APPENDIX C

STATEMENT OF RISK

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This chapter discusses some of the risks facing the Territory, particularly in regard to economic risk, Commonwealth Government funding, investments and borrowings, superannuation liabilities and insurable risk.

Economic Risk

The global economic and financial outlook has improved since the 2012-13 Budget Review. Risks, however, remain to the downside. Many advanced economies continue to face challenges such as persistently high unemployment rates, fiscal consolidation, persistently tight credit conditions and volatile business and consumer confidence. As such, the global economic recovery is expected to remain slow, diverse across economic regions and fragile. Global risks impact the Territory mainly through financial, confidence and export channels.

The most significant risk to the economic forecasts in the ACT relate to the spending and hiring decisions of the Commonwealth Government. These risks remain tilted to the downside despite shifting the target to return to surplus from the 2012-13 financial year to 2015-16. The Commonwealth Government budget remains under pressure, leading to likely ongoing expenditure restraint.

The possibility of changes to future Commonwealth Government policy decisions also adds to uncertainty. Large public sector job cuts and significant savings may damage consumer and business confidence in the Territory and harm the Territory's economic prospects in the short to medium term.

Commonwealth Government Funding

The major risk to Commonwealth funding relates to the Goods and Services Tax (GST) grant to the ACT which represents more than 20 per cent of total ACT revenue. The GST is a broad-based tax on final consumption of goods and services and therefore GST revenue collections are subject to national economic performance.

Risks to the ACT's GST grant may come from:

- reductions in the GST Pool; and
- variation in the ACT's relative share of that Pool.

The GST Pool is sensitive to changes in level and pattern of consumer spending:

- household spending on goods and services generally not subject to GST (e.g. health and education services, fresh food and rent) is tending to increase relative to spending on goods subject to GST; and
- the prices of goods and services which are not subject to GST are increasing relative to the prices of goods and services subject to GST.

The ACT's share of the GST Pool remains subject to revision year on year based on recommendations from the Commonwealth Grants Commission (CGC) as to per capita relativities.

In the longer term, the method of distributing the GST Pool could be subject to further change as a result of the upcoming CGC Methodological Review. The Standing Council on Federal Financial Relations has agreed to the Terms of Reference requesting the CGC to review the methodological approach to determining the per capita relativities to be used to distribute the GST. Any changes from that Review are likely to eventuate in 2015-16. Further details of the Review are provided in Chapter 4 of Budget Paper 3.

Some current National Partnership Agreements are scheduled to expire by the end of 2013-14, but negotiations between the Commonwealth and the States have resulted in the extension of most of these agreements or their replacement with comparable agreements. Therefore, given the current environment, there is only a minor risk to the ACT from residual uncertainty about future funding of National Partnerships.

Government Investment and Borrowings

The large majority of the Territory's financial investment and borrowing transactions are conducted in the global financial markets. A large portion of these 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 is the risk that the value of an investment will decrease, or the value of a liability increase, due to changes in financial market conditions. Changes in market conditions that give rise to market risk comprise, but are not limited to, changes in interest rates, foreign exchanges rates, equity prices, and credit.

Budget revenues and expenses are susceptible to the performance of global financial markets as well as prevailing interest rates.

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

The Territory's financial investments include 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 have unique risk/return characteristics. The diversification across these markets provides some trade off between returns and interest rate risk. Changes in the market valuations of investments as a result from movements in interest rates, will directly impact the Territory's net operating balance and balance sheet.

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 85 per cent of general government sector borrowings are held on a fixed rate basis with the remainder on a variable rate basis. Approximately 35 per cent of public trading enterprise sector borrowings are held on a fixed rate basis with the remainder on a variable rate basis. The variable rate borrowings exposure is mainly related to inflation linked bonds issued for ACTEW with the variable exposure being movements in CPI. An increase or decrease in market interest rates or CPI will have a direct impact on the interest costs of variable rate borrowings.

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 its borrowings are therefore not exposed to currency risk.

Approximately $1.1 billion (41 per cent) of Superannuation Provision Account investments are denominated in foreign currency through the purchase and holding of international equity and fixed interest securities. Currently 53 per cent ($563 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 also serves to reduce overall currency risk.

Equity Risk – Superannuation Provision Account Investments

The Superannuation Provision Account invests in both domestic and international equity securities as part of a long term investment strategy. Unintended equity risk is mitigated through diversification of the number of equity securities held, through broad sector and industry allocations, and broad country allocations.

Changes in the market valuations of equity investment exposures, resulting from changes in equity prices, will have a direct impact on the Territory's net operating balance and balance sheet.

Credit Risk – Territory Banking Account and Superannuation Provision Account Investments

Credit risk or default risk, is the risk of loss due to counter-party default 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 either a Standard and Poor's or Moody's investment grade credit rating as required by the *Financial Management (Investment and Borrowing) Guidelines 2011* and the *Superannuation Management Guidelines 2011*.

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. The ultimate cost of a defined benefit plan is uncertain due to the long term influence by many different financial and membership demographic variables. The superannuation liability valuation is most sensitive to inflation, wages growth, rates and patterns 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.

The discount rate adopted for the annual actuarial review can have a substantial impact on the liability valuation. Small changes in the discount rate adopted for each review can lead to significant variations in the liability valuation and annual superannuation expense.

For consistency and planning purposes, as well as being reflective of the long term nature of the superannuation liability, the budget is prepared using a 20 year average estimate of the long term discount rate, which is approximately 6 per cent.

The discount rate, referenced to the relevant Commonwealth bond yield (April 2029 bond), is currently around 4 per cent. If the discount rate remains at this level by 30 June 2013, the impact will be an increase to the valuation of the liability as at 30 June 2013 of approximately $1.7 billion to $6.8 billion, with the defined benefit superannuation expense for the 2013-14 financial year increasing by approximately $52 million to $505 million. Changes in the defined benefit superannuation expense flow directly through to the Territory's Headline Net Operating Balance.

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 Public Sector Superannuation (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.

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 *Financial Management Act 1996*, 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 http://apps.treasury.act.gov.au/publications.

Outstanding Insurance Claims Liability

The value of insurance liabilities is the present value of the future claim payments that have accrued at the calculation date. This approach is required under Australian Accounting Standard *AASB1023 General Insurance Contracts*.

Accounting for insurance claims is complex and actuarial assumptions are required to estimate the ACT Insurance Authority's obligations, and claims expense. There is uncertainty in the estimate of the liability and this can result in actuarial gains or losses when the claims experience differs from the estimates. The liabilities are discounted to allow for the time value of money as claims may be settled many years after the claim is incurred.

Sensitivity to Discount Rate

The outstanding claims liability is calculated by reference to expected future payments. These payments are discounted to adjust for the time value of money. Australian Accounting Standards *AASB1023 General Insurance Contracts* requires the outstanding claims liabilities to be valued using a 'risk free' rate of return, which are generally accepted to be the discount rate derived from market yields on Commonwealth Government Bonds. The discount rates adopted match the weighted term to maturity of insurance claims. The long term nature of the projected cashflows from the liability mean that small changes in the discount rate adopted can lead to significant variations in the liability valuations and the claims expense.

The outstanding claims provision as at 31 December 2012 was $324.8 million. A one percentage point variation in the discount rate results in an estimated change to the liability of approximately $14-15 million (actuarial gain or loss), equivalent to a 4.5 per cent change.

Other Risks

ACT Launch of DisabilityCare Australia - A National Disability Insurance Scheme

Under the bilateral agreement for the launch of the National Disability Insurance Scheme (now DisabilityCare Australia), the ACT's contribution is capped, with the Commonwealth taking responsibility for 100 per cent of upside risk for higher than anticipated client numbers and average package cost.

The full year required ACT contribution to the DisabilityCare Launch is estimated at around $122 million in 2016-17. The ACT is required to finalise the nature of its contribution by February 2014. This involves identifying eligible existing services provided by the ACT Government to determine if there is a need for additional investment.

The Pre-Election Budget Update estimated an additional investment of $40 million in 2015-16 for the first full year cost. However, since this estimate, the phasing has changed with the full year cost now being incurred from 2016-17.

The 2013-14 Budget does not include additional investment in the scheme, beyond pre-launch funding. The need for investment has reduced by offsetting additional specialist disability services that were not previously identified. The Commonwealth has also announced the ACT will be allocated around $7 million in 2015-16 and $14.7 million in 2016-17 from the increase in the Medicare levy. This will further offset the ACT contribution.

Further work between the Commonwealth and ACT will determine the extent of any requirement for additional investment beyond existing services and the extent to which the ACT needs to fund ongoing disability services that are not covered by DisabilityCare Australia.

National Rollout of DisabilityCare Australia - A National Disability Insurance Scheme

There is risk associated with the Commonwealth Grants Commission's (CGC's) future determination regarding treatment of the scheme once it is operating nationally. The ACT transitions in 2019-20. For the launch the scheme is being treated outside of the CGC's assessment processes.