has approved Leasing Guidelines prepared by the Department of Treasury and Finance (SAFA) to be incorporated as part of existing Treasurer's Instruction No.8, *Expenditure for Supply Operations, and other Goods and Services*.

2. DISCUSSION

- 2.1 There is currently no explicit instruction or guideline as to how South Australian Public Sector agencies should evaluate leases in the context of the overall procurement decision.
- 2.2 Leasing Guidelines (refer attached) have been developed by the Department of Treasury and Finance (SAFA) following consultation with agencies to improve decision-making in regard to leasing transactions.
- 2.3 The objectives of the Leasing Guidelines are to:
- ensure that the Government receives value for money when acquiring assets through a thorough evaluation of the effective cost of leasing relative to direct purchase;
 - enable agencies to assess the risks inherent in leasing arrangements to ensure that the cost of the lease adequately reflects the material risks carried by the parties to the lease agreement; and
 - ensure that leases are properly costed to reflect whole-of-life procurement costs, having regard to the risks and benefits provided by the leasing arrangement.
- 2.4 The Leasing Guidelines are to apply when South Australian Public Authorities contemplate procurement via a leasing arrangement where the cost of the asset or group of assets to be acquired and/or the present value of the proposed lease payments exceeds \$100,000. However it is recommended a basic lease vs buy analysis be undertaken before entering any leasing agreement.
- 2.5 The introduction of Leasing Guidelines is consistent with policy developments in other States, where most States have guidelines specifically covering leasing arrangements.
- 2.6 The Leasing Guidelines will be incorporated as part of the existing Treasurer's Instruction No.8, *Expenditure for Supply Operations, and other Goods and Services*. Treasurer's Instructions apply to all Public Authorities as defined in the *Public Finance and Audit Act*.

3 RECOMMENDATION

- 3.1 It is recommended that Cabinet notes the Treasurer has approved Leasing Guidelines to be incorporated as part of existing Treasurer's Instruction No.8, *Expenditure for Supply Operations, and other Goods and Services.*

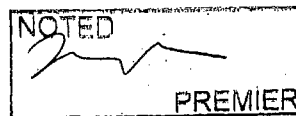


Kevin Foley MP
DEPUTY PREMIER
TREASURER
MINISTER FOR INDUSTRY & INVESTMENT
MINISTER FOR FEDERAL/STATE RELATIONS

22 March 2003

In Cabinet

31 MAR 2002



8. Expenditure for Supply Operations, and Other Goods and Services

Objective

- 8.1 To specify the principles which shall govern contracting for, and incurring expenditure on, Supply Operations, and Other Goods and Services, having regard to the State Supply Act 1985.
- 8.2 To prescribe a policy for purchases from organisations not compliant with the Equal Opportunity for Women in the Workplace Act 1999 (Cth).
- 8.3 To prescribe the process for entering into contracts not subject to the State Supply Act.
- 8.4 To prescribe the financial authority which is necessary for entering into contracts.

Definition

- 8.5 "Approval to enter into contracts" means the approval required under this instruction before a public authority is committed to the liability under a contract for Supply Operations and Other Goods and Services.
- 8.6 "Authority to incur expenditure" means the authority required to make a payment under a contract.
- 8.7 "Supply Operations" has the meaning attributed in the State Supply Act 1985.
- 8.8 "Other Goods and Services" means all procurements not included in the definition of "Supply Operations".
- 8.9 "South Australian Government employee" means a person who is an employee of the Crown or a statutory authority, or appointed to any office under an Act.
- 8.10 "Accredited purchasing unit" means a public authority accredited and approved as such by the State Supply Board.

Instruction

Scope of the Treasurer's Instructions

- 8.11 This instruction specifies the arrangements with which Chief Executives must comply in relation to contracts for the purpose of Supply Operations and in contracting for Other Goods and Services, in addition to any processes and procedures required under any legislation including the State Supply Act 1985.

Approval to Enter into Contracts

- 8.12 If the enabling Act of a public authority authorises its governing body or employees to enter into contracts or to delegate that authority, the Chief Executive must ensure that those authorisations are complied with.
- 8.13 Where the enabling Act referred to in instruction 8.12 does not confer a specific authority to enter into a contract or to authorise the delegation of that authority, the following approvals must be obtained before entering into a contract:
- 8.13.1 The Chief Executive or other authorised officer, where the contract expenditure (inclusive of GST) will not exceed the amount of the standing authority delegated in accordance with 8.21 or \$500,000 whichever is the lesser amount
 - 8.13.2 The Minister, where the contract expenditure (inclusive of GST) will exceed the limit specified in instruction 8.13.1 but will be less than \$4,000,000
 - 8.13.3 Cabinet, where the contract expenditure (inclusive of GST) will be equal to or greater than \$4,000,000.
- 8.14 In addition to any other requirements:
- 8.14.1 The approval of Cabinet shall be obtained for the purchase of land where the expenditure involved (inclusive of GST) exceeds \$1,000,000. Purchases and sales of land must be conducted in accordance with Premier and Cabinet Circular 114
 - 8.14.2 Legal practitioners must be engaged only in accordance with Treasurer's Instruction 10
 - 8.14.3 The approval of Cabinet shall be obtained for an office accommodation project where the cost of the project exceeds \$1,000,000. Office accommodation must be arranged only in accordance with Treasurer's Instruction 16
 - 8.14.4 When entering into a public sector initiative, approvals in accordance with Treasurer's Instruction 17 must be obtained at the completion of the concept evaluation stage and before tenders are called. Public Sector Initiatives shall be evaluated in accordance with Treasurer's Instruction 17.

Calling Tenders

- 8.15 The Chief Executive of each public authority, except a prescribed authority under the State Supply Act 1985, whether it is an accredited purchasing unit or not, must ensure that officers in the public authority enter into contracts and otherwise undertake procurement in accordance with the State Supply Board contract delegations, procurement standards, policies and guidelines which are appropriate for that public authority.

- 8.16 In respect of all contracts for Other Goods and Services:
- 8.16.1 Tenders must be invited by advertisement in the Government Gazette and/or by such other method as deemed appropriate
- 8.16.2 Where a Chief Executive is of the opinion that, due to special circumstances, it is more economical or expedient to invite offers:
- 8.16.2.1 the Chief Executive or an officer authorised by the Chief Executive may invite offers accordingly where the estimated amount involved (inclusive of GST) is not in excess of the authority delegated pursuant to this instruction; or
- 8.16.2.2 the Chief Executive shall forward a submission to the responsible Minister for direction where the estimated amount involved (inclusive of GST) is in excess of such delegated authority.
- 8.17 Except where the estimated amount involved is \$5,000 or less (inclusive of GST), or the Minister has approved other arrangements, all offers must be in writing. A minimum of three representative offers shall be sought wherever possible.
- 8.18 Late tenders must be officially recorded as such at the time they are received and shall only be admitted for consideration with the approval of the Chief Executive.
- 8.19 Contracts or agreements are to be made in the name of the Minister unless the enabling Act of the public authority gives it the power to enter into a contract in its own name.

Authority to Incur Expenditure

- 8.20 A Chief Executive must not permit any liability for expenditure of public moneys to be incurred unless:
- 8.20.1 The expenditure is necessary for the conduct of a public authority and the requirements of the Public Finance and Audit Act, any other Act, law or instruction have been observed in all respects
- 8.20.2 Sufficient uncommitted funds are available.
- 8.21 A responsible Minister may grant annually a standing authority to incur expenditure for the financial year not exceeding a specified amount of money:
- 8.21.1 Appropriated from Consolidated Account
- 8.21.2 Held in a special Deposit Account
- 8.21.3 In the case of a public authority that is a government department, lodged with the Treasurer in accordance with Section 21 of the Public Finance and Audit Act
- 8.21.4 Held in other accounts.

- 8.22 Approval to incur expenditure referred to in instruction 8.21 may be granted to:
- 8.22.1 The board or other governing body, where a public authority is a statutory authority
 - 8.22.2 The Chief Executive, where a public authority is a government department
 - 8.22.3 A person, or the person who is deemed to constitute the corporation, where a public authority is a natural person or a corporation sole.
- 8.23 Approval to incur expenditure granted pursuant to instruction 8.22 may be sub-delegated to the Chief Executive or to an officer of the public authority as appropriate by a body or person referred to in instruction 8.22.
- 8.24 A body or person referred to instruction 8.22 shall remain responsible for all expenditure notwithstanding the exercise of authority delegated to any officer pursuant to instruction 8.23.
- 8.25 Approval to incur expenditure that may be given by the responsible Minister pursuant to instructions 8.21 and 8.22 does not relieve any officer of a public authority or any person appointed or employed by the Crown or State instrumentality who incurs an expense from the responsibility for any overpayment arising from their neglect or inaccuracy.

Affirmative Action Legislation

- 8.26 A public authority must not in the course of supply operations or otherwise purchase anything from or provide assistance to, any firm or supplier which is not compliant with the Equal Opportunity for Women in the Workplace Act 1999 (Cth) - as named in the Federal Parliamentary proceedings. Therefore:
- 8.26.1 All contracts must contain a clause stating that it is a condition of the contract that the supplier remain compliant for the entire duration of the contract.
 - 8.26.2 If a supplier involved in a major Government contract becomes non-compliant, the Government reserves the right to waive the consequences of any breach of the compliance clause, if the alternative were to be potentially disadvantageous to the State.
 - 8.26.3 Any such decision to waive this clause as outlined in instruction in 8.26.2 above must be approved by Cabinet.
 - 8.26.4 Cabinet may waive the requirements of this section in the existence of special circumstances (eg the existence of a sole supplier).
 - 8.26.5 Departments involved in subcontracting must take steps to ensure the main contractor does not appoint a subcontractor that is not compliant with the Equal Opportunity for Women in the Workplace Act 1999 (Cth).

- 8.27 Agencies and contractors must also comply with anti-discriminatory legislation of the Commonwealth and the State including the Equal Opportunity Act 1984.

Additional Guidelines

- 8.28 Chief Executives should also be guided by the following in respect of matters involving contracts for Supply Operations and procurement of Other Goods and Services:
- 8.28.1 "All About Contracting Out", June 1995, Department of Premier and Cabinet;
 - 8.28.2 "Contracting Out Financial Guidelines", November 1995, Department of Treasury & Finance;
 - 8.28.3 "Prudential Management Framework", Department of Premier and Cabinet;
 - 8.28.4 The "Asset Management Policy Series" produced by the Department for Administrative and Information Services;
 - 8.28.5 "Guidelines for the Evaluation of Public Sector Initiatives" December 1997, Department of Treasury and Finance;
 - 8.28.6 "Leasing Guidelines" January 2003, Department of Treasury and Finance.



Department of Treasury and Finance
Leasing Guidelines

January 2003

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1. Introduction

Leasing can provide a cost-effective means for agencies to acquire assets used to provide services to the public. Although leasing is a potentially valuable procurement option, it is nevertheless essential that agencies are aware of the risks and benefits that arise when entering into lease contracts.

A lease is essentially a contract by which the owner of an asset allows another party to use the asset for a defined period, in return for an agreed payment. Lease contracts, however, are often complex agreements that may result in the owner gaining a significant financial advantage, a result that usually arises through inadequate analysis of the total costs and risks of the lease and management of the lease contract.

Failure to achieve the most cost-effective outcome when procuring assets, either directly or through leasing arrangements, is usually a result of a misunderstanding of the following issues:

- ◆ the *effective*, or whole-of-life, cost of leasing compared with the direct purchase of assets, or *vice versa*;
- ◆ the impact of lease terms and conditions that can increase the cost of using the asset, including restricting the use of the asset compared to its intended use;
- ◆ the differences between operating and finance leases and the impact of the risks implicit in either lease;
- ◆ allowing lease payments (ie returns to the owner) that are excessive relative to the apportionment of risks in the lease agreement;
- ◆ failure to ensure that leased assets are acquired through an effective competitive process;
- ◆ the need for ongoing management of lease contracts; and
- ◆ the occurrence of hidden costs through lack of compliance with lease terms, particularly asset maintenance provisions.

In view of these risks, public sector agencies can benefit substantially from the application of uniform leasing guidelines when contemplating procurement by a leasing arrangement.

1.1 Objectives

The objectives of these Guidelines are to:

- ◆ ensure that the Government receives value for money when acquiring assets through a thorough evaluation of the effective cost of leasing relative to direct purchase;
- ◆ enable agencies to assess the risks inherent in leasing arrangements to ensure that the cost of the lease adequately reflects the material risks carried by the parties to the lease agreement; and

Leasing Guidelines

- ◆ ensure that leases are properly costed to reflect whole-of-life procurement costs, having regard to the risks and benefits provided by the leasing arrangement.

South Australian Government agencies are expected to follow these principles as closely as possible when contemplating the acquisition of assets by means of a leasing arrangement.

1.2 Scope

The Leasing Guidelines are to apply when contemplating procurement via a leasing arrangement where the cost of the asset or group of assets to be acquired and/or the present value of the proposed lease payments exceeds \$100,000. However, it is recommended a basic lease vs buy analysis be undertaken before entering any leasing agreement.

The Leasing Guidelines assume that compliance with the necessary processes and approvals, including Treasurer's Instruction No. 8, *Expenditure for Supply Operations, and other Goods and Services*, Treasurer's Instruction No. 20, *Guarantees and Indemnities* and for proclaimed semi-government authorities, the *Public Finance and Audit Act*, has occurred in the decision being made to acquire the asset. Having fulfilled the necessary requirements in order to acquire the asset, the Leasing Guidelines address the question of whether leasing is the most cost-effective means of financing the acquisition of the asset.

These guidelines do not apply to *Office Accommodation, Office Fitout and Decommissioning Works* which are covered by Treasurer's Instruction No. 16.

The guidelines have been developed by the South Australian Government Financing Authority (SAFA), in conjunction with the Department of Treasury and Finance. SAFA provides a comprehensive advisory service relating to leasing and financing including software to assist agencies in the lease versus buy analysis. Any queries on these guidelines and for technical assistance on leasing and financing issues can be directed in the first instance to SAFA's Client Services area on (08) 8226 9452.

Depending on the nature of the issue, advice is also available from other sources including Crown Law, Prudential Management Group and the Department of Administrative and Information Services.

2. Leasing Principles

2.1 What is a lease?

A *lease* is an agreement whereby the owner of an asset allows another party to use the asset in exchange for an agreed periodic payment. The owner or financier of the asset is known as the *lessor* while the asset user is termed the *lessee*.

2.2 Transfer of Risk

The private sector generally cannot raise capital at rates as favourable as the State Government. However, the fact that the Government's cost of finance is lower than the private sector does not necessarily mean that all assets should be purchased directly, as the financial risks associated with the asset over the term of its useful life may be considerable. The realisation of the risks associated with the asset may increase the *effective* cost to the Government to the extent that it may be more efficient to consider leasing the asset from a private supplier.

Consideration must therefore be given to the riskiness of the asset and the degree of risk that can be transferred by means of a lease agreement. These factors are used to determine whether the premium (if any) embodied in the lease payment is justifiable on commercial grounds and whether the arrangement is beneficial to the State.

Different types of leases have different risk profiles, which will affect the risk premium over the Government's nominal borrowing cost that the lessor will require as compensation for accepting these risks. In this context, it is important that agencies understand the different levels of risk implicit in the two basic types of lease, which are operating and finance leases.

2.3 Operating Leases

An operating lease, often known as a rental agreement, has the following features:

- ◆ the term of the lease is usually considerably shorter than the expected useful life of the asset; and
- ◆ it is cancellable by the lessee at short notice with little or no additional cost or contractual penalty.

These two features provide the basis upon which risk is transferred to the private supplier as the owner of the asset. Because the lessee can cancel the lease without penalty, the lessor bears the major part of the risk of the asset. Upon termination of the lease, the lessor must either sell the asset or reinstate the lease with another party. The return on investment to the lessor is therefore determined by value of the asset in the marketplace.

Maintenance, insurance and repair costs are generally covered by the lessor (except in the case of *maintenance leases*).

2.4 Finance Leases

A finance (or capital) lease generally has the following attributes:

- ◆ it is usually for a longer term and covers the majority of the economic life of the asset;
- ◆ it is often non-cancellable or only cancellable at high cost to the lessee; and
- ◆ the lessee assumes all, or the major part, of the risks and benefits of ownership including maintenance, repairs, insurance, residual value and obsolescence.

The lessor's role is therefore primarily that of a financier. At the termination of the lease, the asset is transferred to the lessee for a specified sum, which can often incorporate a guaranteed residual value. A finance lease is therefore a loan from the lessor/financier to the lessee.

Because finance leases are in effect borrowings, agencies and semi-government entities are prevented from entering into finance leases without the approval of the Treasurer.¹ However, even in the absence of this constraint, agencies would not logically enter into finance lease arrangements, as the higher cost of private finance cannot be justified in view of the absence of a genuine transfer of risk to the private supplier. In the absence of risk transfer, it will generally not be possible to justify paying an *effective lease rate* or interest cost that is higher than the State's cost of borrowing.

2.5 Accounting treatment

Australian Accounting Standards Board (AASB) 1008 and Australian Accounting Standard 17 *Accounting for Leases* (AAS17) require that leases be classified as either operating or finance leases. Because finance leases are essentially a loan to the lessee, the Standards require that the lease be recorded as a liability in the lessee's accounts. Lease payments under an operating lease, on the other hand, are recorded as an expense.

While the accounting standards attempt to create a clear distinction between the two types of leases, for evaluation purposes most leases under consideration by agencies fall somewhere between the strict definitions of operating and finance leases. Nevertheless, all leases ultimately have to be classified as either an operating or finance lease.

The degree to which the risks and benefits incidental to ownership are transferred between lessor and lessee is the critical variable in evaluating leases. The methodology outlined below has been developed to resolve these issues.

¹ For example, the *Public Finance and Audit Act*, prohibits proclaimed semi-government authorities from entering into a financial arrangement without the Treasurer's prior approval. In addition, Treasurer's Instruction No 20 prohibits agencies from purchasing goods or services, for which there is no prior appropriation for the procurement, without the approval of the Treasurer.

2.5.1 Accounting tests

Australian Accounting Standards, particularly AASB 1008 and AAS17, provide a number of “tests” that can be applied to determine whether a particular lease may be classified as an operating or finance lease. These tests should nevertheless be regarded as a guide only, and cannot be relied upon as a definitive statement as to the accounting classification of a particular lease. The software available from SAFA incorporates the accounting tests.

Where uncertainty exists as to the classification of a lease, the agency can contact SAFA for assistance.

General guidance for the classification of leases is provided in Attachment 1.

2.6 Financing decisions and whole of life costing

Leasing, whether a finance lease or an operating lease, is simply an alternative to direct purchase. The preparation of a sound business case for the *investment decision* to demonstrate the reason for the acquisition must precede the *financing decision*. Agencies must also demonstrate that the cost of the lease is within current and projected budgetary parameters and all relevant guidelines and instructions complied with.

When making leasing decisions, agencies must satisfy themselves that the most cost-effective financing alternative is adopted. This is not necessarily the *lowest* cost alternative, as the effective cost of the lease will be determined to a large extent by the degree of risk transferred to the lessor. The focus of the procurement and financing decisions is to achieve value for money, having regard to both the risks and benefits of acquiring the asset, from a “whole-of-life” perspective.

Agencies should ensure that one or more of the following conditions exist as a prerequisite to entering the leasing arrangement. At a minimum, the lease must meet at least one of the following conditions:

1. provide use of an asset not otherwise available;
2. meet a need for the temporary use of equipment;
3. provide buying and servicing advantages not otherwise obtainable;
4. shift the risks of ownership; and/or
5. realise a quantifiable economic advantage.

Leasing arrangements can have the effect of transforming capital expenditures into recurrent expenditures. From a budget perspective, leases can therefore provide a means to circumvent capital budget constraints. This applies to investment in new assets and the disposal of existing assets via sale-and-lease-back arrangements.

Budgetary constraint considerations should *not* play a role in lease evaluation. The evaluation of leases centres on delivering a lower whole-of-life cost within a framework that allows for meaningful risk transfer between the parties. Care should be taken to ensure that the whole-of-life cost of leasing is taken into

consideration when assessing a lease, rather than simply the lease payments that fall into the current budget period.

Agencies need to ensure that the net present value (NPV) of all operating lease commitments are provided in feasibility studies and business cases and in any reports to the Department of Treasury and Finance. The discount rate to be applied to derive the NPV is the Government's cost of borrowing for the equivalent term of the lease.

Where leases are correctly valued, the cost difference, in NPV terms, between leasing and buying should be limited to the value of the risks transferred to the private supplier of the leased asset.

2.7 Competitive tendering

In general, agencies should assume that proposals for leasing arrangements will be subject to a competitive bidding process, in accordance with Treasurer's Instruction No. 8, *Expenditure for Supply Operations, and other Good and, Services*. Agencies should also refer to *Contracting Out and Competitive tendering: Guidelines for the Private Sector* when conducting tenders. The State Supply Board is able to provide information on the requirements in relation to tendering.²

The APUs within each portfolio can provide advice on governance issues and procurement.

2.8 Taxation Issues

The *Income Tax Assessment Act 1936* (ITAA) contains several anti-avoidance provisions directed specifically at the leasing arrangements between the private and public sectors. These provisions operate to deny deductions to private sector suppliers where the underlying purpose of the transaction – as determined by the Australian Tax Office - is to reduce the cost of finance through the sharing of the tax benefits between the private and public sector parties to the lease.

The ITAA can introduce considerable uncertainty and complexity in the negotiation and structuring of lease arrangements, so that it is worthwhile that agencies have a working knowledge of the provisions affecting lease contracts.

Further discussion of the taxation issues relating to leases is provided in Attachment 2.

² The Prudential Management Group, *Project Handbook* is also a useful reference as it consolidates into a single resource the various Government policies, guidelines and principles governing contracting out.

3. Lease vs Buy Analysis

The primary objective of lease analysis is to determine whether the total cost, in NPV terms, of entering into a leasing arrangement is lower than the total cost of procuring the asset by outright purchase. In order to make this evaluation, regard must be had to the riskiness of the asset. Exposure to risk increases the effective cost of owning the asset, so that the owner of the asset will require a premium over the risk-free interest rate to compensate for risk.

Ignoring any effect of market distortions such as taxes, transaction costs and different cost of capital rates among competing intermediaries, a lease is equivalent to acquiring assets with 100% debt financing. The difference in the cost of leasing or buying is due to the effective cost of financing the asset, which, in the absence of any guarantees by the lessee, is determined entirely by the riskiness of the asset. Lease premiums (over the riskless cost of funds) vary considerably according to the market's perception of the riskiness of the asset.

In practice, leasing can be a cheaper option than buying because of the differences in a number of factors, such as tax status, cost of capital or specialisation in risk management and market access amongst intermediaries that may not be available to the public sector.

The section below outlines a general approach for the analysis of leases. The approach assumes familiarity with the techniques in discounted cash flow (DCF) methodology. Agencies should contact SAFA if this is not the case.

The simplest method to analyse a lease is by comparing the NPV of cash flows from leasing with the cash flows from purchasing – the latter is usually just the purchase price less the discounted *expected* residual value. If the NPV of the cost of leasing is higher, then owning is the better option.

Care must be taken to ensure that different lease proposals are being compared on the same basis.

SAFA has 'user-friendly' software available complete with detailed explanatory material to enable agencies to readily undertake lease versus buy analysis.

3.1 Cash Flows

It is important to identify all relevant cash flows in a lease versus buy evaluation. In an incremental analysis it is only necessary to identify those cash flows that differ between the two options so as to isolate the additional cost (if any) of leasing over purchasing.

For example, if the asset transfers to the State at the termination of the lease, residual ownership does not differ between options and, thus, the terminal value is excluded from the analysis.

Alternatively, all costs of ownership and leasing can be identified so that a whole-of-life cost of each option is established. This approach is more complex but provides more meaningful results in terms of the overall costs of each option. Both approaches provide equivalent results.

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The prime determinants of leasing cashflows are the purchase price, the residual value, maintenance costs and cancellation options. These determinants are discussed below.

3.1.1 Purchase Price

The purchase price will generally represent the single biggest cash flow in a lease versus purchase analysis. As such, it is important that it represents the full cost of acquiring and bringing the asset to a fit-for-purpose state to the same extent as would occur under the lease option.

3.1.2 Residual Value

The residual value is also a significant component of a lease versus purchase analysis since it helps to offset the cost of the purchase option. It is therefore necessary to reduce the cost of the ownership option by the present value of the asset's worth at termination.

Some finance leases will involve a transfer at termination of the agreement for nominal value. In this case the asset will be owned under both lease and purchase options and the residual value can therefore be excluded.

The residual value is typically the cash flow item exposed to the most risk in the analysis. Indeed, the avoidance of residual or obsolescence risk is often a primary motivation for entering into an operating lease. The appropriate residual value should be carefully determined and the estimate subjected to sensitivity analysis. The impact of residual value on total costs will often be the determining factor of a lease versus purchase analysis.

In determining the expected residual value, the costs of disposal need to be netted off against expected sale proceeds.

3.1.3 Maintenance

Leasing an asset often involves a transfer of maintenance costs and risk to the lessor. If the arrangement is a *maintenance, full service or rental lease*, responsibility for maintenance and other costs may rest with the lessor. It is then necessary to include maintenance as a cost of ownership so as to assess both the purchase and lease option on a comparable basis. Alternatively, the lease quote can be obtained both including and excluding maintenance.

3.1.4 Cancellation Options

In a strict operating lease it should always be possible to cancel the lease.

Cancellation options can be valuable as they provide a means of reducing the risks of ownership. This is more important when the asset has a long life or the asset's value is likely to be volatile or uncertain. A detailed discussion of the valuation methodology applied to cancellation options is beyond the scope of these Guidelines, and assistance can be sought from SAFA for the valuation of cancellation options.

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3.1.5 Discount Rates

Ascertaining the appropriate discount rate for a leasing analysis is an essential component of the assessment.

For the lease rentals, which are known with certainty under the contractual arrangements entered into with the lessor, it is recommended that the appropriate discount rate is the Government's cost of funds for a loan instrument over the equivalent life of the lease as provided by SAFA.

In respect of the residual value cashflow, it is also recommended that the Government's cost of funds for the relevant term be used as the discount rate in the net present value analysis.

The Leasing Guidelines are based on using nominal discount rates to discount nominal cash flows. If the proposal involves real cashflows (cashflows linked to inflation) then a real discount rate is required to be used. SAFA can provide further assistance on this or more generally on the selection of discount rates and valuing cashflows if required. In particular, it is recommended that where there are concerns about the riskiness of future cashflows, SAFA's advice be sought about valuing such cashflows.

4. Sensitivity Analysis

As with all financial evaluations, it is important to test the sensitivity of the result to changes in the key parameters and assumptions used in the analysis. This is particularly important for variables where the outcome is highly uncertain or has the potential to materially affect the lease or buy decision.

The following variables are frequently subject to sensitivity analysis.

Residual value

Given the residual value is typically the cash flow item exposed to the most risk in the analysis it is appropriate to undertake the lease versus buy analysis under a range of residual value outcomes. This is readily facilitated by the software provided by SAFA.

Generally, higher residual values favour purchasing more than leasing. If leasing is preferred, it is useful to ascertain the amount by which the residual value needs to change to make leasing unfavourable.

Maintenance costs

Where a lease provides for the maintenance of an asset, the ownership case must reflect similar costs or the lease / own analysis will be biased against leasing. This is particularly the case for assets with high maintenance costs relative to the leasing costs, where these charges may be volatile.

5. Lease Documentation Issues

Lessors often attempt to include clauses into lease agreements that mitigate the risk of the lessor or transfer risk to the lessee. The result is that lessors have the potential to either increase the cost of the lease to the lessee, or to restrict the lessee's ability to use the asset to the extent intended. In both cases, value for money is diminished, often severely.

This section presents a series of lease terms and conditions advocated by lease financiers that should be considered very carefully by agencies with appropriate reference to Crown Law as applicable.

Commencement date and interim rentals

Interim rentals arise when the lease is drawn on a date other than the rental payment date. The lease payment must be adjusted on a pro rata basis to reflect the interim period. If not adjusted properly, that is, calculated on the number of days from the draw down date to the payment date, interim rentals can significantly reduce the cost effectiveness of the lease.

Inertia rentals

Inertia clauses provide that the lease contract automatically rolls over at termination at full price. The net result is that new equipment prices are being paid for "second-hand" equipment. This can be a highly profitable outcome for the lessor. Inertia clauses are generally not acceptable. If an inertia clause is to be included in the lease contract, the payment terms, which should reflect the depreciated value of the asset at the time, must be expressly stated.

Similarly, some leases provide that the lease must be continued should specified asset returns not be met. This practice is also not acceptable.

End-of-term options

Leases that allow for renegotiation of the payments at a discount are generally not acceptable. Many leases contain extension options at around 80% of the original lease payment. Given that the asset would normally be worth substantially less than this amount, this does not provide value to the agency.

Termination arrangements should provide the option to:

- ◆ purchase the equipment *at market value*;
- ◆ renegotiate the lease at reasonable intervals *based on market value*; or
- ◆ have the equipment removed *by the lessor*.

Furthermore, the lease contract should require the lessor to provide warning of the imminent expiry of the lease.

Note that it is often the actions or omissions of the lessee (or agency) at the end of a lease arrangement that generally determines the overall financial performance of the lease.

Asset upgrades

Lessors can earn windfall profits by "suspending" the lease to upgrade the asset and then reinstate the original lease for an extended term, sometimes at higher interest rates than applied for the original lease. In effect, the "suspension" is a termination of the original lease and the initiation of a new lease, but has a different asset value, capital rate and

Leasing Guidelines

residual value to the original lease. Asset upgrading should not be undertaken without a thorough evaluation of the replacement lease on the same basis as the original lease.

Cancellation penalties

A true operating lease should enable the agency to exit the lease should the equipment become either obsolete or surplus to requirements. In cases where the equipment may depreciate more rapidly than the amortisation rate implied by the lease payment, there may be a commercially balanced adjustment due on cancellation. Early cancellation penalties are generally not acceptable.

Fixed payments

Although common in leases for accommodation, generally lease arrangements should be fixed such that inflation or interest rate risk is passed to the lessor.

Taxes

Any taxation effects (both State and Commonwealth) which arise as a consequence of differential treatment of public versus private sector entities should be included in the lease vs buy analysis, as discussed in the section entitled "Competitive Neutrality". This specifically includes the application of any stamp duty to the lease or the lessor.

Asset management and service bundling

Some lessors attempt to bundle additional services (eg asset maintenance) into lease packages. A third party with whom the agency has no legal relationship often provides these services. The supposed attractiveness of these offers is that the agency makes a single payment for a "package deal", the cost of these services being implicit in the lease payments.

Asset related services are costs, not benefits. Lessors should be required to provide a break-up of the lease on an unbundled basis so that the agency can determine the value for money of each component. Flexibility should be retained as to whether the agency will accept asset maintenance services from the lessor, a third party of its choice, or be undertaken in-house.

Indemnities

Some lessors attempt to incorporate non-standard indemnities relating to changes in the treatment of the lease for taxation purposes. Changes to tax law are a normal risk incurred as a consequence of doing business, and indemnities should not be provided except in exceptional circumstances.

Managing the lease

Once the lease agreement is finalised, it is important to monitor lessor performance and lessee compliance with the lease terms. This includes being well aware of the termination date in advance and evaluating the lessor's performance (against predetermined performance criteria agreed under the lease) before the final lease payment to ensure that all obligations have been complied with and all the products and services that were part of the lease arrangement have been obtained.

6. Competitive Neutrality

Competitive neutrality is achieved when agencies do not gain a competitive advantage or disadvantage relative to private providers by reason only of their public sector status. In the case of leasing, agencies may enjoy a cost advantage from owning the asset by reason of Government ownership that may not be available to the private sector lessor.

The key principle is that direct procurement by the public sector must be compared with private sector providers on an equal footing, net of any regulatory or redistributive mechanisms that may exist as a matter of law or public policy.

Competitive neutrality can be addressed by incorporating into the financial analysis estimates of the financial payments that the public sector would have to make if it were subject to tax.

Some adjustments to the evaluation of leasing compared with purchasing are discussed below.

Income Taxes

The cash flow analysis for the lease evaluation should be conducted on a pre-tax basis for tax exempt entities. Entities subject to the tax equivalent regime should evaluate the project on the basis of their tax status, ie net of tax.

Goods and Service Tax

The Commonwealth Goods and Services Tax (GST), where it cannot be claimed as a credit by the agency as part of providing the good or service in question, must be imputed in the lease evaluation. In the majority of cases, however, it is expected that the agency will be able to claim the GST credit and therefore the GST should not be included in the analysis.

Insurance

The cost of the lessor's insurance will be reflected in the lease rental. The lease evaluation must be adjusted for the cost of insurance to the agency as owner as if it were insured.

Discount rates

Competitive neutrality is achieved by using a pre tax discount rate to discount cashflows. A pre-tax discount rate ensures that financial analysis and comparisons do not become distorted by the effect of taxation. In the main, bids will reflect the individual bidder's effective tax position, which is reflected in the bidder's quote.

7. Summary

The Leasing Guidelines seek to ensure the Government receives value for money when acquiring assets through a thorough evaluation of the effective cost of leasing relative to direct purchase. This requires a full assessment of the risks and benefits of the transaction on a whole of life basis.

A summary of the process to be followed when considering undertaking a lease is provided at Attachment 3.

The process includes a careful comparison between the costs and benefits of owning versus leasing and seeks to ensure a competitive process is undertaken whether the final decision is to own or lease the asset. A summary of the potential pitfalls associated with leasing is also provided at Attachment 4.

Any questions on these guidelines and for any technical assistance, including on leasing software, please contact SAFA's Client Services area on 8226 9452.

Attachment 1 - Classification of leases

Australian Accounting Standards

AASB 1008 and AAS17 "Accounting for Leases"

The accounting treatment for leases is provided by AASB 1008 and AAS17 "Accounting for Leases". The Standard requires leases to be classified as either operating or finance leases, sometimes referred to as "capital" leases.

Operating leases are essentially "off balance sheet" whereby the lease payments are expensed as incurred, whereas finance leases require the "leased" asset to be recorded as an asset and the present value of the lease rentals as a liability.

Paragraph 5.3.1 of AASB 1008 and AAS17 classifies a lease upon the basis of its economic substance.

- ◆ "Where substantially all of the risks and benefits incident to ownership of the leased asset effectively remain with the lessor the lease is an operating lease" ;and
- ◆ "Where substantially all of these risks and benefits effectively pass to the lessee, the lease is a finance lease."

The risks and benefits that are either transferred to the lessee or retained by the lessor are described in paragraph 5.3.2:

- ◆ "The risks of asset ownership include those associated with unsatisfactory performance, obsolescence, idle capacity, losses in realisable value, uninsured damage and condemnation of the asset; the benefits include those obtainable from use of the asset and gains in realisable value".

Paragraph 5.3.4 of the Standard also sets down the criteria for the classification of leases:

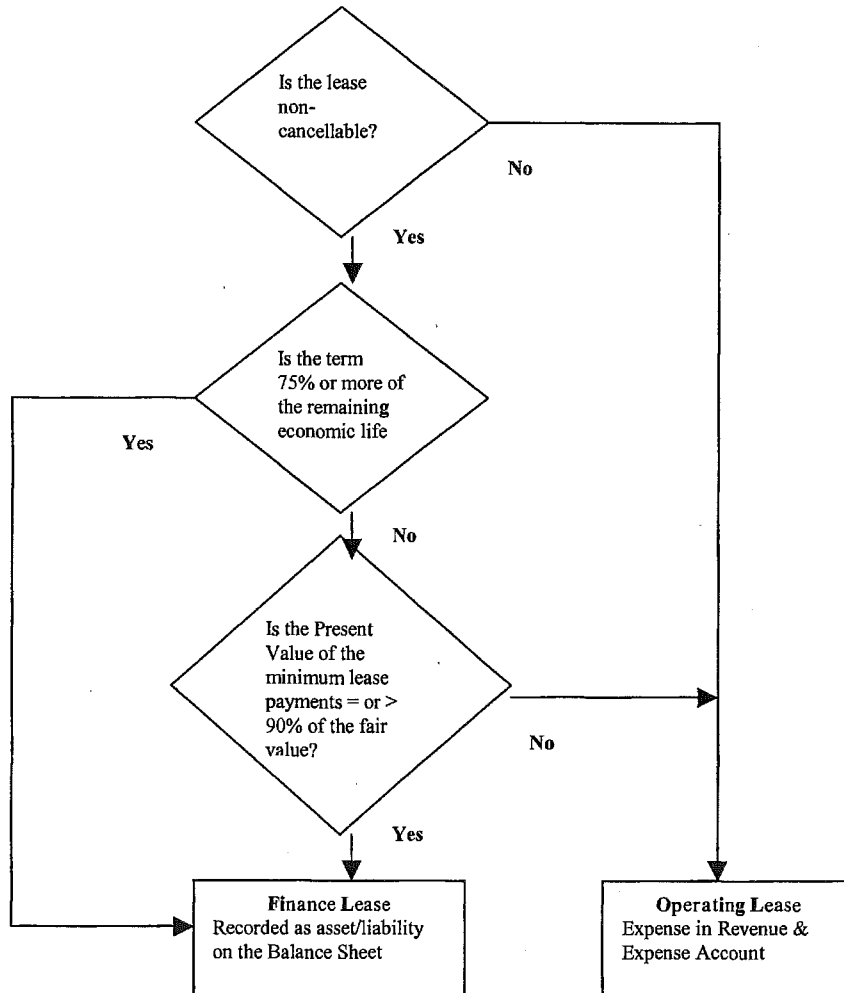
"The effective passing, of substantially all of the risks and benefits incident to ownership from a lessor to lessee, is normally presumed where the following criteria are satisfied:

- (a) the lease is a *non-cancellable* lease
- (b) either one or both of the following tests is met:
 - (i) the *lease term* is for 75% or more of the remaining *economic life* of the leased asset
 - (ii) the present value, at the *beginning of the lease term*, of the *minimum lease payments* equals or exceeds 90% of the *fair value* of the leased asset at the inception of the lease".

Leasing Guidelines

Figure 1 below summarises the criteria to be examined when classifying a lease as either a Finance or Operating lease.

Figure 1. Decision criteria for the classification of leases



Interpretation issues

The main criteria to be examined under AASB 1008 and AAS 17 relate to

- ◆ cancellation clauses;
- ◆ lease term and useful life; and
- ◆ the present value of minimum lease payments.

Leasing Guidelines

Cancellation clauses

Under AASB 1008 and AAS17 a lease is non-cancellable if it is capable of being cancelled only if:

- (a) the lessor consents to the cancellation;
- (b) a remote or unexpected contingency occurs that has a significant impact on the terms of the lease;
- (c) the lessee is required, under the terms of the lease, to enter into another lease for the same or equivalent property with the same lessor or party related to the lessor; or
- (d) the lease provides for substantial penalties so as to discourage cancellation.

Lease term and useful life

The useful life of a leased property is the estimated period, at the beginning of the lease term, over which:

- (a) the property is expected to be used; and
- (b) the remaining benefit represented by the right to use the property is expected to be derived.

The determination of useful life can be difficult in the case of long-life assets, as there may be different assessments of an asset's useful life depending upon whether the assessment relies on an accounting, economic or actuarial viewpoint. For property such as equipment and motor vehicles, the useful life is usually the period over which the agency would expect to use a depreciable asset as if it were the owner.

Present value of lease payments

For accounting classification purposes, the discount rate to determine the present value of the minimum lease payments is the interest rate implicit in the lease. Where this rate is not explicitly stated, it should be calculated by the agency. This calculation can be made using relevant formulae and tables for annuities, or by the internal rate of return (IRR) method. Most spreadsheet packages (Excel, Lotus) provide most financial mathematics functions. SAFA can provide any assistance required here.

Attachment 2 - Taxation issues

The current taxation provisions were enacted during the period when governments were the sole providers of essential public services. Over recent years, however, the private sector has increasingly become involved in all aspects of Governments procurement, ranging from the procurement of operating equipment to major infrastructure projects and the delivery of services. Taxation law has not kept pace with these developments, with the result that significant costs, complexity and delay are imposed on transactions that genuinely seek to involve the private sector in provision of property, assets and infrastructure. It is thus important for agencies to understand the reasons for the structuring of complex transactions in view of the anti-avoidance measures.

This section provides a brief outline of the main areas of tax law of interest to the tax implications of leasing arrangements with the private sector. Sections 51AD and Division 16D of the *Income Tax Assessment Act 1936* deal with the deductibility of depreciation, interest and other expenses for leased assets.

Section 51AD

This section operates to deny deductions for depreciation, interest, financing fees, maintenance, repairs and building allowances, while all income remains assessable for tax purposes.

Section 51AD applies to the provision of assets where the lessee is a tax-exempt entity and captures leasing transactions that have the following characteristics:

- ◆ the asset is financed predominantly by non-recourse debt. Debt is classified as non-recourse where losses in the event of default are recoverable only from the value of the underlying asset, which is sometimes guaranteed by the lessee; and
- ◆ the lease transfers the use of the asset for producing assessable income to a person other than the owner; or
- ◆ in the event that the property is not used to produce income, the 'end-user' *controls* or is able to *control* the use of the asset.

The purpose of Section 51AD is to prevent a Government agency (as a tax-exempt body) from accessing the benefits of the tax deductibility simply by transferring legal ownership to a tax-paying entity while retaining effective control of the asset.

The legal definition of *control* is influenced by both operational and financial factors, including the following:

- ◆ where the tax-exempt body operates the property through its employees or agents or is able to direct others through supervision of day-to-day operations;
- ◆ a tax-exempt body may retain a coordinating, supervisory or regulatory role without being seen to have control;
- ◆ exposure of the Government to commercial risks flowing from inefficient operation of the asset;
- ◆ Government being the principal beneficiary of rewards flowing from a well managed asset as evidenced by a 'fixed return' pricing mechanism that transfers the motivation for operational efficiency to Government;

Leasing Guidelines

- ◆ reversion of property interests or an option to acquire the asset in the future indicates that the lease merely represents an alternative means of financing;
- ◆ step-in rights other than in extreme emergencies or gross default; and
- ◆ In practice, the definition of control has often been interpreted very widely, and resolution of this issue has led to substantial delays in finalising leasing arrangements.

Division 16D

Division 16D applies to situations where the asset is financed other than by non-recourse debt but where the risks and benefits associated with ownership remain with the lessee.

Unlike Section 5IAD, this provision denies only those deductions relating to capital expenditure (eg depreciation), while still allowing deductions for interest and other expenses to the extent that they apply.

Division 16D utilises qualifying tests that are similar in many respects to those applied by AAS17 in the classification of finance and operating leases. The following pre-conditions apply:

- ◆ Section 5IAD does not apply;
- ◆ there must be a *qualifying arrangement* relating to the control or use of the property; and
- ◆ the use or control must be by a tax exempt body.

The definition of a *qualifying arrangement* is as follows:

- ◆ the asset is transferred to the lessor at the end of the arrangement; or
- ◆ the period of the arrangement exceeds one year and the lessee is responsible for repairs; or
- ◆ the term of the arrangement exceeds 75% of the effective life of the equipment (50% in the case of buildings); or
- ◆ payments during the arrangement reimburse the owner for more than 90% of the cost of the asset.

There are exceptions to Division 16D that relate to the ability of the lessor to have the property classified as *plant*.

In summary, the tax laws pertaining to leasing arrangements are complex and can potentially impose prohibitive costs on leasing arrangements that would otherwise be cost-effective to Government. For complex leasing arrangements, it is advised that legal opinion be sought as to the likely treatment of the lease under the Income Tax Assessment Act 1936.

Attachment 3 – Evaluation Process

Step 1: Procurement decision

The process to procure assets is conducted within the framework of Treasurer's Instruction No. 8 *Expenditure for Goods, Services and Works*. The procurement of assets is essentially an investment decision, and is undertaken within the context of agencies' asset management plan.

Step 2: Establish the total or effective cost of owning the asset

Agencies should develop a financial model of the total or effective cost of owning the asset, as described in these Guidelines. Consideration must be given to cost such as maintenance, additional operating costs, training, safety and the economic depreciation of the asset, particularly the expected residual or disposal value of the asset.

The ownership model should reflect the main risks associated with owning the asset. Sensitivity analysis should be applied to key cost factors. Relevant adjustments for competitive neutrality should also be applied. SAFA can provide any assistance required here.

Step 3: Compare ownership with leasing

A highly competitive leasing market exists for many depreciable assets, such as office, medical and IT equipment and a wide range of machinery. A potential leasing transaction arises where agencies require the use of assets in circumstances where the ownership of the asset is not essential to the agency's ability to deliver its core outputs.

A preliminary estimate of the cost of ownership and leasing can be made by calculating the expected lease payments using discount rates provided by SAFA. Care must be taken to include any costs identified in the ownership analysis in the lease model. For example, where a maintenance lease is contemplated, the cost of maintenance to the agency as owner must be included in the analysis.

If a preliminary estimate of the likely lease cost cannot be determined with a reasonable degree of accuracy, agencies may also choose to test the market by seeking indicative quotes from lease arrangers. However, it is essential that any inquiries do not provide a competitive advantage to a particular lease arranger or group of arrangers. Respondents must also be clearly advised that the provision of an indicative quote does not in any way constitute an invitation to transact, nor will the provider be ensured of inclusion in any future tender by the agency.

Step 4: Tendering

Should the analysis indicate that leasing is a viable financing alternative, where applicable, the agency should initiate a tender, following the process required in the Government's tender guidelines, *Contracting Out and Competitive Tendering: Guidelines for the Private Sector*.

The tender documentation should address the issues discussed in the section titled "Documentation Issues", particularly as regards to:

- ◆ lease term;
- ◆ interim and inertia rentals;
- ◆ residual value requirements;
- ◆ cancellation options; and
- ◆ asset maintenance and service bundling.

Leasing Guidelines

Potential bidders must be advised to address the specific criteria provided in the tender documentation and that non-complying bids will not be considered.

Agencies must ensure that all tenders are non-binding on Government. The tender documents must provide that the agency reserves the right to reject all bids and that the cost of tendering will not be reimbursed.

Step 5: Bid evaluation

Bids should be evaluated against the risk-adjusted ownership model developed at Step 2 and the qualifying criteria provided in the tender documentation. Care must be taken to incorporate any changes to lease terms and conditions that may not have been initially incorporated in the procurement analysis to ensure that the ownership model provides an objective benchmark against which to assess bids.

Attachment 4 – Pitfalls of Leasing – What to look out for

GENERAL

Leasing more expensive than outright purchase

The result of the lease versus buy analysis may show the proposed lease rentals to be excessive.

It is important that all cashflows are included in the lease versus buy analysis. It is a common mistake in completing a lease versus buy analysis to overlook the estimated residual value of the asset in calculating the total cost of the purchase alternative.

Upgrades and replacements

Check the lease documentation regarding the upgrade of leased equipment. Upgrading effectively involves a termination of the existing lease, after which the lessee leases back the upgraded equipment for an extended term. A termination in this manner can allow the lessor to make windfall profits.

Bundling of services

Lessors often attempt to bundle additional services (for example, maintenance of the equipment) together with the finance component of the lease under one costing and one contract. This can occur even if the additional services are not provided by the lessor, but by a third party. There are two main concerns with the bundling of lease arrangements with additional services:

- ◆ lessees are not in a position to assess costs or benefits and competitiveness of the services and the finance component of the lease independently of one another; and
- ◆ lessees could lose their ability to seek recourse to the service provider if a problem arises.

Potential problems may arise if a maintenance provider fails to perform its maintenance obligations. Under most rental agreements, the lessee is obliged to continue making payments, despite any breakdown of the equipment.

Unclear termination values

The termination value is the amount due from the lessee where the lease terminates prior to the end of the nominal lease term. The major concern is that the lessee often has no method for verifying its calculation. Accordingly, potential exists for the lessor to exploit lessees when an early termination occurs.

Indemnities

Some lessors attempt to incorporate non-standard indemnities relating to changes in the treatment of the lease for taxation purposes. Changes to tax law are a normal risk incurred as a consequence of doing business, and indemnities should not be provided except in exceptional circumstances.

Leasing Guidelines

OPERATING LEASES

Paying more for risk transfer

Lease payments under an operating lease normally include a premium for the acceptance of the risk in the asset by the lessor and are generally more expensive than a borrowing or finance lease in net present value terms. This premium should equate to the risk being borne by the lessor.

Interim rentals

Lessors commonly nominate *payment dates* (generally limited to four times a year) which limit the commencement of rental terms to the specified payment dates. Where a lessee takes delivery of equipment prior to a nominated payment date, an interim rental will be required (chargeable on a pro-rata basis calculated on the number of days from the draw down date to the payment date). Interim rentals can significantly reduce the cost-effectiveness of the lease.

Cancellation penalties

A true operating lease should enable the agency to exit the lease should the equipment become either obsolete or surplus to requirements. In cases where the equipment may depreciate more rapidly than the amortisation rate implied by the lease payment, there may be a commercially balanced adjustment due on cancellation. Early cancellation penalties are generally not acceptable.

Onerous return conditions

At the expiry of the lease many leases require lessees to return equipment to a specific destination nominated by the lessor. It is important to ensure that this destination is convenient to the lessee, as sometimes significant disposal costs may be incurred in complying with the return clauses when the lease expires.

Automatic extension of lease term (inertia rentals)

Rental agreements often contain onerous conditions that prevent the lease from terminating on the scheduled date unless the lessee has complied with certain notice requirements. In some cases, notice may be required to be given by the lessee during a 5 to 15 day window period up to 6 months prior to the return date.

If these conditions are not adhered to, the rental agreement may be automatically renewed for an extended rental period (which may be up to 12 months from the expiration of the original term). During the extended period, the lessee has to pay inertia rentals to the lessor for the continued use of the equipment. These inertia rentals can significantly reduce the cost effectiveness of the lease.

Include Residual Value in the Lease vs Buy Analysis

The implicit lease rate quoted by the lessor needs to take into account the expected residual value of the asset. Ignoring the residual value understates the true cost of the lease to the lessee, when compared to purchasing.

Leasing Guidelines

FINANCE LEASES

A finance lease has similar accounting and budgeting impact to debt financing

A finance lease is analogous to a borrowing or deferred payment arrangement for outright purchase. Accordingly, the accounting standards require finance leases to be capitalised in the balance sheet of the lessee and the relevant expenditure to be funded from budget allocations.

In a finance lease there is no risk transfer to lessor

Under a finance lease the risks and benefits of ownership rest with the lessee. As a result, for example, the lessee will need to manage the residual value (and obsolescence) risk as well as establishing appropriate disposal channels and upgrading any rollover management systems. There is an implicit cost involved in leased asset management that may be difficult to quantify.

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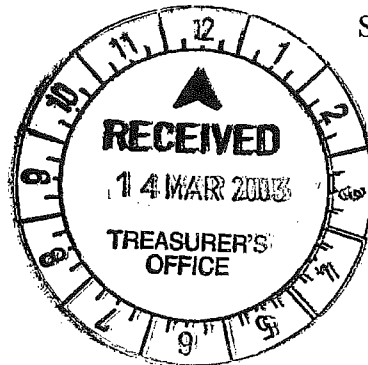
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THE TREASURER

LEASING GUIDELINES

PURPOSE

The purpose of this minute is:

- To submit for your signature a Cabinet Pink regarding the introduction of Leasing Guidelines for the South Australian Public Sector; and
- To seek your approval to the updated Treasurer Instruction No.8, *Expenditure for Supply Operations, and other Goods and Services*.

DISCUSSION

On 10 February 2002 (refer attached) you approved Leasing Guidelines prepared by the Department of Treasury and Finance (SAFA) being incorporated into the existing Treasurer's Instruction No.8 and a Cabinet Pink being prepared to inform Cabinet of the new Leasing Guidelines. A Cabinet Pink has now been prepared and is attached for your signature.

The required changes to Treasurer's Instruction No.8 have also been made and the updated Instruction is attached for your approval. If approved, agencies will be informed through the normal process for advising of new Treasurer's Instructions or amendments to existing Instructions.

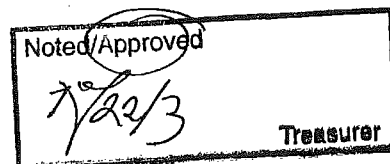
RECOMMENDATION

It is recommended that you:

- sign the attached Cabinet Pink relating to the introduction of Leasing Guidelines; and
- approve the updated Treasurer's Instruction No.8 incorporating the new Leasing Guidelines.

Jim Wright
UNDER TREASURER

14 March 2003



Contact: Kevin Cantley / Mark Priadko
Telephone: 8226 9401 / 8226 3146