STATEMENT 7: ASSET AND LIABILITY MANAGEMENT

This statement covers the management of the major assets and liabilities on the Government's balance sheet and provides detailed information on Australian Government net debt and net worth.

STATEMENT 7: ASSET AND LIABILITY MANAGEMENT

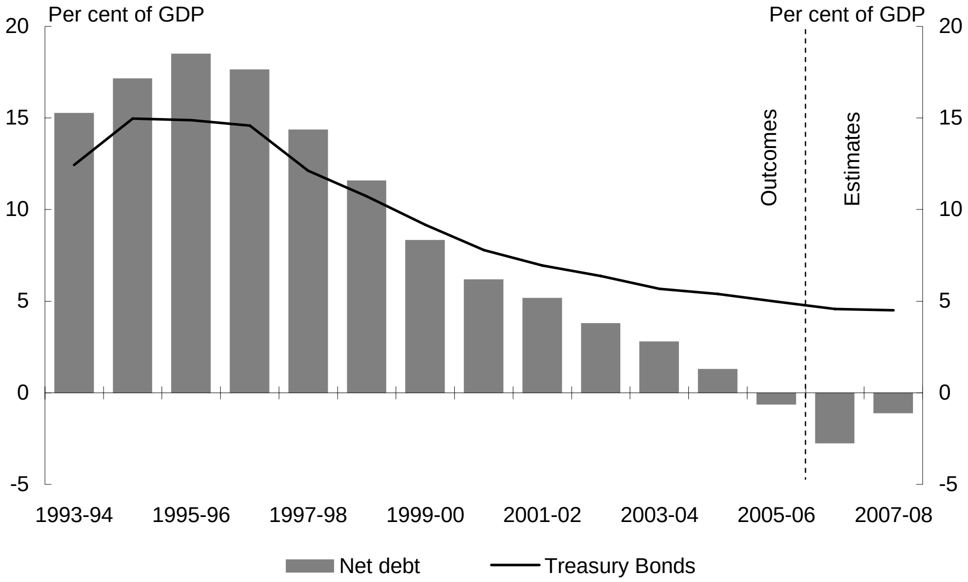
The Australian Government balance sheet provides information on the Government's assets and liabilities and provides an indication of the sustainability of government finances. Maintaining a strong balance sheet provides governments with the capacity and flexibility to deal with longer term fiscal pressures.

The balance sheet presents the Government's assets and liabilities which contribute to the calculation of net debt and net worth. A detailed balance sheet for the Australian Government general government sector is provided in Appendix B of Statement 2 (Table B2).

NET DEBT AND NET WORTH

Net debt was eliminated in 2005-06 after falling from a peak of 18.5 per cent of GDP ($95.8 billion) in 1995-96. Due to continuing strong economic and fiscal management net debt is expected to remain below zero in 2007-08 and over the forward years. Financial assets included in net debt reduce temporarily in 2007-08 (Chart 1). The change in the 2007-08 estimate is largely explained by the Future Fund progressively moving its assets out of cash and fixed interest securities, which are included in the calculation of net debt, into equities, which are excluded. Despite the low levels of net debt, the Government is committed to issuing sufficient Treasury Bonds to support the Treasury Bond futures market.

Chart 1: Australian Government general government sector net debt and Treasury Bonds on issue



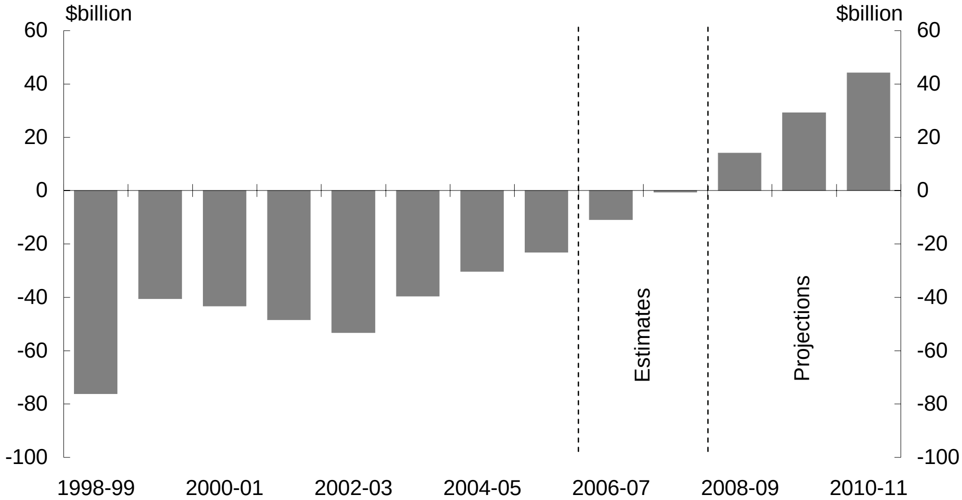
Source: Data are from ABS cat. no. 5501.0, Australian Government Final Budget Outcomes and Treasury estimates.

Australia's net debt position compares favourably to other industrialised countries and is among the lowest in the OECD. The average net debt to GDP ratio in the OECD is around 45 per cent while for Australia it is below zero (see Chart 2 in Statement 1).

Net debt is a sub-set of the Government's broader financial portfolio. It includes financial liabilities such as government securities and other loans and borrowing, and financial assets such as cash and deposits. Net debt is a common measure of the strength of a government's fiscal position and performance.

Net worth is a broader measure of the Government's overall financial position which incorporates the Government's non-financial assets, such as land and other fixed assets, as well as certain financial assets and liabilities not included in net debt, most notably accrued employee superannuation liabilities. Australian Government general government sector net worth is projected to be positive by 2008-09 (Chart 2).

Chart 2: Australian Government general government net worth

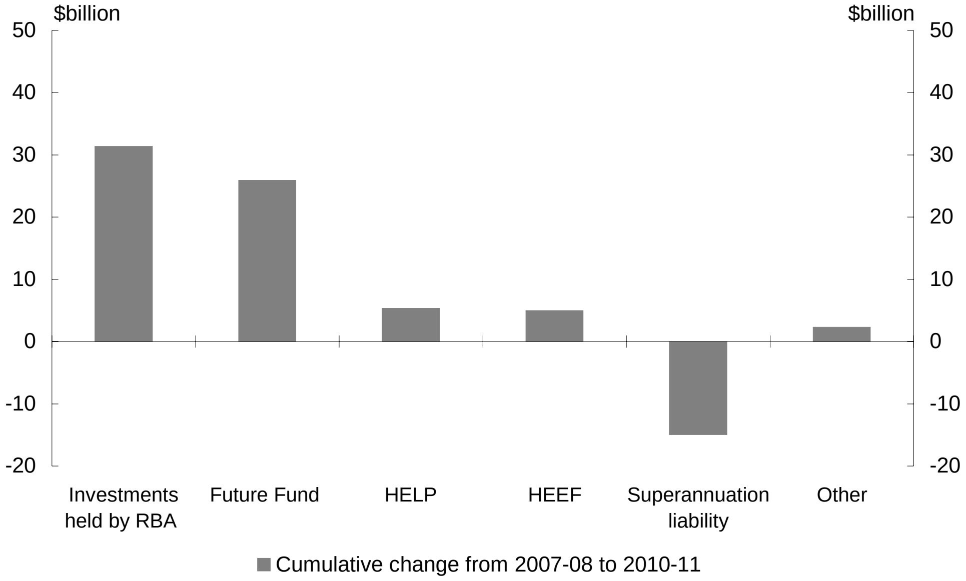


Source: Data are from ABS cat. no. 5501.0, Australian Government Final Budget Outcomes and Treasury estimates.

The present and projected improvement in net worth is primarily driven by budget surpluses and returns on investments in the Future Fund. The Government has projected surpluses over the forward estimates reflecting the current strength of the economy, while Future Fund earnings are expected to grow at a faster rate than other investments.

This increase in net worth is reflected in the balance sheet as higher term deposits at the Reserve Bank of Australia (RBA) from accumulated budget surpluses, an increase in Future Fund assets resulting from transfers to the Fund and earnings, the creation of the Higher Education Endowment Fund (HEEF), and growth in the Higher Education Loans Programme (HELP). These increases in assets significantly outweigh growth in the Government's liabilities over this period, which include the unfunded superannuation liabilities (Chart 3).

Chart 3: Changes in the composition of net worth over the forward estimates



Source: Treasury estimates.

The positive outlook for net worth and net debt means the Government is well placed to deal with future emerging fiscal pressures.

ASSET MANAGEMENT

Strong fiscal outcomes over recent years have contributed to both an increase in the Government's financial assets and in Australian Government net worth.

Continued budget surpluses, together with growth in Future Fund assets, will have an impact on the size and composition of Australian Government assets over the forward estimates.

Investments held by the RBA

Accumulated budget surpluses are held on deposit at the RBA. These assets are managed by the Australian Office of Financial Management, which gives consideration to the Government's cash management requirements and to achieving a rate of return on Government funds. The accumulation of surpluses at the RBA has a positive impact on both net debt and net worth.

Telstra sale

During 2006-07 the Government sold the majority of its shareholding in Telstra (34 per cent) and transferred the first instalment of these proceeds, together with unsold shares, to the Future Fund. The second Telstra sale instalment is due to be received in 2008. By undertaking these transfers the Government will reduce its financial risk relative to holding one single large asset, and will strengthen its financial position by investing in a diversified portfolio of financial assets.

Telstra shares will be held in escrow by the Future Fund Board of Guardians for a period of two years and then gradually sold over the medium-term.

Future Fund

The Government established the Future Fund in 2005-06 with the aim of financing its unfunded superannuation liability — the largest liability on the Government's balance sheet. The Future Fund is expected to offset this liability by around 2020, at a time when fiscal pressures from an ageing population are expected to emerge. The Government released the second Intergenerational Report in April this year which noted that demographic and other factors continue to pose substantial challenges for economic growth and long-term fiscal sustainability.

The Future Fund has now received over $49 billion in contributions comprising $18 billion in seed capital, $13.6 billion from the 2005-06 Budget surplus, and $17.6 billion from the Telstra sale proceeds, bringing the expected balance with earnings at June 2007 to around $52 billion. The Government will consider a transfer to the Fund from the 2006-07 Budget surplus once it is realised. The Government also expects to make a further contribution to the Fund from the second instalment of Telstra sale proceeds.

The Budget assumes that all Future Fund assets, which are currently held as cash and fixed interest securities, will progressively be invested in a mix of cash, fixed interest and equities over the forward estimates. The actual allocation will depend on the investment strategy adopted by the Future Fund Board of Guardians.

Net debt will be affected over the forward estimates as some of the Future Fund's current assets are converted to equities, which are not included in the calculation of net debt. However, in the long term the Future Fund is expected to contribute to an improvement in net debt through growth in its fixed interest and cash holdings (within a balanced asset portfolio).

The Future Fund is expected to improve the Australian Government's net worth in the medium to long term due to an expectation that returns will be higher than those from other assets, such as term deposits held at the RBA.

All States and Territories are now making provision for their unfunded superannuation liabilities (Box 1).

Box 1: State and territory superannuation funding arrangements

All of the States and Territories (the States) have substantial unfunded superannuation liabilities that have resulted from accrued superannuation entitlements from past and present public sector employees. Unfunded State superannuation liabilities are estimated at around $45 billion in 2006-07.

The States have established funds to make provision for unfunded superannuation liabilities now rather than passing costs on to future generations. Annual contributions are typically made from the budget each year to independent trustees who manage the funds. Contributions are based on actuarial assessment with the aim of offsetting the unfunded liability by a specific date. The re-investment of earnings ensures that funds grow over time to help meet the growth in the unfunded superannuation liability.

Western Australia, New South Wales, South Australia and Victoria have established funds to meet their unfunded superannuation liabilities by the years 2025, 2030, 2034 and 2035 respectively. Tasmania expects to meet its superannuation liability by 2033, the Australian Capital Territory by 2030 and the Northern Territory by 2065. Queensland currently has sufficient assets to offset its superannuation liability. In all cases the principal and earnings are retained by the trustees to help fund superannuation expenses as they arise. These funds are not set aside for the purpose of meeting other government priorities.

Higher Education Endowment Fund

The Government will establish a new, perpetual Higher Education Endowment Fund (HEEF) with an initial investment of $5 billion funded from the 2006-07 surplus. The HEEF will be invested to earn income which will be distributed by the Minister for Education, Science and Training, after receiving advice from a panel of experts, to individual institutions for capital works and research facilities on an annual basis. The Future Fund Board of Guardians will be responsible for managing and investing the capital component of the HEEF.

It is intended that capital contributions will be made to the HEEF from future budget surpluses to grow, over time, a Fund which will finance the building of first class institutions in the Australian higher education sector. (See Budget Paper No. 2, *Realising Our Potential*.)

Since the earnings of the HEEF will be spent each year, the impact of the HEEF on net debt and net worth is not expected to change over time.

Higher Education Loan Programme

The Higher Education Loan Programme (HELP), previously known as the Higher Education Contribution Scheme or HECS, is one of the largest financial assets on the

Government's balance sheet. This asset relates to concessional loans that are provided to students so they can defer payment of their student contributions until their income reaches a certain repayment threshold.

The HELP asset currently stands at $12.7 billion and is estimated to grow to $18.0 billion by 2010-11. This includes the impact of the 2007-08 Budget measures in the *Realising Our Potential* package (see Budget Paper No. 2). Due to the broader policy objectives associated with these concessionary loans, returns may be lower than for other assets.

LIABILITY MANAGEMENT

The major liabilities on the Australian Government's balance sheet are the superannuation liability for public sector employees and government debt securities. In 2007-08, these liabilities are estimated to comprise more than three quarters of total Australian Government liabilities.

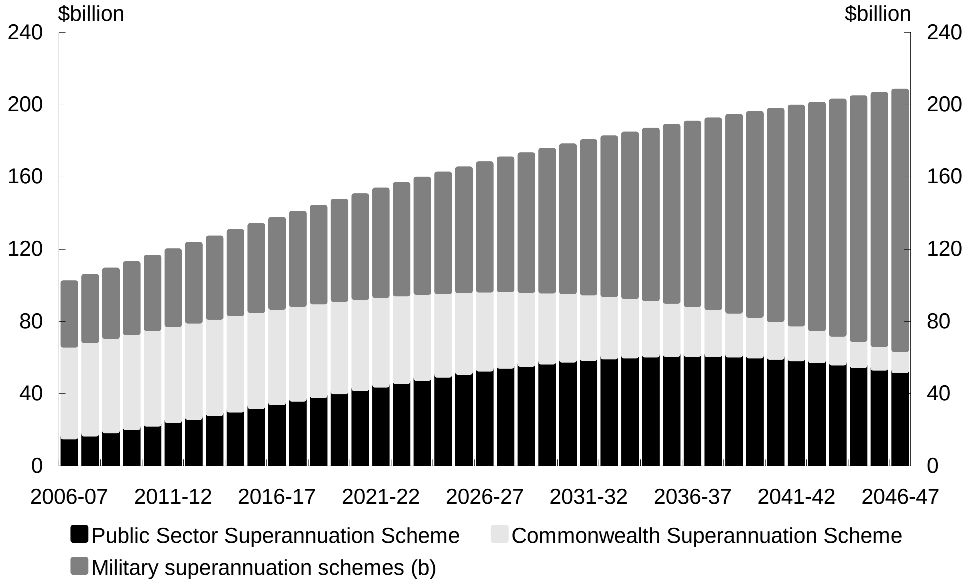
Public sector employee superannuation liabilities

Public sector employee superannuation entitlements relating to past and present public sector employees constitute the largest financial liability on the Government's balance sheet. This liability is currently valued at around $103 billion and is estimated to grow to around $148 billion by 2020.

The Australian Government has never fully funded its superannuation liabilities. However, in 1990 and 2005 the Australian Government closed the main civilian superannuation schemes to new members. From 1 July 2005, the Government introduced the Public Sector Superannuation Accumulation Plan which provides fully-funded accumulation benefits for new civilian employees. Funding employee superannuation entitlements as they accrue contributes to improved net worth over the medium term. Further, the Government also successfully negotiated the extinguishment of its superannuation liability for Telstra and Australia Post in 2004, and its superannuation liability for former Tasmanian and South Australian State Rail employees in 2006. These initiatives are expected to reduce future calls on the budget at a time when significant intergenerational pressures are likely to emerge.

Despite these reforms the existing superannuation liability is expected to continue to grow, largely due to growth in the military superannuation schemes and continued growth of entitlements accruing to existing members of the closed civilian schemes. (Chart 4).

Chart 4: Public sector superannuation liability(a)



(a) The Public Sector Superannuation Scheme and the Commonwealth Superannuation Scheme (the main civilian schemes) and Military superannuation schemes form the dominant part of the Government's total unfunded superannuation liability.
(b) Includes the Military Superannuation and Benefits Scheme and the Defence Force Retirement and Death Benefits Scheme.
Source: Department of Finance and Administration and Australian Government Actuary.

The value of the unfunded superannuation liability has increased since the 2006-07 Budget. This primarily reflects differences between the actuarial assumptions used and the actual experience of both the civilian and military superannuation schemes.

Government securities — issuance in 2006-07 and 2007-08

In line with the review of the Commonwealth Government Securities market in 2002-03, the Government will continue to issue debt, despite a strong fiscal position, in order to maintain liquid and efficient Treasury Bond and Treasury Bond futures markets.

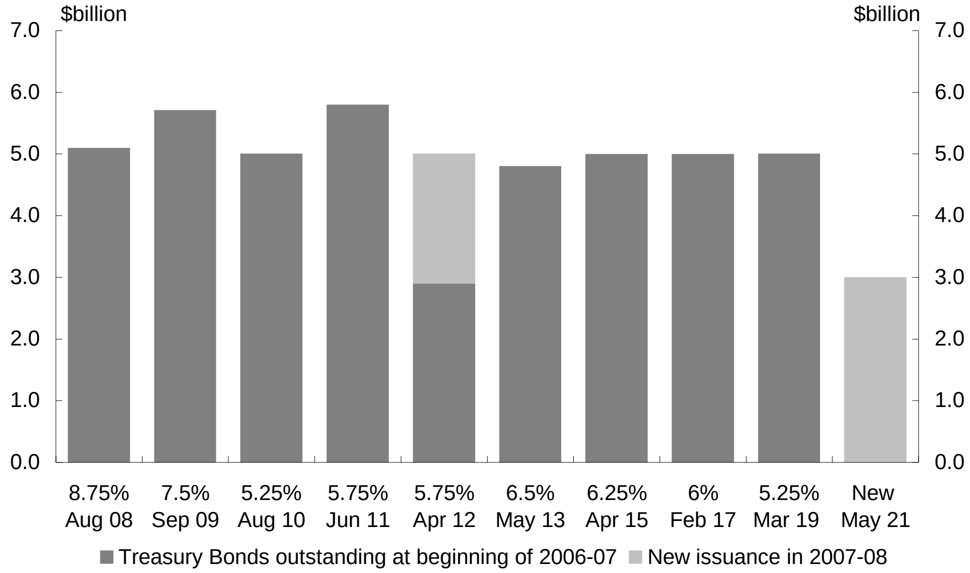
Accordingly, the volume and timing of Treasury Bond issuance takes account of the need to have an appropriate range of Treasury Bonds available for inclusion in Treasury Bond futures baskets. The programme maintains a pattern where new 5-year and 13-year Treasury Bonds are launched in alternate years, with total issuance over two years of around $5 billion in each line.

In 2006-07 one new stock was launched — the April 2012 Treasury Bond. Issuance into this bond line is expected to reach $2.9 billion in the period remaining to 30 June 2007. Issuance in 2006-07 was also directed at building up the March 2019 bond line. A further $2.4 billion was issued in this bond line bringing the total volume on issue for this line to its $5 billion target.

In 2007-08, there will be $2.1 billion of issuance of the April 2012 Treasury Bond, bringing the total volume on issue for this bond line to $5.0 billion. In addition, it is planned to issue a new May 2021 Treasury Bond to support the operation of the 10-year Treasury Bond futures contract. It is planned to issue $3.0 billion of this bond during 2007-08. The remaining issuance necessary to bring this bond line up to $5.0 billion will be undertaken in the first half of 2008-09.

Total Treasury Bond issuance during 2007-08 will be $5.1 billion, while scheduled maturities during this period, net of Australian Government holdings, are $2.9 billion. As a result, the total stock of Treasury Bonds on issue, net of Australian Government holdings, will be around $49.4 billion as at 30 June 2008 (Chart 5).

Chart 5: Treasury Bonds outstanding expected at 30 June 2008[(a)]



(a) Treasury Bonds on issue are net of Australian Government holdings.
Source: Australian Office of Financial Management and Treasury estimates.