7.4 RISK MANAGEMENT

This chapter addresses the risk management issues facing the Territory, particularly in regard to Economic Risk, Australian Government Funding, General Government Borrowings and Investments, Superannuation Liabilities, Insurable Risk, and Operational Risk.

Economic Risk

The ACT economy, due to its significant public sector, tends to be insulated from many of the uncertainties faced by the national economy. This circumstance can have both positive and negative implications for the performance of the ACT economy. From a positive viewpoint, during times of global and national slowdown the ACT economy tends to be protected because of its limited exposure to changing international trade patterns. From a negative viewpoint, the ACT's limited agricultural, mining and manufacturing sector means that it will benefit relatively less from periods of strong global economic growth.

While these factors suggest that any uncertainties in the international and domestic economies are likely to have less impact on the ACT, it does not mean that the ACT economy is immune to risk. The main risk factors for the ACT economy relate to changes in public sector expenditure and movements in interest rates.

Public Sector Expenditure

In 2003-04, public sector consumption and investment expenditure accounted for 50.7% of ACT State Final Demand (SFD) - 46.5% and 4.2% respectively. This share is significantly higher than the National average, where public sector expenditure accounted for only 21.1% of Australian Domestic Final Demand (DFD) in 2003-04.

The public sector dominated industries of public administration and defence, education, health and community services, and the general government sector's consumption of fixed capital accounted for 42.1% of ACT Gross State Product (GSP) at factor cost in 2003-04. By comparison, at the national level these activities accounted for 16.7% of Australia's Gross Domestic Product (GDP).

The estimates cited above highlight the significance of public sector activities, mostly those of the Commonwealth Government, and their influence on the ACT economy. However, to some extent they also understate the economic significance of the public sector, as they do not include the flow-on effects of public consumption expenditure on other areas of the economy. For example, the tourism and hospitality sector is heavily dependent on the business related travel associated with Commonwealth Government activities.

While Commonwealth Government spending per capita continues to be significantly higher in the ACT than in other jurisdictions, the growth rate of Commonwealth expenditure in the ACT has fallen below the national average. For example, the average real annual growth rate in Commonwealth expenditures in the ACT over the five-year period 1990-91 to 1994-95 was higher than the national average, 5.5% and 3.0% respectively. However, over the five-year period 1999-00 to 2003-04 the growth rate in the ACT was lower than the national average, 2.5% and 3.7% respectively. The possibility of the ACT receiving a smaller share of planned increases in Commonwealth Government expenditure in forward years constitutes a downside risk to future economic activity in the ACT.

Interest Rates

Interest rate changes impact on consumption and investment activity in the ACT economy. The Reserve Bank of Australia (RBA) raised the official cash interest rate target by 0.25 percentage points in March 2005. This was the first change in the official interest rate since the 0.25 percentage point rise in both November and December 2003 (i.e. the first change in 15 months). There is a possibility of further interest rate rises in 2005, particularly if capacity constraints in labour and product markets begin to place inflationary pressure on the Australian economy. A shift in consumption from discretionary to non-discretionary expenditure is already evident.

Changes in interest rates will impact on private consumption expenditure, which accounted for 39.7% of SFD in 2003-04, by altering household spending patterns. If interest rates rise, households will need to devote more of their income to servicing the interest component of their mortgage and consumer debt repayments resulting in less disposable income for discretionary spending.

A rise in interest rates is also likely to have a negative impact on investment, which accounted for 13.8% of SFD in 2003-04. In particular, private sector investment, which accounted for 9.6% of SFD in 2003-04, is likely to be dampened by the interest rate rise in March 2005 and any further rises.

Private investment in dwellings, despite its relatively small contribution to the level of SFD (3.2% in 2003-04), can be highly volatile and therefore can have a disproportionate impact on the overall rate of economic growth in the ACT. Indeed, the pattern of residential dwelling approvals has been variable over the past five years, beginning with a surge in approvals before the introduction of the GST in July 2000. Approvals slowed in 2003 and into 2004, as the stock market strengthened and the RBA raised interest rates in November and December 2003.

Just prior to the recent interest rate rise in March 2005, residential dwelling approvals were resurgent. There were 1,299 dwellings approved in the three months to January 2005, the highest quarter-year result since the three months ended September 1992. Housing finance commitments are also on the rise since reaching a 14-year low in late 2004. However, the recent pick-up in these leading indicators of building activity is yet to be reflected in dwelling commencements. Dwelling commencements are currently averaging around 400 per quarter, well below the longer-term average of 600 commencements per quarter. As the residential construction sector has relatively high multiplier flow-on effects through the economy, the impact on SFD of any change in activity in this sector will be magnified.

The potential contractionary impact of the interest rate rise in March 2005, and any future rises, are likely to be magnified by the recent growth in household debt. The initial impact of rising interest rates is a tendency to dampen conveyancing revenue with some flow-on effect to other transaction-based taxes.

Australian Government Funding

The forward estimates for the GST revenue in this Budget are based on a number of important variables: growth in GST revenues; population growth; and a constant per capita revenue sharing relativity. As with any estimation process, the GST estimates will be susceptible to changes in these variables over the life of the Budget.

The GST is largely a broad-based tax that is linked to national economic performance. Adverse economic conditions could see a moderating of GST revenues, particularly as the GST is not imposed on some staples, such as basic food products. Any deterioration would automatically place at risk the expected growth in additional funding to the States and Territories.

There is also growing evidence that the States and Territories will be required provide greater funding in relation to Australian Government Specific Purpose Payments in the future, particularly in a number of costly service delivery areas such as health, housing and disability services.

General Government Borrowings and Investments

Market risk is the exposure to an adverse variation in costs or returns resulting from a change in a market price or rate. The Territory is exposed to market risk mainly through its financial investments. The Territory's general government financial investments are diversified across a number of asset classes including cash, short-term debt instruments (maturity is less than 12 months) and fixed interest bonds (maturity is greater than 12 months), each of which has its own unique risk/return characteristics. The diversification between these asset classes provides an efficient trade-off between returns and market risk. Changes in the fair market valuations of investments will have a direct impact on the current and future operating results of the Territory.

Territory borrowings are presently accounted for on a historic cost basis and are typically held to maturity, or repaid on an amortising basis. Additionally, a large proportion of borrowings are held on a fixed interest rate basis. Accordingly, there is little if any significant market risk attributable to Territory borrowings.

At current levels of investments and debt, the interest rate is naturally hedged meaning that a change in interest rates will result in investment earnings being offset to a large degree by an associated change in debt costs.

Level of Territory GGS Debt

A key objective of the Government is to maintain a high credit rating. A key factor in the retention of a high credit rating is the maintenance of a level of borrowings that deliver benefits to the ACT economy. An important issue is not so much the level of debt, but rather whether the capacity exists to service the debt.

Credit rating agencies have a very strong view that recurrent expenditure should be funded by current taxpayers and not deferred to future generations via the cost of debt financing and future principal repayments; and the funding of non-recurrent or capital expenditure by way of debt financing is appropriate where the benefits are to be distributed over time. This approach is consistent with the principles of inter-generational equity. Present and future taxpayers bear the cost of asset amortisation, debt servicing and repayments as the asset distributes its benefits to them over time.

The credit ratings agencies also require that any increase in the level of borrowings must be supported by an annual recurrent budget that has the financial capacity to meet annual debt servicing costs (interest and principal) and ultimately will not have an undue effect on the overall financial performance of the Territory.

Interest Rate Risk

Interest rate risk is the exposure of the Territory's financial position to adverse movements in interest rates. Accepting this risk is a normal part of financial operations. However, excessive interest rate risk can pose a significant threat to the Territory's earnings and capital base. Changes in interest rates affect the Territory's operating result by changing its net interest income and the level of other income and operating expenses sensitive to interest rates. Changes in interest rates also affect the underlying value of the Territory's assets, liabilities and off-balance sheet instruments as the present value of future cash flows, and in some cases, the cash flows themselves change when interest rates change.

The Territory is exposed to changes in interest rates, primarily due to its financing, investing and cash management activities, which include long and short-term borrowings.

In regard to the General Government Sector investment portfolio, the impact of a 1% variation in the estimated interest rate returns assumed in the Budget estimates for interest revenue is shown in the following table.

Table 7.4.1
Impact of interest rate change on General Government Sector investment portfolio: Interest Revenue

	2005-06 $'000	2006-07 $'000	2007-08 $'000	2008-09 $'000
Budget	40 026	29 137	26 212	28 578
+/- 1%	+/- 6 673	+/- 4 768	+/- 4 294	+/- 4 692

The Territory borrowings comprise approximately 42% on a fixed rate basis, and 58% on a floating rate basis. Presently, the floating rate borrowings are exposed to interest rate movements. 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% variation in the assumptions used to calculate the interest costs on the floating rate borrowings is shown in the following table.

Table 7.4.2
Impact of interest rate change on borrowing costs

	2005-06 $'000	2006-07 $'000	2007-08 $'000	2008-09 $'000
Budget	36 513	34 377	33 946	32 819
+/- 1%[a]	+/- 2 724	+/- 2 856	+/- 2 856	+/- 2 856

[a] A 1% increase in interest rates will lead to increased expense and, accordingly, a corresponding reduction in the budgeted operating result and vice versa.

Overall, rising interest rates will have a net positive effect on the budgeted outcome due mainly to the low proportion of debt exposed to interest rate movements and comparatively higher levels of investments.

Foreign Exchange Rate Risk

The Territory does not have any financial borrowings in non-Australian denominated currency and therefore is not exposed to any foreign exchange risk in respect of its debt.

The Territory does not have a significant exposure to foreign exchange risk variations in relation to the purchase of goods and services.

Approximately 35% of the Superannuation Provision Account's investments are denominated in foreign currency. Of this, 43% is fully hedged using currency derivatives. Appreciation of the $AUD will have an adverse impact on the values of the unhedged investments in $AUD terms.

Governance, Advisory and Consultancy Arrangements

An important aspect of the Territory's investment and borrowing arrangements, particularly due to their significance as a proportion of the total Territory balance sheet, is the established governance, advisory and consultancy arrangements.

In 2000, a Finance and Investment Advisory Board was established to provide advice to Treasury on all financial investment and borrowing related issues. The main purpose of the Finance and Investment Advisory Board is to contribute to better outcomes for the ACT Government's financial dealings by enhancing financial returns and improved governance.

During 2001, the Territory appointed Frontier Investment Consulting Limited as its investment consultant. The consultant provides advice on portfolio optimisation and strategic asset allocation, fund manager and portfolio monitoring.

The Territory currently has a contractual arrangement with JPMorgan to provide master custodian services to the Territory including safekeeping, settlement, derivatives clearing, valuation of investments, accounting reconciliations, accounting reporting, mandate compliance reporting, performance measurement, performance reporting, audit, performance attribution, transition of assets and taxation equivalent reporting.

Macquarie Risk Advisory Services Limited is currently contracted as the Territory's risk management adviser 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. This contract expires in October 2005 and a procurement process will be undertaken to establish a new advisory role.

The established governance, advisory and consultancy arrangements provide the Territory with a solid platform from which it is able to implement best practice management of the Territory's financial assets and liabilities.

Superannuation Liabilities

Sensitivity to wages

A 1% variation to the actuarially assumed long-term level of salary growth has a substantial impact on the Territory's net unfunded superannuation liability. The current level of annual salary increases assumed in the actuarial determination of the Territory's superannuation liability is 4% nominal (approximately 1.5% real). A 1% increase in the long-term actuarial assumption used for salary growth results in an estimated increase to the current liability of approximately 4%, or $100 million.

Sensitivity to domestic and overseas share prices

The modelling applied to the Territory's unfunded superannuation liability assumes a long-term rate of return on investments of 5% real per annum, net of fees and charges. This equates to a long-term nominal net rate of return on investments of 7.5% per annum. As a non-tax paying entity, the assumed long-term rate of return is comparative to rates used for investment strategies in respect of matching liabilities over periods greater than 10 years.

A variation of 1% in the valuation of domestic equity investments over 2005-06 is estimated to impact on the operating result in 2005-06 by +/- $4.7 million, with the variation flowing through assumed investment returns over the forward years.

Similarly, a variation of 1% in the valuation of international equity investments is estimated to impact on the operating result in 2005-06 by +/- $5.5 million, with a consequential impact on the forward years.

Superannuation liabilities

The level of liabilities associated with defined benefit superannuation schemes are actuarially determined. This process requires setting a range of demographic and financial assumptions that are fully reviewed every three years and are applied annually to actual staffing and salary levels. Actuarial estimates are therefore subject to change as a result of various demographic factors - such as life expectancy, the periods of members' working lives and variations in benefit options taken by retiring members. In particular, there has been a history of scheme members retiring earlier and an increasing tendency of retiring members opting to take their benefits by way of indexed pension rather than by way of a lump sum payment.

The financial and demographic assumptions used for the most recent determination incorporate the same assumptions used for the most recent review of the Commonwealth Government's superannuation liabilities for CSS and PSS memberships.

The considerable public debate on superannuation benefit design and the appropriate working life of the Australian workforce is likely to further change working patterns of Territory employees, along with increased life expectancy and better health. It is not possible to quantify these particular impacts in isolation.

Commonwealth legislation has been passed to amend the scheme design of the PSS scheme from defined benefit to defined contribution for new members from 1 July 2005. The amended scheme design will introduce an accumulation arrangement from 1 July 2005 for which the Territory will be required to contribute 15.4% of an employee's superannuable salary and to meet scheme administration costs.

The latest actuarial determination incorporates these changed arrangements. Whilst this has not materially impacted on current liability estimates, this will significantly reduce the future liabilities over the longer term.

Totalcare employees

In February 2004, the Treasurer announced that the Government was investigating possible inconsistencies with the application of appropriate superannuation arrangements for Totalcare employees. Employee records are being reviewed and the Government has indicated that all obligations to past and current employees will be met.

Past Totalcare employee records are continuing to be reviewed.

The current superannuation liability of the Territory incorporates an amount estimated at $17.3 million, unchanged from last financial year.

Insurable Risk

The ACT Insurance Authority (ACTIA) was established as a statutory authority under the *Insurance Authority Act 2000*. The Authority commenced operation on 1 April 2001.

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

- enable the Territory to meet the cost of its claims and losses in an orderly, timely and cost effective manner;
- ensure the costs are fully reflected in the Territory's accounts in accordance with accrual accounting principles;
- protect the budget from the risk of very large claims; and
- promote and improve risk management practices in all agencies.

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 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. The agency levies are set at a level sufficient to meet most claims or losses experienced through the normal operations of government agencies.

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 January 2003 bushfires, 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 officially launched in early 2004.

This framework and policy gives ACT Government agencies the direction and tools to identify risk and implement risk management practices across all aspects of their operations and business.

During 2004 and 2005, several major ACT Government agencies began developing and implementing their own risk management plans and policies.

Risk management training workshops conducted by ACTIA in 2004 involved 98 ACT Government employees with responsibilities in risk management and the workshops covered the topics:

- 'Introduction to Risk Management'; and
- 'Running a Risk Management Workshop'.

ACTIA also conducted several lunchtime forums which were well attended and covered:

- 'Business Continuity Planning';
- 'Risk Management Benchmarking';
- 'Risk Management in a Large Department/Agency'; and
- 'Australian NZ Risk Management Standard AS/NZS 4360-2004'.

In 2005, ACTIA's risk management activities will be focussed on the following:

- increased agency participation in risk management benchmarking program;
- development of a risk reporting framework to monitor Government wide identified and emerging risk;
- development of a risk management transition rating system to track developments of risk management practices across ACT Government Agencies; and
- targeted risk management training workshops and lunchtime seminars to raise the skills and expertise of all ACT Government employees.

Operational Risk

In addition to good risk management practices, a procurement strategy has been developed with the aim of reducing risks associated with the procurement of goods and services on by the Government.

Procurement Policy

The *Government Procurement Act 2001* established the Government Procurement Board (the Board) to develop, implement and review policies and practices for the procurement of goods, services and works by Territory entities.

The Board has established a procurement framework within the Territory supported by:

- legislation issued as Disallowable Instruments and circulars issued for guidance purposes;
- a planning regime that requires the preparation of procurement plans, including full risk management plans, for all proposals in excess of $50,000 for examination by Approved Procurement Units (APUs) and endorsement of the Board if over $1 million;
- training arrangements to ensure that staff have the necessary competencies to undertake procurement projects in accordance with the requirements of the Board; and
- performance monitoring through audit and review.

Specific guidance is provided for procurement activity both under and over $50,000 that addresses the risks associated with purchasing goods, services or works, within a value for money framework.