STATEMENT OF RISK

This chapter addresses 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 ACT economy generally performs better than the national economy during periods of economic downturn. The economic forecasts contained in this Budget have been made on the assumption that falling household wealth stabilises and that consumer confidence returns to the economy in response to significantly lower interest rates. The forecasts are also predicated on a very low increase in Commonwealth Government outlays in the ACT, as foreshadowed in the Commonwealth's Mid-Year Economic and Fiscal Outlook (MYEFO).

Interest rates have fallen significantly since September 2008. Market economists are predicting further falls before the end of the monetary policy loosening cycle, but many are acknowledging that the rate cutting cycle is almost nearing its end. The risk to the economic forecasts is that consumer confidence does not respond to the significantly lower interest rates, for example, if household wealth continues to decline and the expected pick up in household consumption does not materialise.

Furthermore, since Commonwealth Government expenditure is a large component of the ACT economy, if the Government reduces outlays over and above the levels published in the MYEFO, then there is a risk economic activity will be much lower than forecast.

Risk to Tax Revenue

Economic risk extends to the Territory tax revenue. Payroll tax, duties, rates and land tax are exposed to risk associated with employment levels and wages in the ACT.

The major economic risk to taxation revenue stems from the uncertainty surrounding the Global Financial Crisis. If the severity and duration of the crisis is greater than expected then unemployment is likely to be greater than would otherwise have occurred. This would have detrimental flow-on effects to payroll and property related taxation revenue. Likewise, a significant cut to Commonwealth Government expenditure in the ACT would impact taxation revenue. As Commonwealth Government departments and agencies are not subject to payroll tax, the fall would more likely occur in property-related taxation as confidence in the market disappears.

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 the vagaries of the national economy. Any adverse changes can lead to reduced revenue collections and thus a smaller pool of funding for the States. Given current economic circumstances, the Commonwealth's next revision to the pool is more likely to be downward.

GST revenue grants to the ACT also remain subject to revisions by the Commonwealth Grants Commission (CGC) to States' GST relativities. The CGC will release its latest major methodology review in February 2010. The outcome, which will affect the ACT's share of GST revenues from 2010-11 onwards, is yet unquantifiable.

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.

The Federal financing arrangements between the States and Commonwealth will see a move towards equal per capita funding for SPPs over the next five years. Thus, the ACT's share of SPPs will also vary according to the Territory's relative share of the Australian population.

The newly agreed Federal financing arrangements between the States and the Commonwealth have reformed the existing framework for federal financial relations. Central to the new framework is a significant financial package that provides an additional $7.1 billion in five National Specific Purpose Payments (SPPs) to the States, initially over five years.

A priority of the States during the reform process was to negotiate SPP growth factors that more accurately reflected the demand and cost pressures faced by the States in delivering key services. By developing more appropriate and reflective growth factors, the financial efforts required to fund key State services is maintained for both the Commonwealth and the States.

Under the previous arrangements, the Commonwealth's financial contribution to services such as health and education did not keep pace with the demand for such services, placing a greater burden on State governments to finance services in these areas.

This new framework effectively removes a major downside risk to the ACT Budget and forward years as the new SPPs will be ongoing, rather than for fixed periods, and will be reviewed every four to five years in terms of adequacy of funding.

However, one incremental risk to the ACT arising from the new framework relates to the potential for future Commonwealth policy to translate into a proliferation of new National Partnerships, which could reduce the flexibility of State budgets (as they may contain input controls — to be known as 'co-contributions').

As more National Partnerships are introduced over time, there will be opportunities for the ACT to sign up to engage in further nationally significant reforms, with the likelihood of reward and incentive payments, but also offsetting expenditure responsibilities.

Tax reform

One of the objectives of the previous *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations (1999)* was the achievement of a new national taxation system, including the elimination of several business taxes which were impeding economic activity. The schedule on tax reform in the new Intergovernmental Agreement contains the on-going commitment that these inefficient taxes will not be reintroduced in the future.

Finally, the Commonwealth Government's wide ranging review of the Australian tax and transfer system, including State taxes (but excluding the GST), is due to report in December 2009. At this stage, the extent to which any possible recommendations of the review are accepted and implemented, and their potential impact on the ACT's finances is difficult to gauge. The Commonwealth has suggested that the report should be seen as a strategic approach for the nation over a 20 year period, and not a 'quick fix' package for implementation in the near term.

Government Investment and Borrowings

Governance, Advisory and Consultancy Arrangements

Established governance, advisory and consultancy arrangements provide the Territory with the ability to implement best practice management of the Territory's financial assets and liabilities. This includes:

- An external Investment Advisory Board is established to provide advice to Treasury on financial investment and borrowing related issues.
- An independent investment consultant is contracted by Treasury to provide a range of investment advisory services, including portfolio optimisation and strategic asset allocation, fund management and portfolio monitoring.
- Treasury also uses the services of external risk management advisers to provide assistance with the development of appropriate financial risk management policies and practices, identification of financial exposures, reporting and benchmarking, and performance management in respect of the Territory's borrowing liabilities.

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, which is 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, which is 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, which is 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 Superannuation Provision Account, will reduce the probability of fully funding the defined benefit superannuation liability by 2030.

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 per cent variation in the estimated interest rate returns assumed in the Budget estimates for interest revenue is shown in Table B.1.

Table B.1
Impact of an interest rate change on interest revenue

+/- 1%	2009-10 $'000	2010-11 $'000	2011-12 $'000	2012-13 $'000
TBA	+/- 12,943	+/- 7,447	+/- 8,527	+/- 8,977
SPA	+/- 1,754	+/- 206	+/- 223	+/- 229

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 30 per cent of Territory borrowings are held on a fixed rate basis, 70 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 per cent variation in the assumptions used to calculate the interest costs on floating rate borrowings is shown in Table B.2.

Table B.2
Impact of interest rate change on borrowing costs

+/- 1%	2009-10 $'000	2010-11 $'000	2011-12 $'000	2012-13 $'000
Total Borrowings	+/- 2,604	+/- 2,115	+/- 1,904	+/- 1,904

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

In relation to Territory borrowings, the Territory does not have any financial borrowings in non-Australian denominated currency and therefore is not exposed to any currency risk. The Territory also does not have any significant exposure to currency risk in relation to the purchase of international goods and services. Likewise, the TBA investment portfolio does not have any foreign currency exposure.

Approximately $627 million (36 per cent) of SPA investments are denominated in foreign currency through the purchase and holding of international equity and fixed interest securities. Currently, 56 per cent ($352 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 per cent variation in the Australian dollar against all international currency holdings, assuming all other parameters being constant, is shown in Table B.3.

Table B.3
Impact from the movement of the Australian dollar on valuations*

+/- 1%	2009-10 $'000	2010-11 $'000	2011-12 $'000	2012-13 $'000
SPA	+/- 2,814	+/- 3,950	+/- 4,303	+/- 4,616

** A negative outcome represents an appreciation of the Australian dollar relative to other currencies.*

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 will invest in domestic and international equity securities during 2009-10. 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 good 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.

Table B.4 outlines the impact on the SPA equity portfolio valuation from a 1 per cent variation in equity security valuations.

Table B.4
Impact of a change in equity valuations

+/- 1%	2009-10 $'000	2010-11 $'000	2011-12 $'000	2012-13 $'000
SPA	+/- 12,837	+/- 13,985	+/- 15,002	+/- 16,013

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 these 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 different from actual outcomes. The liabilities are measured on a discounted basis because they may be settled many years after the 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.

Sensitivity to Discount Rate

The discount rate is meant to reflect both the estimated average timing of benefit payments and the time value of money. AASB119 ‘Employee Benefits’ International Financial requires the defined benefit employer superannuation liabilities to be valued, at 30 June each year, using a discount rate equivalent to an 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 per cent variation in the discount rate results in an estimated change to the current liability of approximately $650 million (actuarial gain or loss), resulting in the approximate annual variation estimates of superannuation related expenses (accruing liability) outlined in Table B.5. As a general rule, a 1 per cent variation from the budget estimated discount rate of 6 per cent equates to approximately $35 million impact on the superannuation expense (positive or negative).

Table B.5
Impact of liability valuations on superannuation expense from variation in discount rate

+/- 1%	2009-10 $’000	2010-11 $’000	2011-12 $’000	2012-13 $’000
SPA	+/- 35,000	+/- 33,000	+/- 31,000	+/- 29,000

Consistent with usual practice, the Budget is prepared using an estimated discount rate of 6 per cent. The actual discount rate as at 30 June 2009 is used for the preparation of the annual financial statements and establishes the superannuation expense for the 2009-10 actual financial year. The 2009-10 Budget estimate is updated at the time of the 2009-10

Mid-Year-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 a better 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.

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.

Under the FMA, it is the responsibility of the Government to disclose its contingent liabilities as they relate to the presentation of the financial report in accordance with the Australian Equivalents to International Financial Reporting Standards (AASB 137). This is done by way of a note in the Financial Statements.

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 operation 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, to take action for realising, enforcing, assigning or extinguishing rights against third parties arising out of or in relation to its 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;
- give advice to the Treasurer about insurance and the management of Territory risks; and
- administer, under agreement with the Chief Minister's Department, the Default Insurance Fund.

ACTIA is financed through risk-based levies that reflect the asset holdings and liability risks faced by each agency. In theory, the levies are set to generate sufficient funds to ensure 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 later year.

Each agency meets the cost of claims below the level of an agreed deductible or excess. ACTIA purchases insurance to protect the Territory against large claims or losses, or a series of such events, which would threaten the viability of ACTIA's internal funds. Because of worldwide insurance events and the ACT bushfires in January 2003, this protection is becoming increasingly difficult and expensive to purchase. As a result, ACTIA's self-insured retentions are being reviewed to ensure an appropriate balance between risk transferred and risk retained.

The Enterprise Wide Risk Management Framework for the ACT Government was launched in early 2004. This framework and policy gives agencies the direction and tools to identify risk and implement risk management practices across all aspects of their operations and business. ACT Government agencies are continuing to develop and implement their own risk management plans and policies based on the guidelines.

In relation to risks associated with dealings with external organisations, the Government has revised its guidelines under the FMA. In the case of procurements, the main change is to shift the onus of establishing the insurance risk and level from individual tenders to the procuring agency. Centralised procurement provides the opportunity to manage this in a more consistent and cost effective manner.