STATEMENT OF RISK

This chapter addresses some of the risks facing the Territory, particularly in regard to Economic Risk, Australian Government Funding, Investments and Borrowings, Superannuation Liabilities, and Insurable Risk.

Economic Risk

The ACT economy, while not immune to risk, tends to be insulated from many of the uncertainties faced by the national economy due to its significant public sector activity. Generally, the main risk factors for the ACT economy relate to changes in public sector expenditure and movements in interest rates. Additional risk factors facing the ACT economy are a worsening of the skills shortage and a higher CPI as a result of price increases for drought-affected commodities.

The ACT is currently in Stage 3 water restrictions, which prohibits all private and commercial watering of lawns and limits watering of gardens to hand held hoses or buckets during specified periods only. Under proposed Stage 4 restrictions all outdoor use of water will be primarily limited to non-potable water. Should Stage 4 water restrictions be introduced in the ACT, there is an additional risk to industries dependent on the use of water and therefore to some economic activity in the ACT. If drought breaking rains are not received and tighter restrictions are considered necessary then more widespread consequences may become apparent throughout the entire ACT economy.

Risk to Tax Revenue

Economic risk extends to the Territory tax revenue. Payroll tax, stamp duty, rates and land tax are exposed to risk associated with employment levels and wages in the ACT, which are driven largely by expenditure in the public sector. A significant change in Australian Government public sector expenditure, particularly in the form of ACT based staffing levels, would affect the property market in the ACT with a flow-on effect on property related taxation revenue. This would also have a flow-on effect on private sector economic activity, and therefore affect payroll tax revenue.

Stage 4 Water Restrictions

ACTEW is proposing to introduce Stage 4 Water Restrictions in the ACT from 1 July 2007, and possibly sooner if water consumption intensifies or storage levels do not stabilise. This is the highest level of the current water restrictions scheme. Stage 4 water restrictions are based on an ACT water supply target of around 30 to 35 gigalitres (Gl) per annum. On average, 65 Gl of water is supplied in the ACT per annum. In 2006-07, consistent with stage 3 water restrictions, supply is estimated at 48 Gl.

Stage 4 water restrictions would have a substantial impact on the community and Government. Notwithstanding, their introduction may be a necessary step, which will help protect the ACT's remaining water supply, should inflows not improve from present levels.

It is expected the introduction of Stage 4 water restrictions would have a significant impact on the Budget. Losses would arise from the effects of lower ACTEW water revenue, and reductions in returns from the Water Abstraction Charge. ACTEW expects that some of these losses may be recouped via water pricing at a later stage (during the 2008-13 price direction). However, this would require a determination by the Independent Competition and Regulatory Commission (ICRC).

The Government and ACTEW will continue to investigate all available options to secure the ACT's water supply and to minimise the economic impacts on those groups affected by the restrictions.

ACTEW will consult with key affected business and industry groups to understand their needs and assess the potential for industry-related exemptions with the objective of maintaining core business activities.

Australian Government Funding

Adverse economic conditions could result in a moderating of Goods and Services Tax (GST) revenues, particularly as the GST is not imposed on a range of staple items, but instead on discretionary expenditure. Deterioration in the national economy may place at risk the expected growth in additional funding to the States.

State shares of GST revenue grants are derived from Australian Bureau of Statistics population estimates. Any increase in population share as a result of 2006 Census revisions at some point in 2007 could see a positive impact on GST funding. Conversely, any decline in population share would adversely impact on GST funding to the ACT.

At the time of the release of the 2001 Census data, the ACT's population share was revised upwards. There is a risk that the 2006 Census data will show the ACT population to be currently underestimated.

A number of significant Specific Purpose Payments (SPPs) will be due for negotiation in 2007. These include:

- Commonwealth-State and Territory Disability Agreement;
- Commonwealth-State Housing Agreement;
- Natural Resource Management Agreement; and
- Australian Health Care Agreements (AHCAs).

As future SPP funding levels are unknown, particularly matching requirements, this presents a risk of reducing the flexibility of upcoming ACT Budgets.

The Australian and State Governments have reached agreement on the abolition of the majority of business related duties subject to review under the *Intergovernmental Agreement on the Reform on Commonwealth-State Financial Relations*. However, the future of the largest duty, on business conveyances for real property, remains an outstanding matter.

The Council of Australian Governments has endorsed a broad range of initiatives under the banner of the National Reform Agenda. Initiatives include competition and regulatory reform, improved access to major infrastructure and improvements to human capital in the areas of health, education and workforce participation. The Australian Government has indicated that funding of these initiatives will be on a case-by-case basis, once specific implementation plans have been developed, and payments to States and Territories would be linked to achieving agreed actions or progress measures. These initiatives would likely affect upcoming SPP re-negotiations such as the AHCAs and the Schools Quadrennial Funding Agreement.

National Capital Roads

The Australian Government in its 2007-08 Budget allocated $71.8 million over 4 years to roads infrastructure projects associated with the Griffin Legacy. Funding of these projects is conditional on the ACT ceding control of the road asset and/or land associated with these projects to the Commonwealth.

At this stage, uncertainty exists in regard to the actual land/assets proposed for transfer to the Commonwealth. Until such time as there is clarity and agreement regarding which assets may transfer, and associated valuations are established, no adjustment has been made to the Budget.

Under both Australian Accounting Standards and Government Finance Statistics any transfer of Territory assets to the Commonwealth is accounted for as an expense, therefore, decreasing the Territory's operating result and/or Net Operating Balance respectively. The amount of the expense would be the net book value of the road asset at the time of transfer. Land under roads and unleased Territory land does not carry a value, therefore would not result in an expense.

The Australian Government has also announced an extension of the Roads to Recovery program through Auslink 2. An amount of $30.1 million has been allocated to the ACT. As projects are unknown at this stage, no adjustment has been made to the Budget. If included, this would increase revenue and improve the Net Operating Balance. Corresponding expenditure would not be shown in the Operating Statement as it relates to expenditure on non-financial assets.

Government Investments and Borrowings

Governance, Advisory and Consultancy Arrangements

- 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 managers 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.

The 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.

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 forces. 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 increase, 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 risk, which is the risk that the valuation of stock market equity securities will decrease.

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 operating result 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%	**2007-08** **$'000**	**2008-09** **$'000**	**2009-10** **$'000**	**2010-11** **$'000**
General Government	+/- 4,971	+/- 3,863	+/- 3,910	+/- 3,919
SPA	+/- 1,391	+/- 243	+/- 267	+/- 292

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 50 per cent of Territory borrowings are held on a fixed rate basis, 50 per cent 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 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%	2007-08 $'000	2008-09 $'000	2009-10 $'000	2010-11 $'000
Total Borrowings	+/- 1,808	+/- 2,417	+/- 3,173	+/- 4,200

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 $870 million (42 per cent) of SPA investments are denominated in foreign currency through the purchase and holding of international equity and fixed interest securities. Currently, 52 per cent ($456 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%*	2007-08 $'000	2008-09 $'000	2009-10 $'000	2010-11 $'000
SPA	+/- 4,622	+/- 5,087	+/- 5,577	+/- 6,092

* A negative outcome represents an appreciation of the AUD 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 have approximately $1.5 billion invested in domestic and international equity securities during 2007-08. Equity markets are inherently volatile and not suitable for short-term investments. However, equity investments have shown to be an excellent long-term investment, if managed prudently. Over the long term, equity markets are also 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 certain 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%	2007-08 $'000	2008-09 $'000	2009-10 $'000	2010-11 $'000
SPA	+/- 15,023	+/- 16,533	+/- 18,125	+/- 19,780

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* and the *Territory Superannuation Provision Protection Act 2000*.

Defined Benefit Employer Superannuation Liabilities

The level of employer liability associated with defined benefit superannuation schemes is actuarially determined. This process requires setting a range of demographic and financial assumptions that are fully reviewed every three years (triennial review) and are applied annually to actual staffing membership and salary levels. Because of the influence these variables have over time, the ultimate cost of a defined benefit plan (final benefits to employees) is uncertain. This uncertainty is likely to persist over a long period of time.

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

The ACT Government currently has approximately 31,100 members in either the defined benefit Commonwealth Superannuation Scheme (CSS) or the defined benefit Public Superannuation Scheme (PSS). Of these members, approximately 15,200 are current contributors, 9,900 have preserved their benefits, and 6,000 are current pensioners. 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. The Australian Equivalent to International Financial Reporting Standards (AIFRS) requires reference to an Australian Government long-term bond rate as the appropriate discount rate to be used when undertaking an actuarial review of the defined benefit employer superannuation liability. 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 $590 million (actuarial gain or loss), resulting in the approximate annual variation estimates of superannuation related expenses (accruing liability) outlined in Table B.5.

Table B.5
Impact of liability valuations on superannuation expense from variation in Discount Rate

+/- 1%	2007-08 $'000	2008-09 $'000	2009-10 $'000	2010-11 $'000
SPA	+/- 51,000	+/- 49,000	+/- 47,000	+/- 45,000

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, which was established to finance the cost of insurable risk for ACT 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 the 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 parties 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. Since the January 2003 bushfire ACTIA's self-insured retentions have been reviewed to ensure an appropriate balance between risk transferred, the premium paid for this, 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. 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 tenderers to the procuring agency. Centralised procurement provides the opportunity to manage this in a more consistent and cost effective manner.

Australian Government Reform to the CSS and PSS

The Australian Government recently outlined a package of reforms, included in its 2007-08 Budget, designed to provide Public Sector Superannuation Scheme (PSS) and Commonwealth Superannuation Scheme (CSS) members with more flexible super arrangements and encourage members to remain in the workforce longer. Further details of the scheme changes are provided in Chapter 6.3 Superannuation.

Due to the flexibility of these new arrangements, including increased PSS maximum benefit limits (MBLs) and the removal of mandatory employee contributions, it is too early to estimate the financial impact the CSS/PSS changes may have on the Territory.

Depending on ACT Government employee member behaviour in the future, these changes may potentially lead to increased (negative impact) or decreased (positive impact) long-term employer defined benefit superannuation liabilities for the Territory.