APPENDIX C

STATEMENT OF RISK

STATEMENT OF RISK

This chapter discusses some of the risks facing the Territory, with particular attention to economic risk, Commonwealth Government funding, investments and borrowings, superannuation liabilities and insurable risk.

Economic Risk

Risks to the short term economic outlook in the ACT prevail, mainly due to uncertainty regarding the strength of Commonwealth Government's expenditure. The Commonwealth Government's fiscal strategy of achieving a budget surplus in 2012-13 will affect the local economic activity.

Concerns around the eurozone debt markets and their potential impact on the eurozone real economy continue to cloud the outlook for the global economy, and therefore the national economy. If global growth is weaker than expected, this would inevitably have a negative impact on the local economy through various financial and confidence channels in the short term and potentially Commonwealth Government consumption expenditure in the longer term.

Monetary policy tightening in response to potential inflationary pressures in the medium term also poses a risk to forecasts. Higher interest rates will have a dampening effect on interest rate sensitive components of State Final Demand and the broader economy.

Commonwealth Government Funding

The major risk to Commonwealth funding relates to the Goods and Services Tax (GST) grants to the ACT. The GST is a broad-based tax on final consumption of goods and services and therefore GST revenue collections are subject to national economic performance.

Risks to the GST Pool relate to:

- households tending to reduce spending on goods subject to GST and continuing to spend on necessities (goods and services generally not subject to GST e.g. health services, food and rent); and
- the prices of goods and services which are not subject to GST increasing relative to the prices of goods and services subject to GST (health, education, rent and food costs).

GST revenue grants to the ACT also can be volatile from year to year as the share of the pool remains subject to revisions by the Commonwealth Grants Commission (CGC) to States' GST relativities.

The ACT's share of the GST pool could decline due to the method of distributing the pool changing as a result of the Commonwealth Government's GST Distribution Review. This may occur in 2014-15, however, is more likely to eventuate in 2015-16. Further details of the Review are provided in Chapter 9.2 of Budget Paper 3.

A number of National Partnership Agreements are beginning to expire and it is unclear as to whether the Commonwealth will continue to provide funding to now established programs. Expiring agreements will remain a risk to the ACT.

Government Investment and Borrowings

The large majority of the Territory's financial investment and borrowing transactions are conducted in the global financial markets. Accordingly, a large portion of these financial investment assets and financial liabilities have some exposure to a number of risks. These are set out below.

Market Risk – Investment Assets and Financial Liabilities

Market risk associated with the management of the Territory's investment assets and liabilities is the risk that the value of an investment will decrease, or the value of a liability increase, due to movements in financial market conditions. Market risk includes:

- interest rate risk – the risk the relative value of a security, mainly debt securities, will decrease, or that the value of liabilities will decrease, due to an interest rate increase;
- currency risk – 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 price risk – the risk the valuation of stock market equity securities will decrease.

Budget investment revenues are susceptible to the performance of global financial markets and prevailing interest rates.

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 net operating balance and balance sheet.

In regard to the Territory Banking Account (TBA) and Superannuation Provision Account (SPA) cash investment portfolios, the impact of a 1 percentage point variation in the estimated interest rate returns assumed in the Budget estimates for interest revenue is shown in Table B.3 of Appendix B.

Whilst cash investments are directly impacted by changes in interest rates, 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 78 per cent of general government sector borrowings are held on a fixed rate basis with the remainder on a floating rate basis. Approximately 41 per cent of public trading enterprise sector borrowings are held on a fixed rate basis with the remainder on a floating rate basis. The floating rate borrowings exposure is mainly related to inflation linked bonds issued for ACTEW with the variable exposure being movements in CPI. An increase or decrease in market interest rates or CPI applicable to the Territory's floating rate borrowings, above or below the assumptions 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 percentage point variation in the assumptions used to calculate the interest costs on floating rate borrowings is shown in Table B.4 of Appendix B.

Currency Risk – Territory Banking Account and Superannuation Provision Account Investments and Territory Borrowings

The Territory does not have any financial borrowings in non-Australian denominated currency and therefore is not exposed to currency risk. Likewise, the TBA investment portfolio does not hold any international investment assets and is not exposed to currency risk.

Approximately $900 million (37 per cent) of SPA investments are denominated in foreign currency through the purchase and holding of international equity and fixed interest securities. Currently 57 per cent ($516 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 also serves to reduce overall currency risk.

The estimated impact on international asset valuations from a 1 percentage point variation in the Australian dollar against all international currency holdings, assuming all other parameters are held constant is shown in Table B.5 of Appendix B.

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 invests in both domestic and international equity securities as part of a long term investment strategy. Unintended equity risk can be mitigated through diversification of the number of equity securities held, through broad sector and industry allocations, and broad country allocations.

The impact on the valuation of the SPA equity portfolio from a 1 percentage point variation in equity security valuations is shown in Table B.6 of Appendix B.

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 *Financial Management (Investment and Borrowing) Guidelines 2011* and the *Superannuation Management Guidelines 2011*.

Defined Benefit Employer Superannuation Liabilities

The value of accrued superannuation liabilities is calculated as the present value of the future payment of benefits that have actually accrued in respect of service at the calculation date. This approach is in line with Australian Accounting Standard *AASB119* and the requirement to use a projected unit credit valuation approach.

The ultimate cost of a defined benefit plan is uncertain due to the long term influence by many different financial and membership demographic variables. 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. The superannuation liability valuation is most sensitive to inflation, wages growth, rates of retirement and resignation and the proportion of benefits taken in pension form. The superannuation liability is measured on a discounted basis because the benefits may be settled many years after employees render their related service.

Sensitivity to Discount Rate

The discount rate reflects both the estimated average timing of benefit payments and the time value of money. Australian Accounting Standards *AASB119 Employee Benefits* requires the defined benefit employer superannuation liabilities to be valued at 30 June each year, using a discount rate equivalent to a Commonwealth Government long term bond rate (in practice, currently the annualised ten year Government bond rate).

The discount rate adopted for the annual actuarial review has a substantial impact on the liability valuation. Small changes in the discount rate adopted for each review can lead to significant variations in the liability valuation and annual superannuation expense.

A 1 per cent decrease in the discount rate results in an estimated increase to the current liability of approximately $840 million (actuarial gain or loss), resulting in the approximate annual variation estimates of superannuation related expenses (accruing liability) outlined in Table B.7 of Appendix B.

A 1 per cent decrease in the budget estimated discount rate of 6 to 5 per cent equates to an approximate increase in annual superannuation expense of $29 million. For consistency and planning purposes the budget is prepared using an estimated long term discount rate of 6 per cent.

The discount rate as at 30 June 2012 is used for the preparation of the annual financial statements and establishes the actual superannuation expense for the 2012-13 financial year. Currently, the yield on Commonwealth Government bonds is materially below the long-term discount rate budget estimate of 6 per cent due to the ongoing impact of the European sovereign debt crisis and outlook for low global economic growth.

If domestic interest rates remain at their current low levels, the impact on the liability valuation and superannuation expense for the 2012-13 financial year will be substantial. The valuation of the liability as at 30 June 2012 could increase by approximately $2.5 billion, with superannuation expense for the 2012-13 financial year increasing by $77 million.

A revised *AASB119 Employee Benefits* was recently released in Australia and will come into effect on 1 January 2013 and will impact the 2013-14 Budget. The revised accounting standard will require that the rate used in recognising the expected long term earnings of SPA assets be changed from the current long term earning assumption (recognised at 7.5 per cent over the longer term) to a market based 10 year government bond rate (currently recognised at 6 per cent over the longer term). As a result, the amount that the Territory adds back to the Uniform Presentation Framework Net Operating Balance to arrive at the Headline Net Operating Balance will be substantially reduced.

Sensitivity to Demographic Assumptions

Demographic assumptions incorporated in the reviews by the actuary are used to provide an 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.

National Carbon Price

The Commonwealth's *Clean Energy Act 2011* sets a price on carbon which will be effective from 1 July 2012. This has financial implications for Government agencies through increased energy costs. The Budget provides for a new $5 million Carbon Neutral Government fund to provide agencies with a loan facility to undertake projects responding to the national carbon price and to meet the ACT Government's commitment to a carbon neutral government by 2020. An ACT Government Carbon Neutral Framework will be released in 2012.

National Disability Insurance Scheme

The ACT supports the development of a National Disability Insurance Scheme (NDIS) to fund long term care and support for eligible Australians with significant and ongoing disabilities.

The NDIS is estimated to cost $8 billion in addition to the combined $7 billion that States and Territories and the Commonwealth currently expend. While the Productivity Commission recommended that all of the additional cost of the NDIS be funded by the Commonwealth, cost sharing arrangements with States and Territories are yet to be determined.

In addition significant design issues relating to the scheme's governance, structure, eligibility and funding continue to be worked through between States and Territories and the Commonwealth Government. This work will inform the number of people to benefit from the scheme, how much it will actually cost and where the funding will be sourced.

A key challenge will be to ensure that the NDIS is both affordable and viable, with sustainable costs, including those associated with residual services managed by the States and Territories. It will also be important that public expectations are managed carefully to ensure they match the support that is ultimately delivered.

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. Contingent liabilities can also occur when a liability is contingent on the outcome of an event outside the Territory's control, such as the outcome of a court case.

Under the *Financial Management Act 1996*, it is the responsibility of the Government to identify contingent liabilities that may affect the budget estimates.

Types of 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.

Outstanding Insurance Claims Liability

The value of insurance liabilities is the present value of the future claim payments that have accrued at the calculation date. This approach is required under Australian Accounting Standard *AASB1023 General Insurance Contracts*.

Accounting for insurance claims is complex and actuarial assumptions are required to estimate the Authority's obligations and claims expense. There is uncertainty in the estimate of the liability and this can result in actuarial gains or losses when the claims experience differs from the estimates. The liabilities are discounted to allow for the time value of money as claims may be settled many years after the claim is incurred.

Sensitivity to Discount Rate

The outstanding claims liability is calculated by reference to expected future payments. These payments are discounted to adjust for the time value of money. Australian Accounting Standards *AASB1023 General Insurance Contracts* requires the outstanding claims liabilities to be valued using a 'risk free' rate of return, which are generally accepted to be the discount rate derived from market yields on Commonwealth Government Bonds. The discount rates adopted match the weighted term to maturity of insurance claims. The long term nature of the projected cashflows from the liability mean that small changes in the discount rate adopted can lead to significant variations in the liability valuations and the claims expense.

The outstanding claims provision as at 31 December 2011 was $342.039 million. A 1 percentage point variation in the discount rate results in an estimated change to the liability of approximately $20-$23 million (actuarial gain or loss), equivalent to a 6 to 7 per cent change.