1.5 STATEMENT OF RISK

This statement of risk is made inline with the Section 11(1)(d) of the *Financial Management Act 1996*.

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.

Public sector expenditure

While Australian Government expenditure on a per capita basis continues to be significantly higher in the Territory than in other jurisdictions, the growth rate of Australian Government expenditure in the ACT has fallen below the national average. The possibility of the Territory receiving a smaller share of the increases in Australian Government expenditure in the future constitutes a downside risk to future economic activity in the Territory.

Interest Rates

Changes in interest rates will impact on private consumption expenditure. If interest rates rise, households will need to devote more of their income to servicing the interest component of their outstanding mortgage and consumer debt, resulting in less disposable income for discretionary spending. The potential contractionary impact of interest rate rises is likely to be magnified by the recent growth in household debt.

A rise in interest rates is also likely to have a negative impact on investment, particularly private investment in dwellings. The residential construction sector has relatively high multiplier flow-on effects through the economy and, therefore, the negative impact on State Financial Demand (SFD) of any downturn in this sector will be magnified.

While interest rates are forecast to rise only moderately, there is a risk that inflationary pressures, either from wage-induced demands due to labour supply shortages, or sustained high oil prices, will push interest rates higher.

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 decline in Australian Government public sector expenditure, particularly in the form of ACT based staffing levels, would have an adverse effect on the value of property in the ACT, and the decline in the level of private economic activity would be reflected in lower collections of payroll tax.

Australian Government Funding

Adverse economic conditions could result in moderating of Goods and Services Tax (GST) revenues, particularly as the GST is not imposed on a range of necessities, but rather on discretionary expenditure. Deterioration in the natural economy may place at risk the expected growth in additional funding to the States. Estimates of GST revenues paid to the ACT adopt Australian Bureau of Statistics (ABS) population estimates, which show a declining share for the ACT of the national population. Any further decline in population share would adversely impact on GST funding.

The ACT, along with most States and the NT, has proposed a schedule to the Australian Government for the abolition of certain business taxes under the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*. The Australian Government is yet to respond. If accepted it will reduce the aggregate surplus over the Budget period by approximately $13m. Further details are provided in part 4.2.

General Government Borrowings and Investment

Government borrowings and investments are exposed to 'market risk'. That is, they are exposed 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 and, to a lesser extent, through its borrowings.

Financial Investments

The Territory's general government financial investments are diversified across a number of asset classes including cash, short-term debt instruments (maturity less than 12 months), and fixed interest bonds (maturity 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.

Borrowings

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.

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.

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

Superannuation Liabilities

The Territory's net superannuation liabilities are sensitive to:

- the level of ACT public sector wages;
- changes in domestic and overseas share prices;
- demographic assumptions (e.g. life expectancy assumptions);
- financial assumptions (e.g. the assumed propensity for retiring members to opt for the indexed pension rather than the lump sum payment benefit); and
- forthcoming results from the current investigation of possible inconsistencies with the application of appropriate superannuation arrangements for Totalcare employees.

Changes in actual and/or assumed parameters can have significant impacts on the level of estimated liabilities. Liability estimates are actuarially reviewed every year.

Contingent Liabilities

Contingent liabilities are possible liabilities that arise from past events and can only be confirmed by the incidence, or non-occurrence, of uncertain future events which are not within the control of the entity.

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 financial statements in accordance with Accounting Standards (AASB 1044). 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 2003-04 financial year at: www.treasury.act.gov.au.

Operational Risk

Insurable Risk

The Government has implemented an enterprise-wide risk management framework. The risk management framework is based on the Risk Management Standard (AS/NZS 4360:2005). 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.

In respect of insurable losses, such as property, public liability and professional indemnity, each agency meets the cost of claims below the level of an agreed deductible or excess. The ACT Insurance Authority (ACTIA) purchases insurance to protect the Territory against large claims or losses, or a series of such events. 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 continually being reviewed to ensure that an appropriate balance is achieved between risk transferred and risk retained.

Non-Government Sector Risk Initiatives

The Government has established new guidelines on public liability insurance for community groups using or occupying government property under the terms of written agreements.

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

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.

Business and Integrity Risks

The operation of government agencies and the provision of government services involves a range of business and integrity risks, including delivery failures, unforseen costs and the possibility of fraud or corruption. Many of these may not be readily insurable, or effective risk management will mitigate the likely insurance cost.

The key elements of the ACT Public Service Integrity policy include:

- an integrity risk assessment to underpin Departmental Fraud and Corruption Plans;
- the importance of Departmental Audit Committees to provide independent opinion on integrity activities;
- regular and systematic assessment of potential areas for theft, fraud and corruption to ensure control procedures are being followed and are effective;
- the appointment of Senior Executives responsible for Business and Integrity risks; and
- the use of qualified investigators to undertake fraud investigations.

The Government Procurement Board has also prescribed appropriate risk management practices and the preparation of risk plans as part of the procurement planning requirements. This process identifies and provides for the reduction of the impact of those risks that are part of the procurement process. The procurement plans also require a probity plan to further reduce risk.

Corporations and Public Enterprises

The Government is exposed to a range of financial, commercial and operational risks through its ownership of corporations and public enterprises. The governing boards of these bodies are primarily responsible for identifying, monitoring and controlling risks that might affect their operations. There are also a broad range of prudential controls contained in the *Financial Management Act 1996*, the *Territory Owned Corporations Act 1990* and the enabling legislation of Statutory Authorities. In particular, the accountability arrangements require regular reports to be provided to the Government to allow performance and any associated risks to be monitored and assessed.

Accountability arrangements are continually kept under review. In order to further strengthen the existing accountability framework, the *Territory Owned Corporations Act 1990* was amended in 2004 to enhance accountability and financial oversight provisions.

Accounting Standards

Australia is adopting the International Accounting Standards (IASs) from 1 January 2005. This means that most ACT agencies will apply these new standards in financial reports for the financial year ending on 30 June 2006.

Although there are several issues of a technical accounting nature resulting from the adoption of the IASs, these are unlikely to significantly impact the Territory's operating result and financial position, except for changes in superannuation and insurance accounting.

The Australian Accounting Standards Board (AASB) issued a revised standard late December 2004 that significantly changes superannuation accounting. The revised standard has introduced two additional options to account for movements in the values of superannuation assets and liabilities - the 'corridor' approach, which was not permitted in the standard as issued in July 2004, and the 'direct to retained earnings' approach. As a result of these amendments, the Territory has early adopted in 2004-05 the treatment of taking actuarial gains and losses directly to equity rather than impacting the Territory's operating result.

The new standards also require general insurers to include an additional (explicit) risk margin to any outstanding claims liability. This new requirement will apply to the ACT Insurance Authority (ACTIA).

The AASB is undertaking a project, in conjunction with Australian Treasuries, to enable harmonisation of financial reporting currently required under both Generally Accepted Accounting Principles and Government Finance Statistics. The project is yet to be completed but is likely to substantially change the format of future financial reports.