APPENDIX C

STATEMENT OF RISK

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This chapter discusses some of the risks facing the Territory, with particular attention to economic risk, Commonwealth Government funding, investments and borrowings, superannuation liabilities and insurable risk.

Economic Risk

The major risk for the ACT economy originates from Commonwealth spending in the medium term. The Commonwealth Government's fiscal strategy of achieving a budget surplus in 2012-13 by applying its fiscal rules, particularly the cap on real spending growth of two per cent or less during above trend years, will weigh on local economic activity. The forecasts of a moderating economic growth assume fiscal consolidation by the Commonwealth Government. Any further spending constraint poses risk for the economic forecasts.

There is also a risk that the ACT's share of national government consumption expenditure will decline as the Commonwealth Government re-prioritises its spending in response to additional budget pressures caused by recent natural disasters.

Nationally, households have continued to demonstrate caution in their spending and borrowing behaviour, and there is a risk that this might continue for an extended period of time. The economic impact of recent natural disasters in Australia also remains uncertain. The outlook for export growth remains positive, but depends to a large extent on the pace of monetary policy tightening in China, as the country responds to consumer and asset price inflationary pressures and credit growth.

At the international level, concerns continue about the sustainability of public finances in a number of European countries. Renewed stresses in global commodity markets have also emerged due to heightened political tension in the Middle East and North Africa, adding to already increasing global inflationary pressures. Further, there remains uncertainty about the economic impact of the recent natural disaster in Japan, which is likely to impact negatively on the global manufacturing supply chain.

Commonwealth Government Funding

The major risk to Commonwealth funding relates to the GST. As the GST is a broad-based consumption tax, GST revenue collections are subject to national economic performance. Any adverse changes can lead to reduced revenue collections and thus, a smaller pool of funding for distribution to the States. The current economic climate gives rise to a downside risk in GST revenues compared to current estimates.

GST revenue grants to the ACT also remain subject to revisions by the Commonwealth Grants Commission (CGC) to States' GST relativities. The CGC annually updates States' recommended shares of the GST pool according to comparisons of States' revenue and expenditure needs. Thus, the ACT's share of the GST pool is dependent on its performance relative to other States.

Further, the ACT's share of the GST revenue pool is determined on a weighted population share basis, therefore, any revision by the Australian Bureau of Statistics to the States' estimated populations will have a flow on effect to GST revenue grants. As Specific Purpose Payments (SPP) move toward an equal per capita distribution in 2014-15, the ACT's share of SPPs will also vary according to the Territory's relative share of the Australian population.

As the number of National Partnership Agreements grow, there will be further opportunities for reward and facilitation payments from the Commonwealth, but at the same time there will be offsetting expenditure responsibilities.

Gaming Machine Tax

There is a risk of a reduction in the gaming machine tax revenue, through the implementation of the September 2010 agreement between Prime Minister, the Hon Julia Gillard MP, and Mr Andrew Wilkie MP. This agreement commits the Commonwealth Government to implementing a full pre-commitment scheme for electronic gaming machines by 2014. Depending on the effectiveness of the pre-commitment scheme, there could be a negative impact on gaming machine turnover in the ACT with consequent impacts on club revenues, gaming machine tax collections and community contributions.

Water Abstraction Charge and Utilities Network Facilities Tax

In September 2010, the Full Court of the Federal Court ruled that the utilities network facilities tax (UNFT) applied under the *Utilities Network Facilities Tax Act 2006* and the water abstraction charge (WAC) applied under the *Water Resources Act 2007* were valid. Subsequently special leave for Queanbeyan City Council to appeal this decision in the High Court was granted on 8 April 2011. If the decision of the Full Federal Court is overturned on appeal it could put at risk future estimated revenue of approximately $44.3 million against the 2011-12 Budget estimates.

Government Investment and Borrowings

The large majority of the Territory's financial investment and borrowing transactions are conducted in the global financial markets. Accordingly, a large portion of the financial investment assets and financial liabilities have some exposure to a number of risks. These are set out below.

Market Risk – Investment Assets and Financial Liabilities

Market risk associated with the management of the Territory's investment assets and liabilities, including Territory Banking Account (TBA) investments and the Superannuation Provision Account (SPA), is the risk that the value of an investment will decrease, or the value of a liability increase, due to moves in market conditions. Market risk includes:

- interest rate risk – the risk that the relative value of a security, mainly debt securities, will decrease, or that the value of liabilities will decrease, due to an interest rate increase;
- currency risk – the risk of incurring losses in relation to the value of international assets or liabilities as a result of movements in international exchange rates; and
- equity price risk – the risk that the valuation of stock market equity securities will decrease.

The Budget is susceptible to the performance of global financial markets and interest rates. Interest returns below those estimated will have a negative impact on revenues and, in respect of the SPA, will reduce the probability of fully funding the defined benefit superannuation liability by 2030. Conversely, returns exceeding the target may mitigate the risk of not meeting the target of full funding.

Interest Rate Risk – Territory Banking Account and Superannuation Provision Account Investments

The Territory's financial investments include some diversification across the domestic money and capital markets, including cash, short-term debt instruments (maturity less than twelve months) and fixed interest bonds (maturity greater than twelve months), each of which has its own unique risk/return characteristics. The diversification between these markets provides some trade-off between returns and interest rate risk. Changes in the fair market valuations of investments and interest income, resulting from changes in interest rates, will have a direct impact on the Territory's net operating balance and balance sheet.

In regard to the TBA and SPA cash investment portfolios, the impact of a 1 percentage point variation in the estimated interest rate returns assumed in the Budget estimates for interest revenue, is shown in Table B3 of Appendix B.

Whilst cash investments are directly impacted by changes in interest rates, in the case of fixed interest investments for both the TBA and SPA, the majority of securities held will have fixed interest payments (coupons) for the life of the security. Changes in interest rates will therefore not cause material changes to expected interest earnings. However, interest rate changes will impact on the valuation of debt securities and on the total return achieved. Although many of these debt securities will be held until maturity, changes in interest rates will impact the total return achieved through the reinvestment of coupon payments over the life of the bond at rates different to what is assumed under a yield to maturity measure. The market valuation of these securities for accounting and trading purposes will also change over time due to changes in interest rates. An increase in interest rates will generally lead to a decrease in the valuation of debt securities and vice versa. The degree of change in the valuation will depend on, amongst other things, the term to maturity and the coupon rate.

Interest Rate Risk – Territory Borrowings

Total Territory borrowings are accounted for at amortised cost and are typically held to maturity, or repaid on an amortising basis.

Approximately 37 per cent of total Territory borrowings are held on a fixed rate basis and 63 per cent on a floating rate basis. Presently, the floating rate borrowings are exposed to interest rate movements (and in the case of the inflation linked bonds – movements in CPI). An increase or decrease in market interest rates applicable to the Territory's floating rate borrowings, above or below the interest rates used in the development of the budget estimates will have a direct impact on the interest costs of these borrowings.

The impact of a 1 percentage point variation in the assumptions used to calculate the interest costs on floating rate borrowings is shown in Table B4 of Appendix B.

Currency Risk – Territory Banking Account and Superannuation Provision Account Investments and Territory Borrowings

The Territory does not have any financial borrowings in non-Australian denominated currency and therefore is not exposed to any currency risk. Likewise, the TBA investment portfolio does not have any foreign currency exposure.

Approximately $990 million (43 per cent) of SPA investments are denominated in foreign currency through the purchase and holding of international equity and fixed interest securities. Currently, 58 per cent ($573 million) of these investments are fully hedged back to Australian dollars using currency derivatives. The use of currency hedging mitigates the impact on international asset valuations in Australian dollar terms from the changes in exchange rates.

Without currency hedging, an appreciation of the Australian dollar against foreign currency asset holdings would have an adverse impact on the valuation of the investments in Australian dollar terms. In relation to unhedged foreign investments, holding a diversified basket of currency investments may also serve to reduce overall currency risk.

The estimated impact on international asset valuations from a 1 percentage point variation in the Australian dollar against all international currency holdings, assuming all other parameters are held constant is shown in Table B5 of Appendix B.

Equity Risk – Territory Banking Account and Superannuation Provision Account Investments

The TBA investment portfolio does not invest in publicly listed equity securities and is not exposed to equity risk.

The SPA invests in domestic and international equity securities. Equity markets are inherently volatile and not suitable for short-term investments. However, equity investments have proven to be an excellent long-term investment, if managed prudently. Over the long term, equity markets can also be a source of inflation protection, through maintaining and growing asset valuations in real terms.

The equity risk is part of a total investment portfolio strategy for the SPA and a significant level of portfolio exposure to this risk is acceptable and required. Unintended equity risk can be mitigated through diversification of the number of equity securities held, including maximum allowable exposure to any one security, through broad sector and industry allocations, and broad country allocations.

The impact on the SPA equity portfolio valuation from a 1 percentage point variation in equity security valuations shown in Table B6 of Appendix B.

Credit Risk – Territory Banking Account and Superannuation Provision Account Investments

Credit risk, or default risk, is the risk of loss due to a counter-party defaulting on a contract, or more generally the risk of loss due to some ‘credit event’.

The level of credit risk exposure to the Territory’s investment portfolios with allocations to debt securities is managed through limiting allowable investment securities to an investment grade credit rating. Each individual security held must hold an acceptable short or long-term credit risk rating by either Standard and Poor’s or Moody’s. The applicable credit ratings are outlined in the investment management guidelines issued under the *Financial Management Act 1996* (FMA) and the *Territory Superannuation Provision Protection Act 2000*.

Defined Benefit Employer Superannuation Liabilities

The value of accrued superannuation liabilities is calculated as the present value of the future payment of benefits that have actually accrued in respect of service at the calculation date. This approach, which is known as the ‘actual accruals’ basis, is in line with Australian Accounting Standard AASB119 and the requirements to use a projected unit credit valuation approach.

Accounting for defined benefit plans is complex because actuarial assumptions are required to measure the obligations, and the expense, and there is a possibility of actuarial gains and losses which can arise when actuarial assumptions are substantially different from actual outcomes. The liabilities are measured on a discounted basis because they may be settled many years after employees render their related service.

Due to the large number of members in these schemes, small variations to the financial or demographic assumptions can lead to large impacts on individual liability valuations and therefore, the total liability estimate for the Territory. The liabilities are most sensitive to inflation, wages growth, rates of retirement and resignation and the proportion of benefits taken in pension form.

Sensitivity to Discount Rate

The discount rate reflects both the estimated average timing of benefit payments and the time value of money. Australian Accounting Standards AASB119 ‘Employee Benefits’ requires the defined benefit employer superannuation liabilities to be valued, at 30 June each year, using a discount rate equivalent to a Commonwealth Government long-term bond rate (in practice, the annualised ten year Government bond rate). The discount rate adopted for the annual actuarial reviews has a substantial impact on liability valuations. Small changes in the discount rate adopted for each review can lead to significant variations in the liability valuations and annual superannuation expenses.

A 1 percentage point variation in the discount rate results in an estimated change to the current liability of approximately $619 million (actuarial gain or loss), resulting in the approximate annual variation estimates of superannuation related expenses (accruing liability) outlined in Table B7 of Appendix B.

As a general rule, a decrease in the budget estimated discount rate of 6 per cent to 5 per cent equates to an approximate increase in the superannuation expense of $29 million.

Consistent with usual practice, the budget is prepared using an estimated discount rate of 6 per cent. The discount rate as at 30 June 2011 is used for the preparation of the annual financial statements and establishes the superannuation expense for the 2011-12 financial year. The 2011-12 Budget estimate is updated at the time of the 2011-12 Budget Review to incorporate the impact of any variation between the actual discount rate and the budget assumption.

Sensitivity to Demographic Assumptions

Demographic assumptions incorporated in the reviews by the actuary are used to provide an estimate of the current and future liability valuations for the Territory. The assumptions incorporated include variables such as salary increases from promotions, invalidity, mortality, retirement, resignation, preservation, pension election by PSS members, member contribution levels for the PSS, and spouse assumptions. Over time these assumptions will change based on actual membership experience and will impact upon future liability valuations.

Enterprise Bargaining Negotiations

Employee expenses are the largest expense incurred by the Territory. The majority of the Government's enterprise agreements are due to expire in June 2011. These have the potential to impose increased financial pressure if the outcomes exceed the amounts currently factored into the forward estimates provided for in the Budget.

Contingent Liabilities

Contingent liabilities are liabilities resulting from uncertain timing or amount. They arise from past events, which are not recognised because their outflow of economic benefit is not probable or the liability cannot be measured reliably. Contingent liabilities can also occur when a liability is contingent on the outcome of an event outside the Territory's control, such as the outcome of a court case.

Under the FMA, it is the responsibility of the Government to identify contingent liabilities that may affect the budget estimates.

Types of claims lodged against the Territory include property damage, contract disputes, economic loss, personal injury and tax related claims. Further details of the Territory's contingent liabilities are provided each year in the Australian Capital Territory Consolidated Annual Financial Statements available at www.treasury.act.gov.au.

Insurable Risk

The ACT Insurance Authority (ACTIA) is a statutory authority under the *Insurance Authority Act 2005*. The Authority commenced operations on 1 April 2001.

ACTIA manages a fund, established to finance the cost of insurable risk for Government agencies, excluding workers' compensation risks. The objectives of ACTIA are to:

- be the insurer of Territory risks;
- take out insurance of Territory risks with other entities;
- satisfy or settle claims in relation to Territory risks;
- with the Treasurer's approval, take action for realising, enforcing, assigning or extinguishing rights against third parties arising out of or in relation to it's business, including, for example:
  - taking possession of, dealing with or disposing of property; or
  - carrying on a third party's business as a going concern;
- develop and promote good practices for the management of Territory risks;
- advise the Treasurer about insurance and the management of Territory risks;
- carrying out the role of the Nominal Defendant of the ACT; and
- administering, under agreement with the Chief Minister's Directorate, the Default Insurance Fund.

ACTIA is financed through risk-based levies that reflect the asset holdings and liability risks faced by each agency. The levies are set to generate sufficient funds such that ACTIA's internal funds and its overlying insurances will be able to meet all claims incurred during the current year, even if those claims are not paid until a subsequent year.

ACTIA provides a range of insurance products to agencies including cover for Public Liability, Property, Medical Malpractice, and Professional Indemnity. Each agency meets the cost of claims below the level of an agreed deductible or excess. ACTIA purchases reinsurance cover to protect the Territory against large claims or losses, or a series of such events. ACTIA's self-insured retentions are reviewed annually to ensure an appropriate balance between risk transferred and risk retained. Because of recent, regional and worldwide natural catastrophic events, this protection is expected to become increasingly expensive to purchase as the Australian and International insurance markets begin to reassess their risk exposure.

The Enterprise Wide Risk Management Framework for the ACT Government was launched in early 2004. The framework is currently under review in consultation with Territory agencies. A revised ACT Government Risk Management Framework is expected to be endorsed by the Government in mid 2011. The framework and supporting policy gives agencies the direction and tools necessary to identify risk and implement risk management practices across all aspects of their operations and business. ACTIA will assist agencies to develop their own risk management plans and policies based on these guidelines.