7.4 STATEMENT OF RISK

This chapter addresses some risk facing the Territory, particularly in regard to Economic Risk, Commonwealth 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. The main risk factors for the ACT economy relate to changes in public sector expenditure and movements in interest rates.

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.

Commonwealth Funding

Adverse economic conditions could result in a moderating of Goods and Services Tax (GST) revenues, particularly as GST is imposed on discretionary expenditure and not on a range of staple items.

State shares of GST revenue grants are derived from Australian Bureau of Statistics population estimates, which show the ACT's relative share of the Australian population declining. Any decline in population share would also adversely impact on GST funding to the ACT.

The Australian Government has provided the Commonwealth Grants Commission (CGC) with terms of reference to review the interstate distribution of local roads grants, currently paid as part of the untied Specific Purpose Payment Financial Assistance Grants for Local Government.

The CGC is due to report by 30 June 2006 and it is likely that it will recommend a change from the historical basis of distribution to a needs based distribution. If so, it is unlikely that the ACT would retain its current share for 2006-07, with any reduction likely to come into effect from 2007-08.

The Australian and State Governments have reached agreement on the abolition of the majority of the business related duties subject to review under the *Intergovernmental Agreement on the Reform on Commonwealth-State Financial Relations.* However, the

Australian Government has said it considers that the largest duty, duty on business conveyances for real property, remains subject to future review.

General Government Investments and Borrowings

Governance, Advisory and Consultancy Arrangements

In 2000, the Finance and Investment Advisory Board was established to provide advice to Treasury on all financial investment and borrowing related issues.

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 management and portfolio monitoring.

Barrington Treasury Services Limited and Visual Risk Pty Ltd are currently contracted as the Territory's 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.

The main risks associated with the management of the Territory's investment assets and liabilities, including General Government investments and the Superannuation Provision Account (SPA), include market risk.

Market risk 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, especially 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 – General Government and Superannuation Provision Account Investments

The Territory's General Government financial investments are diversified 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 balance sheet.

In regard to the General Government Sector 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 7.4.1.

Table 7.4.1
Impact of an interest rate change on Interest Revenue

+/- 1%	2006-07 $'000	2007-08 $'000	2008-09 $'000	2009-10 $'000
General Government	+/- 3,889	+/- 2,654	+/- 3,154	+/- 4,836
SPA	+/- 2,656	+/- 1,506	+/- 229	+/- 248

In the case of the fixed interest investments for both the General Government 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. Although many of these debt securities will be held until maturity so changes in interest rates will not impact the total return achieved, the market valuation of these securities for accounting and trading purposes will change over time. 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 – General Government Borrowings

Total Territory borrowings are accounted for on a historic cost basis and are typically held to maturity, or repaid on an amortising basis. In addition to this, a large proportion of borrowings are held on a fixed interest rate basis.

The Territory borrowings comprise approximately 50 per cent on a fixed rate basis, and 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 the floating rate borrowings is shown in Table 7.4.2.

Table 7.4.2
Impact of interest rate change on borrowing costs

+/- 1%*	2006-07 $'000	2007-08 $'000	2008-09 $'000	2009-10 $'000
General Government	+/- 1,708	+/- 2,108	+/- 2,608	+/- 2,958

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

Currency Risk – General Government and Superannuation Provision Account

In relation to the General Government, the Territory does not have any financial borrowings in non-Australian denominated currency and therefore is not exposed to any currency risk in respect of its debt. The Territory also does not have any significant exposure to currency risk in relation to the purchase of international goods and services.

Approximately $756 million (42 per cent) of the SPA investments are denominated in foreign currency through the purchase and holding of international equity and fixed interest securities. Currently, 50 per cent ($378 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 the foreign currency asset holdings will 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 7.4.3.

Table 7.4.3
Impact from the movement of the Australian dollar on valuations*

+/- 1%*	2006-07 $'000	2007-08 $'000	2008-09 $'000	2009-10 $'000
SPA	+/- 4,100	+/- 4,400	+/- 4,800	+/- 5,300

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

Equity Risk – General Government and SPA

The General Government does not invest in publicly listed equity securities and is not exposed to equity risk.

The SPA will have approximately $1.3 billion invested in domestic and international equity securities during 2006-07. 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. The risk budget for the portfolio is monitored carefully, with equity risk having a substantial allocation, but being maintained within an acceptable range. 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 7.4.4 outlines the impact to the SPA equity portfolio valuation from a 1 per cent variation in equity security valuations.

Table 7.4.4
Impact of a change in equity valuations

+/- 1%	2006-07 $'000	2007-08 $'000	2008-09 $'000	2009-10 $'000
SPA	+/- 13,500	+/- 15,400	+/- 16,900	+/- 18,400

Credit Risk – General Government and SPA

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 debt investment portfolios 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 Poors or Moodys. The applicable credit ratings are outlined in the *Financial Management Act 1996*.

Superannuation Liabilities

The level of 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 therefore 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). 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 32,000 members in either the defined benefit Commonwealth Superannuation Scheme or Public Superannuation Scheme. Of these members, approximately 17,000 are current contributors, 9,000 have preserved their benefits, and 6,000 are current pensioners. As such, 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. In the past, the discount rate has been set as a long term assumption by the Actuary. Adoption of the Australian equivalent to International Financial Reporting Standards (AIFRS) now requires reference to a Commonwealth Government long term bond rate as the appropriate discount rate at the time of review. 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 variation in

the liability valuations and annual superannuation expenses. Adoption of AIFRS will increase the variability of liability valuations.

A 1 per cent variation in the discount rate results in an estimated change to the current liability of approximately $450 million (actuarial gain or loss), with approximate annual variation estimates in superannuation related expenses (accruing liability) outlined in Table 7.4.5.

Table 7.4.5
Impact on liability valuations from variation in Discount Rate

+/- 1%	2006-07 $'000	2007-08 $'000	2008-09 $'000	2009-10 $'000
SPA	+/- 37,300	+/- 34,000	+/- 31,500	+/- 29,100

Sensitivity to Demographic Assumptions

Demographic assumptions incorporated in the actuarial reviews by the Actuary are used to provide a better estimate of the current and future liability valuations for the Territory. Demographic assumptions incorporated include variables such as promotional salary increases, 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 may therefore impact upon future liability valuations.

Contingent Liabilities

Contingent liabilities are liabilities of 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 can not be measured reliably.

Under the *Financial Management Act 1996* (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 should be 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 in the Australian Capital Territory Consolidated Annual Financial Statements for the 2004-05 financial year 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 the 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, 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 Minister about insurance and the management of Territory risks; and
- administer, under an agreement with and on behalf of the Chief Minister's Department, the Default Insurance Fund, established 1 July 2006.

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 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 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. ACT Government agencies are continuing to develop and implement their own risk management plans and policies based on the guidelines.

ACTIA facilitates risk management training workshops and risk manager networking forums to further improve risk management knowledge across ACT Government. ACTIA conducted eight workshops in 2005 and involved 116 ACT Government employees with responsibilities in risk management and the workshops covered the topics:

- Introduction to Risk Management;
- Running a Risk Management Workshop; and
- Business Continuity Planning.

In 2006, ACTIA's risk management activities will be focussed on the following:

- 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;
- targeted risk management training workshops and lunchtime seminars to raise the skills and expertise of all ACT Government employees; and
- sponsoring the ACT Business Continuity Institute and encouraging participation by ACT Government agencies and staff.