Submission No 2

INQUIRY INTO DEBT RETIREMENT FUND

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NSW Treasury submission

Inquiry into Debt Retirement Fund

NSW GOVERNMENT | Treasury

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Executive summary

1. Introduction

We welcome the opportunity to make a submission to the Standing Committee on State Development in relation to its inquiry into the Debt Retirement Fund (DRF). It was established in 2018 through the *NSW Generations Funds Act 2018* (NGF Act) and as part of the NSW Generations Fund (NGF).

This submission provides background information on the establishment of the NGF (and the DRF) and addresses specific issues raised in the inquiry's terms of reference.

2. Background

The use of funds in the DRF is constrained by section 8 of the NGF Act, which states that money in the DRF must be used to reduce State debt, in accordance with the principles of sound financial management set out in the *Fiscal Responsibility Act 2012* (FRA), including:

1. The responsibility and sustainability of spending, taxation and investment
2. The effectiveness of financial and asset management
3. Intergenerational equity.

The objective of the FRA is to maintain the State's triple-A rating[1]. The DRF was established with the intent to support intergenerational equity, by providing an option for future generations to reduce the State's projected burden. The State's[2] financial position when the DRF was established was:

1. a surplus of $1.2 billion
2. interest expenses of $1.8 billion (weighted average bond yield of 3.9 per cent)
3. net debt of negative $10.4 billion
4. gross debt of $38.7 billion.

The State's fiscal position has significantly weakened since 2018-19 due to increased spending for COVID, natural disasters and new policy measures; coupled with a large infrastructure program that is largely debt funded. This led to increased gross debt. The 2023 Pre-Election Budget Update (PEBU) projected the General Government financial position as:

1. a $12.0 billion deficit in 2022-23
2. interest expenses of $4.4 billion (weighted average bond yield of 2.5 per cent)
3. net debt of $79.2 billion
4. gross debt of $129.5 billion.

The State's economic performance in 2018-19 included real GSP growth of 1.9 per cent and unemployment of 4.6 per cent, while national inflation was below the RBA's 2–3 per cent band and the RBA cash rate was 1.25 per cent.

The economic environment deteriorated temporarily due to COVID-19 (and associated restrictions). However, PEBU forecast real GSP growth of 3.75 per cent and

[1] Note that S&P and Fitch use the notation AAA, while Moody's uses the notation Aaa, collectively referred to as triple-A ratings.

[2] General Government Sector.

unemployment of 3.5 per cent in 2022-23. There are now significant inflation pressures and interest rates are materially higher, with the RBA cash rate at 4.10 per cent.

This prompted Treasury to commission a report from EY Port Jackson Partners (the PJP Report) to develop a possible framework to determine contributions to the DRF. The PJP Report was finalised in March 2023 and can be found in Attachment A. Relevant sections are noted in this submission.

3. Response to the Terms of Reference

3.1 The longer-term purpose of the DRF, considering the fiscal outlook

a. In March 2023, the Pre-election Budget Update (PEBU) showed the State's fiscal outlook is challenging. The return to surplus in 2024-25 is precarious and maintaining a surplus requires an intentional response to identify savings and lower gross debt.

b. The State is facing increased levels of expenses, numerous difficult to avoid pressures, significant revenue volatility, a significant infrastructure program that is largely debt funded and rising interest expenses.

c. Higher interest expenses reduce resources available for key services or require increases in State taxes, fees and charges. It also increases the State's interest rate risk and refinancing risks.

d. The State's weak operating position and large infrastructure program are putting significant pressure on its credit ratings (see Attachment B):

   i. Moody's (2022) flagged that "a larger and longer-lasting increase in debt" could lead to a downgrade. Moody's "expect NSW cost of debt to progressively increase given its large funding requirements", with increasing pressure on the State's debt affordability. Treasury notes this will likely put pressure on the State's rating.

   ii. Fitch (2022) flagged that the "failure by the State to control expenditure and return to surplus… could result in downward rating action".

   iii. S&P Global (2023) also flagged downward pressure on the State's credit rating if there is a further delay in the return to a net cash operating surplus.

e. S&P noted in 2021 in a response prepared on 'frequently asked questions' about the DRF that the impact of the former Government's decision "to tip more money into the DRF is that NSW's gross debt and its financial assets are expanding at a faster pace". S&P indicated that by doing so, the State was being exposed to potential market risks, which they factored into their credit assessment by reducing the value of the DRF's financial assets when calculating the State's overall debt burden.

f. It is important to focus on stabilising the State's financial position, with constrained funds available for spending and the reliance on debt. The Government is looking to guide the 2023-24 Budget with a financial strategy that considers the current economic conditions.

g. As the State moves towards stabilising its financial position, the DRF's role in supporting intergenerational equity needs to be balanced against the fiscal risk posed by a large DRF. The primary mechanism for growing the

DRF is the direction of certain revenues into the DRF (including Mining Royalties and State-Owned Corporation Dividends), at the 2023 PEBU.

h. The DRF provides benefits to the State's headline operating position (through higher revenues, less any associated interest expenses), and these benefits can only be used to reduce debt. This may create the perception that Government has discretion to allocate funds to where it's most needed. At a larger size, the DRF may introduce significant volatility through its exposure to financial markets.

i. While a large DRF improves the State's net debt outlook and receives positive consideration from rating agencies in the form of the debt offset, it results in an increase in gross debt. While the State's net debt burden may be less, debt affordability (interest expenses to revenue) will be lower with a large DRF.

j. In addition to the impact of the State's fiscal outlook, the DRF's long term purpose must also be considered in light of Government's broader risk appetite and policy objectives, and other factors that are considered below.

k. These factors in turn require consideration of the optimal sizing of the DRF, when (and when not) to consider contributing additional funds to the DRF and when the DRF should be called on to retire debt.

3.2 Factors to be considered when determining the DRF's optimal size

a. Treasury recommends a holistic approach when considering the optimal size of the DRF that considers how the State manages it's medium and long-term fiscal capacity, size of gross debt, budget sensitivities and the operating position under various economic scenarios.

b. Key metrics that have previously been considered to inform the optimal size include:

   i. General Government (GG) Net Debt to GSP, which measures the overall net debt burden

   ii. GG interest expenses to GG Revenue, which measures debt affordability

   iii. DRF balance to GG Gross Debt. This measures the DRF's capacity to provide an effective and meaningful offset to debt (noting this does not include any adjustments made by S&P)

   iv. DRF investment returns to GG interest expenses, which measures the DRF's capacity to cover borrowing costs

   v. DRF Conditional Value at Risk (CVaR) to GG revenue. This is a measure of how much DRF risk the balance sheet can support.

c. Treasury notes that the State's fiscal position and the economic environment have changed materially since the COVID pandemic, which suggests it is appropriate to consider the adoption of a more conservative approach to contributions into the DRF (see Section 3.3 below).

d. Such a decision would largely mitigate the need to focus on the optimal size of the DRF in the short and medium term. The DRF's size would primarily be driven by the considerations (and metrics) adopted to determine when contributions or withdrawals should be made to the DRF (and the size of those contributions or withdrawals in a given period).

e. The relative size of the DRF will affect the State's credit rating assessments as demonstrated in relevant credit rating opinions in Attachment B.

f. The PJP Report did not consider the optimal size of the DRF and noted the relative overall size of the DRF as one of several factors that should be considered when setting prudent limits on the growth rate of the DRF.

3.3 Appropriate thresholds for further contributions to the DRF

a. When looking at the threshold for contributions to the DRF, the PJP Report notes two relevant considerations:

   i. When to contribute to the DRF?

   ii. How much to contribute to the DRF?

b. This will depend on the risk appetite of the State and how the State operationally defines the threshold for making contributions.

c. Treasury recommends that thresholds are defined using financial metrics that are common across Australian States and our comparable international peers (e.g., operating position, debt position, cash operating position, etc).

d. The PJP Report considered the operating position and cash operating position for three possible options using financial metrics as the basis for any contributions rule:

   i. Net Lending/(Borrowing):

      a. The Government would only contribute to the DRF once all operating and capital funding requirements have been met from operating revenues

      b. Treasury notes that this metric would be the most risk averse approach, with the General Government only achieving a net lending "surplus" three times in the past 20 years.

   ii. Budget Result

      a. The Government would only contribute to the DRF once all operating funding requirements (including depreciation) have been met.

      b. Treasury notes that this would be less risk averse than the Net Lending/Borrowing rule, with the State in surplus 13 times in the past 20 years.

   iii. Net Cash Operating Balance

      a. The Government would only contribute to the DRF once all cash operating funding requirements have been met from cash operating receipts.

b. Treasury notes that this metric is less risk averse than the other two metrics as it would not account for either the funding of new capital or the replacement of the existing asset base (i.e. depreciation).

e. It is recommended that the metric selected should also serve to create the cap on the amount of contributions made – in essence the metric becomes the measure of the State's capacity to contribute in a given year. For example, if a budget result metric was adopted, then contributions in a given year should be capped at the amount of the budget surplus in that year.

f. Treasury also recommends that any budget result metric is calculated after removing the net impacts of the DRF (removing both the investment revenues and implied borrowing expenses of the DRF) – in effect, an 'underlying' budget metric.

g. Even if the threshold for contributions is triggered, Government should retain the discretion to allocate any underlying budget surplus to where this is most needed.

h. This approach removes the need to consider specific sources of funding to provide limits on contributions. Rather the contributions are capped by (for example) the size of the underlying budget surplus and could simply be appropriated on that basis.

i. Limiting DRF contributions to the amount of an underlying Budget surplus would result in a materially smaller fund over the forward estimates (and beyond) compared with previous forecasts.

j. An alternative approach could be to target a desired level of gross debt for the State and to determine the quantum of contributions or withdrawals required to meet that desired level of gross debt.

3.4 Appropriate thresholds for retiring debt using funds from the DRF

a. Section 8 of the NGF Act states that money in the DRF is to be used to reduce State debt, in accordance with the principles of sound financial management set out in the FRA. The FRA principles are there to support the FRA's object – maintaining the triple-A credit rating of the State.

b. The PJP Report notes that there are two possible scenarios under which drawdowns could be considered:

   i. During a fiscal and economic shock. The Government would need to weigh the temporary fiscal impacts of the DRF during a fiscal and economic shock versus the likelihood of having to liquidate investments when asset prices are comparatively low.

   ii. When the State is on negative outlook or credit watch by the ratings agencies. This would be when the benefit of maintaining the DRF (i.e., the debt offset) no longer outweighs the fiscal risk of maintaining a larger DRF. Such an event might occur if rating agencies determine that they should no longer treat the DRF as an offset to the State's debt for ratings purposes.

c. The relationship between long-term borrowing rates and long-term forecast investment returns (with appropriate consideration of the riskiness of those returns) is also a consideration when deciding whether to retain money in the DRF or to repay debt. Other things held equal, when the cost of borrowing for the State is very low, retaining money in the DRF is generally a more attractive option than when the cost of borrowing is very high. The decision to invest in the DRF should be considered with the size of and growth in gross debt.

d. The State previously used the DRF to repay debt in 2021-22 and 2022-23, using the sale proceeds of the State's 49 per cent share in WestConnex, repaying $11 billion of debt over time. The final repayment was on 20 April 2023. The repayments commenced during the delta outbreak. The State did not have to rely on liquidating existing investments to fund the debt repayments because of the WestConnex proceeds.

3.5 Risks and opportunities to consider

a. As noted in earlier sections, key budget considerations related to the DRF (which become increasingly material as the DRF becomes larger) include the reliance of the budget result on DRF distributions, and the long-term interest costs of the State's debt. The volatility of the DRF's distributions, and the corresponding volatility that passes through to the budget result, is therefore an important consideration in conjunction with the Government's risk tolerance for such volatility.

b. Conversely, the DRF does present the opportunity to improve the expected budget position and over the longer term, is expected to have the capacity to offset the State's debt burden.

c. There are other considerations with respect to the DRF, including:
   i. Credit Rating agency assessments
   ii. Increase in general borrowing costs, where the DRF becomes large
   iii. Issues accessing the market when needed, where the DRF becomes large
   iv. The risk of a fall in public confidence.

d. Further information is in Chapter 7 of Attachment A. Importantly, the credit rating analysis in the PJP Report is indicative and hypothetical and the "AAA thresholds" indicated in the PJP Report are EY Port Jackson Partners' views and do not represent the views of NSW Treasury or the credit rating agencies. The Credit Rating agencies opinions, bulletins and FAQs included in Attachment B note any risks that they consider with respect to the DRF.