

8.4 RISK MANAGEMENT

This chapter addresses the Risk Management issues confronting the Territory, particularly in regard to Economic Risk, Commonwealth Funding, General Government Borrowings and Investments, Superannuation Liabilities, Insurable Risk, Non-Government Sector Risk Initiatives, 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 2002-03, public sector consumption and investment expenditure accounted for 48.9% of ACT State Final Demand (SFD) - 45.4% and 3.5% respectively. This share is significantly higher than the National average, where public sector expenditure accounted for only 21% of Australian Domestic Final Demand (DFD) in 2002-03.

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 42.6% of ACT Gross State Product (GSP) at factor cost in 2002-03. By comparison, at the national level these activities accounted for 16.9% of Australia's 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 tourism associated with Federal 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 1992 to 1996 was 4.9% compared to the national average growth rate of 2.6%. However, over the five-year period 1999 to 2003, the growth rate in the ACT was 1.8% compared to 2.5% nationally. 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.

The Federal election expected to be held in the second half of 2004 and, to a lesser extent, the ACT election to be held in October 2004 will both impact on the ACT economy. The tendency for elections to dampen employment growth - due to a decline in business related tourism and related industries, and a usual hiatus in recruitment processes - has been factored into the ACT's employment forecast. Employment and/or wages growth in the private sector impacts on the ACT Government's revenue from payroll tax. However, there is no direct impact from employment and/or wages growth in the public sector because Commonwealth agencies are exempt from payroll tax.

Interest Rates

Interest rate changes impact on consumption and investment activity in the ACT economy. The Reserve Bank of Australia raised the official cash interest rate by 0.25 percentage points in both November and December 2003. There is a possibility of further interest rate rises in 2004, particularly if the global economic expansion, most evident in the second half of 2003, begins to place inflationary pressure on the Australian economy.

Changes in interest rates will impact on private consumption expenditure, which accounted for about 40.5% of SFD in 2002-03, 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 14.1% of SFD in 2002-03. In particular, private sector investment, which accounted for 10.6% of SFD in 2002-03, is likely to be dampened by the interest rate rises in late 2003 and any further rises.

Private investment in dwellings, despite its relatively small contribution to the level of SFD (3.4% in 2002-03), can be highly volatile and therefore can have a disproportionate impact on the overall rate of economic growth in the ACT. Dwelling investment was a large component of the growth in private investment in the ACT in 2002-03. However, there are signs that activity in this area was beginning to slow, even before the interest rate rises in November and December 2003 had time to take effect.

The quarterly number of residential approvals for the three months December / January / February 2004 is 1.5% higher than for the three months September / October / November 2003, however they are 36.5% lower than for the three months December / January / February 2003.

The potential contractionary impact of the interest rate rises in November and December 2003, and any future rises, is likely to be magnified by the recent growth in household debt. The initial impact of rising interest rates would be to dampen conveyancing revenue with some flow-on effect to other transaction-based taxes.

Revenue estimates relating to activity in housing market take account of interest rate rises. Similarly, SFD forecasts also incorporate these changes.

Commonwealth Funding

The introduction of the GST as a State revenue source entrenched in legislation instils a high degree of predictability in Commonwealth transfers, at least in aggregate terms.

Importantly, the principles underpinning national tax reform and the GST have provided a safety net to date for all jurisdictions to ensure that States' budgets would be no worse off after the implementation of the GST. This will continue until such time as the GST revenue exceeds the funding which would have been available to the jurisdictions under pre-GST arrangements, an outcome now fast approaching that could lead to the non-requirement of guarantee arrangements in the near future.

This outlook, of course, is predicated on the fact that the GST is a broad-based tax that is linked to economic performance. Adverse economic conditions could see a moderating of GST revenues, particularly as the GST is not imposed on a range of necessities, but rather on discretionary expenditure. Any deterioration would automatically place at risk the expected growth in additional funding to the States.

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 variations from the estimated values for these variables over the life of the Budget.

Existing commitments under the national tax reform agenda to embark on further tax reform in the areas of other business taxes will be a vexed question requiring closer scrutiny by all jurisdictions. Affordability will be of paramount consideration. An earlier than expected requirement for the abolition of various State revenues by the Commonwealth or similar pressure brought to bear for the abolition of additional taxes not already earmarked for possible cessation could pose a risk to the integrity of State own-source revenues.

Similarly, a change of government at the federal level could reinvigorate the call for a major overhaul of fiscal equalisation by States receiving less than an equal per capita share of the GST (donor States). Any further attempt to destabilise the current distribution arrangements could pose some risk for the Territory.

There is growing evidence that the States will be required to match greater levels of Commonwealth Specific Purpose Payments (SPPs) funding in the future, particularly in a number of costly service delivery areas such as health, housing and disability services.

Finally, State Treasurers have expressed their concern with the Commonwealth Treasurer's recent statements linking the continuation of National Competition Policy (NCP) Payments to new reforms, regardless of past achievements.

The States believe that reforms undertaken will continue to generate revenues for the Commonwealth beyond 2005-06 and hence, all jurisdictions, including the ACT, have incorporated an NCP Payment amount based on current reforms in their respective 2006-07 forward estimates. The likely Commonwealth position is that continued payments will be conditional on commitment to further new reform.

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.

The Territory's general government financial investments most susceptible to changes in market value are the fixed interest bonds. The market value of a bond represents the present value of a future cash flow stream (coupons) and repayment of principal on maturity. The present value calculation uses market interest rates as the discount factor to 'discount back' the future cash flow stream to its present value. A high discount factor (interest rate) reduces the present value of a bond. This is because the future cash flow stream is converted to its present value at a higher rate.

The discount factor of a bond, commonly known as yield, moves in the opposite direction to the market (present) value of a bond. Hence, for an increase in interest rates, bond discount factors or yields will increase, reducing the market (present) value of future cash flow streams. On the other hand, a decrease in interest rates will decrease yields, increasing the market (present) value of future cash flow streams.

The allocation to fixed interest securities in the general government investment portfolio is in the order of 20%. Accordingly, the associated market risk is somewhat mitigated through the low allocation.

Territory borrowings are presently accounted for on an 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.

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 is 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 intergenerational 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.

An increase in the level of borrowings that is not commensurate with the principles set out by the ratings agencies could result in a downgrade of the credit rating. A lower credit rating is likely to lead to higher financing costs as investors (lenders) will regard the Territory as a higher risk counterparty. The financing costs of the Territory are a reflection of the credit rating provided by the ratings agencies.

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 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 8.4.1
Impact of interest rate change on general government investment portfolio: Interest Revenue

	2004-05 \$'000	2005-06 \$'000	2006-07 \$'000	2007-08 \$'000
Budget	46 502	37 658	32 628	33 401
+1%	4 122	2 598	1 693	1 741
-1%	-4 081	-2 557	-1 653	-1 700

The Territory borrowings comprise approximately 43% on a fixed rate basis, and 57% 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 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 8.4.2
Impact of interest rate change on borrowing costs

	2004-05 \$'000	2005-06 \$'000	2006-07 \$'000	2007-08 \$'000
Budget	26 930	30 746	30 178	30 146
+1%^a	3 117	3 669	3 768	3 556
-1%^a	-3 470	-3 681	-3 324	-3 550

^aA 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 a comparatively higher level of investments.

Foreign Exchange Rate Risk

The Territory's exposure to currency risk in respect of the general government financial investments is nil. General government investments are not permitted to be invested offshore.

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

The Territory does not have a significant exposure to foreign exchange, in relation to goods and services purchases.

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.

The established governance, advisory and consultancy arrangements provide the Territory with a very 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 level of wages has a substantial one-off impact on the Territory's net unfunded superannuation liability. The current level of annual salary increase assumed in the actuarial determination of the Territory's superannuation liability is 4%. The average level of employer contribution for the ACT public sector is 17.5%. A 1% change from the actuarial assumption used for wages growth results in a movement in the assumed liability of \$8.3 million in the first year.

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 domestic share prices over 2004-05 is estimated to impact on the operating result in 2004-05 by +/- \$3.807 million, with the variation flowing through assumed investment returns over the forward years.

Similarly, a variation of 1% in overseas share prices is estimated to impact on the operating result in 2004-05 by +/- \$4.441 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 period of member's working life 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.

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.

The 2003-04 estimated outcome incorporates an estimate of the net liabilities. However, the estimate may require some level of upward adjustment, once the investigation is completed and the appropriate remedial actions are determined.

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 the 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.

ACTIA's risk management development work for the past 12 months included the following highlights:

- ACTIA developed an Enterprise-wide Risk Management Framework, which was approved in the later part of 2003;
- a Risk Management Policy statement for the ACT Government was adopted in January 2004; and
- the Enterprise-wide Risk Management Framework was launched by the Treasurer in February 2004.

The expected outcomes of this framework are more efficient and effective service delivery and thus better management of resources across the Government. The approach is designed to produce a culture that will ensure that officers are more aware of the possible impact of all risks on the ACT, and be prepared for them.

The proposed risk management framework is based on the Risk Management Standard (AS/NZS 4360:1999). This standard defines risk, provides guidelines on policies, strategies and procedures to manage it, and leads the user to assess both the positive and negative aspects of risk.

Consistent with the Government's ERM framework, implementation of the policy will require each agency to:

- develop a risk management policy statement which reflects the Government's commitment to its fiscal, service, environmental and social responsibilities;
- establish strategies and tactics to manage risk by way of procedures and manuals;
- report on the risk management process in annual reports and Chief Executive performance agreements; and
- be subject to compliance audits by the Auditor General.

ACTIA is implementing processes where premiums will be adjusted to provide economic incentives for agencies that adopt best practice risk management strategies and demonstrate improvement in risk management performance over time.

During 2003-04, Risk Management initiatives to be promoted include:

- continuing promotion and roll out of the Enterprise-wide Risk Management Framework to all agencies;
- promotion of agency participation in the Risk Management Benchmarking programme which measures and compares the standard of risk management within an organisation;
- conducting monthly lunchtime Risk Management Networking Forums for ACT Government personnel;
- provision of focused risk management training of agency managers and staff to enable progress towards development of risk management plans;

- provision of risk management tools and guidebooks to enable best practice risk management to be introduced to all business processes, not just insurable risk;
- production of ACTIA's quarterly newsletter Insurance & Risk Management Update; and
- regular review of existing major claims to ensure appropriate management is being applied to claims, and that realistic estimates of costs are included in ACTIA's accounts.

Non-Government Sector Risk Initiatives

The ACT Government has moved on two fronts with respect to risk issues in the non-government sector in light of the insurance crisis.

Firstly, the Government has established new Guidelines on Public Liability Insurance for community groups using or occupying ACT Government property under the terms of written agreements.

The Guidelines apply whether or not the ACT Government funds the community group. The controlling and sole determinant with respect to the operation of these guidelines is the occupation of ACT Government property under the terms of a written agreement.

The Guidelines support efforts already undertaken by ACT Treasury and community umbrella groups. For example, Treasury conducted a series of 20 formal, and a number of informal risk management seminars for leaders and administrators of community groups. These seminars brought the terms of the guideline into focus for the groups. Volunteering ACT conducted volunteer management seminars in conjunction with the Treasury risk management seminars to supplement broader risk amelioration strategies.

It was considered necessary for the community to have at its disposal procedures already established for it and recognised as the means of dealing with public liability insurance levels. Treasury then moved to educate departmental officers so they, too, could embrace procedures the community had already been exposed to and adopted.

Secondly, governments throughout Australia have agreed to introduce professional standards legislation and proportionate liability for economic loss. This legislation will apply liability caps in exchange for risk management, designed to assist small businesses to understand and apply principles such as continuous service improvement. There will also be minimum appropriate levels of insurance.

The key feature of professional standards legislation is risk identification and management. Treasury has provided over twenty Introduction to Risk Management for Small Business courses for local small business, providing access to risk identification, mitigation and management principles in advance of the legislation so that local small and emerging businesses will be able to develop and maintain their competitive advantage in the event they choose to enter the scheme.

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

behalf of the Government. Also, considerable attention has been given to reducing future risks to the Territory from bushfires.

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.

Bushfires

The impact of the January 2003 bushfires is still being felt, however considerable attention has been given to reducing future risks through Government acceptance of the Inquiry into the Operational Response to the January 2003 bushfires in the ACT, conducted by Mr. Ron McLeod AM. The report made 61 recommendations, which have all been accepted by the ACT Government. The recommendations include actions to mitigate risk including:

- improved fuel management;
- strategic fire access;
- incident command and control improvements;
- strengthening of training;
- better public education and information;
- a more unified and independent emergency services organisation;
- the introduction of a fire-abatement zone; and
- changes to the Emergency Management Act.

