REPORT OF PROCEEDINGS BEFORE

GENERAL PURPOSE STANDING COMMITTEE No. 1

INQUIRY INTO THE NEED FOR A MINI-BUDGET

At Sydney on Thursday 9 October 2008

The Committee met at 10.00 a.m.

PRESENT

Reverend the Hon. F. J. Nile (Chair)

The Hon. Amanda Fazio
The Hon. K. F. Griffin
The Hon. Dr J. Kaye
The Hon. M. R. Mason-Cox
The Hon. M. J. Pavey
The Hon. Greg Pearce
The Hon. P. G. Sharpe

CHAIR: Welcome to the first public hearing of the inquiry into the need for a mini-budget. Today we will be hearing from officials from the New South Wales Treasury. We were happy to have the Treasurer, the Hon. Eric Roozendaal, appear as well and he has sent the Committee a letter, which I will read.

The Hon. MELINDA PAVEY: Which was received on Tuesday.

CHAIR: It is dated 7 October 2008, and it states:

> Thank you for your letter inviting me to appear at the Legislative Council Standing Committee No. 1 (GPSC1) inquiring into the need for a mini budget.
>
> Unfortunately I will be unable to attend any hearing that takes place on Thursday 9 October, as this day falls on an important Jewish holiday. This holiday, Yom Kippur (Day of Atonement), is the most important date in the Jewish calendar, and requires members of the Jewish faith to abstain from certain activities including working, eating and drinking. One of the Treasury officials that you have invited, Mr Michael Schur, is unable to attend for the same reason.
>
> However, Treasury officials will be available to assist the inquiry.
>
> It should be note that I will be appearing at the budget estimates hearing of GPSC1 the following Tuesday (14 October). This would be an ideal opportunity for committee members to ask questions of myself and senior Treasury officials.
>
> Yours sincerely
> THE HON ERIC ROOSENDAAL MLC
> Treasurer

I apologise on behalf of the Committee for not noting that this day is Yom Kippur when the date of the hearing was selected. The Committee chose the latest possible date to allow time for you to prepare material. That was the main priority.

The Hon. MELINDA PAVEY: And we would have considered having the hearing tomorrow had we been given more notice that the Treasurer was unable to attend.

CHAIR: The Committee has previously resolved to authorise the media to broadcast sound and video excerpts of its public proceedings. In accordance with the guidelines, members of the Committee and witnesses may be filmed or recorded. However, people in the public gallery should not be the primary focus of any filming or photographs. In reporting these proceedings, the media must take responsibility for what they publish or what interpretation is placed on anything that is said before this Committee. Witnesses, members and their staff are advised that any messages should be delivered through the Committee clerks. Please turn off any mobile phones during the proceedings.

I welcome our first witnesses representing the New South Wales Treasury, including the Secretary of the Treasury, Mr John Pierce; the Deputy Secretary of Fiscal Economics, Mr Kevin Cosgriff; and the Deputy Secretary of Budget and Finance, Mr Mark Ronsisvalle.

PIERCE, JOHN, Secretary, New South Wales Treasury, Governor Macquarie Tower, 1 Farrer Place, Sydney;

RONSISVALLE, MARK, Deputy Secretary, Budget and Finance, New South Wales Treasury, Governor Macquarie Tower, 1 Farrer Place, Sydney;

COSGRIFF, KEVIN, Deputy Secretary, Fiscal and Economics, New South Wales Treasury, Governor Macquarie Tower, 1 Farrer Place, Sydney; sworn and examined:

CHAIR: Thank you for appearing. We appreciate that you are very busy preparing the mini-budget, and the Treasurer has raised that point with me a number of times.

Mr PIERCE: Thank you.

CHAIR: The Committee felt that it was important that this inquiry be held, so it has proceeded. Do you wish to make an opening statement?

Mr PIERCE: It might be helpful if I make an opening statement. First, thank you for the opportunity to address the Committee and perhaps to explain a few things. When the Government decided to have a mini-budget, it had three somewhat related issues on the table: First, the lack of parliamentary approval for the electricity transactions; secondly, the emergence of risk to the budget operating results due to pressures on both revenues and expenses; and, thirdly, and perhaps most importantly, Standard and Poor's revising the outlook for the State's credit rating from stable to negative.

Perhaps the best way to explain why the mini-budget was seen as necessary and how these three things are interrelated would be to go through why Standard and Poor's has changed the outlook, because that then suggests the framework for the mini-budget and the things it would seek to achieve. Similar issues to those raised by Standard and Poor's have also been raised by Moody's, the other rating agency we deal with. A Moody's executive recently told me that triple-A governments normally have stable political environments, stable debt levels and stable economies. However, that is not what they see when they look at New South Wales at the moment.

Unlike Standard and Poor's, Moody's has maintained a stable outlook, but it has done so on the expectation that the mini-budget will contain sound policy responses, particularly to the first two issues to which I referred. The essential difference in the approach taken by the two agencies is that one is saying, "You are on a negative outlook. Now show us what you are going to do in response to those issues." The other is saying, "Show us what your response is and then we will express a judgement." In both cases, there is an expectation of a response to the first two issues in front of the Government.

When we have these discussions about ratings processes it is worth keeping in mind three things. The first is that it is a rating of the credit risk of government—that is, government with a small g. It involves things like governance structures, institutional arrangements and federal-state relations. They are all relevant. Secondly, it is a forward-looking process. However, it is not only about the economics and the financial numbers; it is also about the confidence that the rating agencies have that government will act in a manner consistent with a particular rating and that it can demonstrate flexibility in its finances to cope with things that emerge over time that may not have been known about beforehand. Thirdly, when it does come to the financial numbers, in particular, the scope is the total public sector. It includes the public trading enterprises, not only the general governance sector, which tends to be the focus of the state budgeting process.

Why has Standard and Poor's revised the outlook to negative? On 23 September it rather helpfully tried to explain that in a public way. I will quote from part of the statement put out at that time. It asked the question, "Why did S&P's change the outlook to negative on 28 August", particularly given that just a week before it affirmed the rating and the outlook as stable. The statement reads:

> The risk associated with a failure in the proposed privatisation of the electricity assets was foreshadowed when we affirmed the rating on August 21. We noted at the time that the stable outlook reflected our expectations that the State would deliver its assets sales and other credit metrics would not deteriorate beyond forecasts.

"Other credit metrics" is credit rating language for meeting budget. The statement continues:

> At that time we further noted that in the event that assets sales were not achieved there would be negative pressure on credit quality in two ways. Firstly, no sales would be likely to require the reprioritisation or deferment of the capital program, or an increase in debt to accommodate about $15 billion of investment in the electricity sector by June 2020. Secondly, it may call into question the Government's ability to enact difficult or unpopular decisions in the future.

It gave two reasons for the change in outlook. In relation to the electricity transactions, there are two impacts on State finances. These two impacts were spelt out in some detail in the Owen report, which is now more than 12 months old. The first relates to the proceeds of the transactions. Owen used a figure for net proceeds of around $10 billion to illustrate that there were these two effects. Obviously, the first effect of the proceeds of around $10 billion used in that report, is to reduce the State net financial liabilities, whether those proceeds are put into financial assets or used to reduce gross debt. There are differences between the two but the essential effect is to reduce financial net financial liabilities.

In accordance with past practice when we are dealing with business sales, those proceeds were not included in the budget numbers or in the budget that was presented. While the rating agencies noted that the proceeds would provide additional fiscal flexibility into the future, they told us that they did not factor it into their assessments at the time. In fact, they told us that they expected surplus proceeds beyond that which were necessary to replace the loss of dividends from the business, to be used to fund future capital investment that currently was not committed to and that that would happen at some time in the future. Essentially, the proceeds side of the impact of the transaction was put to one side—both in the budget and by the rating agencies.

The second impact—again this was spelt out as part of the central argument in the Owen report—was the avoidance of the need for the public sector to investment in the generation and retail sectors. Although the proceeds from the transactions would have strengthened State finances, that was not being relied upon when putting the budget together or by the rating agencies when they were looking at the quality of our credit. Rather the major driving factor behind the rating agencies' concerns is the public sector's longer-term exposure to the cost of new investment in the generation and retail sectors.

Professor Owen's report estimated that the cost of that new investment was somewhere in the range of $12 billion to $15 billion over the next 10 to 15 years. It was made up of three components: $7 billion to $8 billion for building of new power stations; $3 billion to $4 billion to improving the environmental performance of the existing fleet of stations—although that $3 billion to $4 billion was factored in very much at the back end of that time frame and not an immediate issue; and $2 billion to $3 billion to maintain the ongoing viability of the retail businesses—effectively the argument was if the Government was going to be in these businesses then they needed to be successful and in order to be successful they needed to pursue upstream gas positions, develop their own gas turbines and start to integrate their business to manage their risks.

Professor Owen's report pointed out that if the public sector funded all this investment then the total State debt as a share of the economy would exceed 14 per cent by 2020. It was noted at the time, that was similar to the levels that New South Wales had when it was on credit watch from Moody's for a possible downgrade in 1991. In this regard the current concern being shown by the rating agencies is consistent with Professor Owen's findings and the fact that the rating is under pressure, given that those transactions are not happening, is not a surprise. It is a bit of a surprise at how quickly Standard and Poor's responded; it is certainly not a surprise that the two rating agencies are raising concerns. The Government was quite explicit about this. In fact in the Budget Papers it was noted that if the Government were to fund the electricity investments in order to keep the electricity supply secure it would have to re-prioritise existing capital programs.

So what do we do? The extent of the re-prioritisation that is necessary is then governed by the extent that a revised electricity strategy is able to remove the need for the public sector to invest in the generation and retail sectors and to replace that with private sector investment. On 29 August the Government announced a revised strategy for the sale of the retail businesses and generation development sites. The revised strategy will eliminate the need for the public sector to fund the cost of maintaining the competitiveness of the retail businesses—that is a component of that $12 billion to $15 billion amount. The new owners of the retail businesses, particularly if they have access to the sites that currently sit within the public sector, will have an incentive to build new generation capacity in order to manage the risks of being in the business. However, the real question is the extent to which that investment will obviate the need for the public sector to make other investments in the generation sector.

That is something we are assessing at the moment as part of the further development of the electricity strategy and of the mini-budget, given that we will need to have an estimate of that in order to then define the extent of the re-prioritisation of the rest of the capital program necessary to make room for whatever is left for the public sector to do in the generation sector. Again, consistent with the findings of the Owen report, it would not be prudent to rely on the private sector making all of the necessary investments in baseload electricity generation while the Government maintains a significant presence in the generation sector. Hence the mini-budget will need to provide the State with the fiscal flexibility to both upgrade the environmental performance of the existing stations and to deliver the necessary new generation investment and the size of that is something we are assessing at the moment in the lead up to the mini budget.

The electricity sorts of issues are not the only questions that are being asked of us by the rating agencies. Other questions go to the flexibility in the capital program that the Government has published; the adverse effects of the slowing economy; the downturn in the housing market on State revenues; and the continuing pressure on expenses, principally due to wages. As we have made explicit in the Budget, the Budget is predicated on both the adherence to the Government's wages policy and the achievement of efficiency dividends across agencies. The rating agencies have also raised with us how we are going to manage the incremental risk associated with continuing to own the electricity generation assets—that is a point I might come back to. The final point the agencies have been raising is around the confidence they can have in the ability of the Government to implement reforms, given that the political situation that manifested itself during the electricity debate.

The budget itself is presently facing a number of challenges in addition to those presented by what has happened in the electricity area. As I mentioned, the capital expenditure profile in the State Infrastructure Strategy, which projects the capital expenditure beyond the four-year forward estimates period in the Budget, is being reviewed to provide more flexibility to deal with continuing public ownership in the electricity generation sector but there are also other projects that have been discussed that have not been committed to in terms of dates and dollars and hence are not in the budget numbers, such as the proposed Western Metro, the M4 East, augmentations to the M5.

The rating agencies are aware of these projects having been discussed and hence when they add them on to our existing capital program and allowance for additional investment in the electricity sector, the inclusion of those additional capital projects on top of the pre-existing State Infrastructure Strategy creates an increasing debt profile that the rating agencies regard as unsustainable. I should note that a lot of those additional projects that have been spoken about: the Western Metro, the M4 East, and the like, are the ones that the Government is discussing with Infrastructure Australia to see the extent to which Federal funding may be available for those projects in the future.

On the recurrent side, the mini-budget will also need to address revenue and expense pressures which have intensified since June 2008. The budget surplus for 2007-08 will be significantly weaker than we expected when we brought down the 2008-09 budget. When the budget was delivered in early June we were estimating a surplus of around $700 million for the general Government sector. It is now apparent that the surplus will be less than expected, principally because of the increased health expenses.

Looking forward, the outlook for the budget forward estimates has deteriorated. The revenue estimates that we included in the 2008-09 budget and over the forward years reflected an expectation of slower economic conditions in 2008-09. The transfer duty revenues, for instance, budgeted for in 2008-09 were around $300 million dollars lower than the previous year. So we were factoring in a slowdown but the extent of that slowdown has been sharper than we expected. Compared to the budget numbers we are currently running at around $270 million below budget for the first three months of the current financial year. So we were expecting a slowdown and we got that plus some more.

The deflating property transfer revenues and—I should also probably add—the reduced investment returns are arguably cyclical events caused by the current economic slowdown and compounded by the dislocation in the financial markets. These cyclical events really only represent a concern to the rating agencies, if the State's finances do not have sufficient buffer built into them to withstand a temporary increase in debt. Our medium-term fiscal strategy aims to maintain service delivery despite these types of temporary economic or fiscal shocks that inevitably occur from time to time. Essentially a strong balance sheet means you can let debt fluctuate in response to those cyclical changes in revenue or, indeed, in expenditure without resorting to making adjustments to services or taxes. If, however, the structural changes to the budget limit the extent to which debt can temporarily be increased, having to invest in generation capacity is structural change, then the cyclical events compound on top of the structural events to cause the concern.

A key structural issue for us, of course, is the wages policy. The budget was based on the Government's policy of maintaining in real terms the value of wage rises that public sector employees have enjoyed over the last decade—this was quite extensively covered in the budget. Under that policy the growth in budget funded wage rates is limited to 2½ per cent. Wage rates can still rise more than 2½ per cent but agencies must fully fund any increase above 2½ per cent through employer-related cost savings. The Budget Papers highlighted the sensitivity of the budget result to the wages policy. It is certainly something that the rating agencies have been aware of and at the moment we have a number of agreements which have yet to be released, principally the most important ones for the budget are teachers and police.

So what does the mini-budget need to achieve? Standard and Poor's have already indicated that the mini-budget is a key issue in any decision to return the outlook to stable or to downgrade. One of the most important measures used to assess our creditworthiness by Standard and Poor's is the ratio of total State net financial liabilities—that is net debt and unfunded super that sits in both the general Government sector and the public trading enterprises to total State revenue. So it is not just general government revenues, it also includes the revenues from the public trading enterprises.

It is a relatively simple measure and it is certainly not the only thing that is looked at, but it is a useful indicator of what our debt carrying capacity is, and it indicated that for New South Wales the sort of trigger point for a downgrade is in the range of 120 to 130 per cent. So net financial liabilities being 120 to 130 per cent of the total State revenue. That is a specific New South Wales number and it takes account of the diversity of our economy and the nature of our tax base. It will be a different number for other States, so I would expect that for Queensland and Western Australia, for instance, given the narrower economic base, and the greater revenue volatility and exposure to commodity prices in those jurisdictions, that number could be lower.

Our current budget estimates contained here show that ratio, as Standard and Poor's measure it, increasing over the forward estimates period, but remaining below that 120 per cent level by the time you get out to the end of forward estimates period. So essentially the budget projections keep us below that level, but then the rating agencies look at the State Infrastructure Strategy and the continuing increase in capital expenditure beyond the forward estimates, the rate of increase in net debt that we have been experiencing in recent years and are projected to have in the future, then they add on the level that might be associated with investing in electricity generation. They are aware, as I said, of projects being discussed that currently are not in our numbers, and when they add that up together that is what brings us above the 120 per cent number and causes them to say, "What are you going to do to adjust?"

It is important to realise that it is not just the level that causes concern it is the rate of growth. Essentially, you might be below that trigger level but if you are driving a car at 100 miles an hour we cannot expect you to stop within 50 metres. So we need a sustainable rate of growth in the net debt level even though we might be below the ceiling, which is an indication of the sort of thing we are trying to achieve in the mini-budget—a lower rate of growth in net debt and a sustainable level so that people can see we are not going to rise above that 120 per the number that the rating agencies have determined.

There has been a lot of focus on achieving those debt numbers through re-prioritisation of the capital program, and no doubt there will be a significant element of that. I should point out that there are really three paths to the achievement of any particular debt number: yes, the capital expenditure number, but also the size of the operating result, the size of the budget result, and, thirdly, any proceeds from asset sales or business sales. They are effectively the three levers that are available in order to achieve a particular debt number, and there are trade-offs between them. The stronger the operating results and the more of your capital you can fund from your current revenues the lower the level of re-prioritisation of the capital program that will be necessary, and vice versa. So the mini-budget is not just about re-prioritising your capital program it is about putting in things we are working on at the moment, about building a greater degree of confidence in the operating results so that we have operating results that can support the capital program that we have.

There are a number of other budget type rules that are guiding us. The first is that it is necessary to maintain the budget operating result or the budget result in surplus. Rating agencies have made it clear that triple-A rated States do not run operating deficits—this stands to reason. Running structural deficits essentially means that you are borrowing to pay for recurrent expenses like wages and interest costs, and that is not sustainable. That is not to say that the budget cannot go into deficit temporarily as a result of cyclical events. What is important is that the budget is in surplus over the course of an economic cycle. The size of that surplus though is a variable that is determined by both the size of the capital program and the size of any asset sales.

The second, I suppose, rule is that expense growth should not exceed the sustainable revenue growth over the economic cycle. This was an issue in the 2006 Audit of Expenditure and Assets where it found that weaker operating results were due to expense growth outstripping trend revenue growth, and there has been a strong emphasis since then on cost control and in ensuring that budget expenditure and actual expenditure equal one another, which has essentially been able to be achieved over the past three years and it is something that both rating agencies cite to us as a strength in the credit.

I suppose the third rule is that the general government net debt also needs to grow in line with the sustainable revenue over the economic cycle—certainly grow no faster than the rate of growth of the economy, given that that debt eventually has to be paid out of general government revenues. As we have spoken about here before, the fourth element that we work with is the need to take account of decisions made about revenues and expenditures today and their impact over the longer term. Work that was done on this to underpin the Owen Inquiry and the State Infrastructure Strategy—before all that we published the Long Term Fiscal Pressures report in the budget a number of years ago now, which was really looking at the effects of demographic changes and the ageing of the population on growth of the economy and on the budget. We are always mindful of the pressures those demographic effects are going to have on the budget in the future and we need to make allowances for that.

Just in conclusion, I should point out that the mini-budget in and of itself, irrespective of what it contains almost, will not be sufficient to have the negative outlook removed. Standard and Poor's have been clear about that. They have indicated that it is really important to demonstrate "the Government's ability to enact and implement the decisions that are contained in the mini-budget". The Government has given every indication that it is determined to retain its triple-A credit rating and remains committed to the fiscal strategy that is consistent with that rating, to maintain a balance sheet that is consistent with that rating and to have State finances put on a path that is sustainable over the longer term, not just because it is nice accounting numbers—not even because of that—it is because that sustainable position of the State finances allows us to maintain a sustainable rate of growth in service delivery over time. And at the end of the day all this financial stuff is really about having the resources available to sustain service delivery. Thank you for your time. We are happy to take any questions that people may have.

CHAIR: Thank you very much for that very comprehensive introduction. You have covered many matters. Just to re-emphasise one point you made and to clarify it, you said that the negative outlook in the credit rating and the correspondence you quoted were the major factor in the failure of the Government's plan for the reorganisation of the electricity industry?

Mr PIERCE: It was the trigger, and, as I said, we always expected that if those transactions did not happen that the rating agencies would be asking questions about the rating. As I said, we had in the budget papers quite explicitly that if it did not happen there would have to be re-prioritisation of the capital program. The surprise, I suppose, was really just how quickly they did that rather than it becoming obvious that the electricity transactions were not going to happen and then asking us, "Okay, what are you going to do?" and then seeing what we are going to do and passing a judgement, which was the approach that Moody's have taken. They put us on negative outlook straightaway and they changed the onus of proof, if you like.

CHAIR: Because they were anticipating it was going to proceed?

Mr PIERCE: Yes. They were quite explicit about that when they affirmed the rating. It was affirmed on the basis that it would proceed.

Dr JOHN KAYE: That is the 31 August affirmation, is it?

Mr PIERCE: No, it was 21 August.

CHAIR: You would know, of course, the former Treasurer Michael Costa, gave a fairly dramatic press conference on his view of the financial situation facing New South Wales with the blow-out in expenses in the hospital budget. He referred to a $300 million increase in the hospital budget over a very short period and a reduction in stamp duty. Was that an accurate presentation or crying wolf?

Mr PIERCE: The $300 million for health is accurate, and I was referring to that in the opening statement.

The Hon. MELINDA PAVEY: When did Cabinet know of that $300 million blow-out?

Mr PIERCE: I am not entirely sure when they knew about it.

The Hon. MELINDA PAVEY: Was Treasury provided briefings on that?

Mr PIERCE: We knew about it after the end of the financial year.

The Hon. GREG PEARCE: Which financial year?

The Hon. MELINDA PAVEY: July?

Mr PIERCE: After July. So after the budget and after the end of the financial year.

The Hon. MELINDA PAVEY: So the Treasury knew in July and blew the whistle in August in the dramatic exit?

Mr PIERCE: It was mid August as they were finalising their accounts.

The Hon. MELINDA PAVEY: What about the $300 million at the end of the financial year? Had there been any indication from Health to Treasury officials about the trend?

Mr PIERCE: As we were preparing each year's budget of course we were consulting with agencies and monitoring them about how they are going in that particular financial year. Up until the time of budget and the start of the finalisation of the State accounts the advice from Health was that they would be consistent with what we published in the 2008-09 budget for 2007-08. In terms of the numbers they were giving us that is what they were saying. They did raise some concerns and issues just indicating the sort of pressures that they were under, but the advice was they would be coming in with the result that was consistent with what we published in the budget.

The Hon. GREG PEARCE: Just to clear that up, you say you only became aware of this $300 million after the end of the financial year? Well then, what was Mr Costa talking about on 30 May 2008 when he said, "New South Wales is going backwards by about $300 million a year to fund rising health costs associated with the growing population"? That was in the *Daily Telegraph* on 30 May 2008.

Mr PIERCE: I would have to see the rest of the context. I am not specifically aware of that. It could just be a general comment about the state of health funding generally.

The Hon. GREG PEARCE: Just a very convenient $300 million that Mr Costa knew about but you did not?

Mr PIERCE: As I say, I would have to see the context to square the circle for you.

The Hon. GREG PEARCE: You have made a number of statements about the Owen report and your reliance on the report and the ratings agencies' reliance on it, and looking at the funding scenario in the Owen report, how much of the expected expenditure for generation was in the current estimates period to 2012?

Mr PIERCE: Given I would have to look at the report—

The Hon. GREG PEARCE: I pass it over to you.

Mr PIERCE: The report talked about the need to be prepared for, and the words "prepared for" are important, generation investment to be available, new baseload generation to be available, by 2013-14, I would have expected that there would have been a fair amount of it—

The Hon. GREG PEARCE: Perhaps you could look at the scenario, which is the Owen report scenario, which says no expenditure on generation until 2014-15.

Mr PIERCE: Yes, 2014-15 on this graph.

The Hon. GREG PEARCE: That is the graph that you are relying on?

Mr PIERCE: Yes, well that is—

The Hon. GREG PEARCE: So 2014-15 is the first expenditure on the new baseload generation capacity, according to Owen?

Mr PIERCE: I would have to look at the relationship between the quantity and the—

The Hon. GREG PEARCE: Have you not looked at the Owen report before, Mr Pierce?

Mr PIERCE: Yes, but that specific question—

The Hon. GREG PEARCE: That is the funding scenario out of the Owen report. It is in your hand. You must have seen it before?

Mr PIERCE: Most certainly.

The Hon. GREG PEARCE: Yes. It says that expenditure on new baseload generation capacity starts in 2014-15.

Mr PIERCE: That is what the graph says; there is another explanation if the—

The Hon. GREG PEARCE: Another explanation?

Mr PIERCE: Earlier in the report in relation to the debt levels that I was referring to, there are graphs that show a base case and an increase in net debt consistent with the investment profile that was embedded in Owen and the effect of the proceeds on that net debt. Those changes started around about now, and then grew over time—

The Hon. GREG PEARCE: So, how much money has to be put aside in the current budget estimates period to 2012 to fund the new baseload generation, assuming the Government had to pay the lot?

Mr PIERCE: I do not have a figure for you. That is one of the things that we are assessing at the moment for the mini-budget. The forecasts embedded in Owen are, um,—

The Hon. GREG PEARCE: They are outside the current estimates period, are they not? So when we are reprioritising the capital expenditure for electricity, how much of that will be reprioritised in the current budget estimates period?

Mr PIERCE: I do not know the answer to that, because that is the work we are doing at the moment. I make the point that whilst the major focus of the ratings agencies is over the forward estimates period, for all the States including New South Wales, they do look at what is coming around the corner—

The Hon. GREG PEARCE: That is right.

Mr PIERCE: —and what is coming beyond the forward estimates period and they get an indication of what that is by looking at the State Infrastructure Strategy. So the world does not end at the end of the forward estimates period.

The Hon. GREG PEARCE: But the mini-budget ends at the end of the current estimates period.

Mr PIERCE: But the mini-budget—

The Hon. GREG PEARCE: It is not going to cover electricity generation at all, is it?

Mr PIERCE: No, but—

The Hon. GREG PEARCE: "No", thank you.

Mr PIERCE: The mini-budget will need to have a view of the 10-year capital program to work out what you can do over the first four years.

The Hon. GREG PEARCE: Correct, "a view". You are really talking about a change to the 10-year State Infrastructure Strategy to pick up potentially some costs in baseload generation?

Mr PIERCE: I will know the answer to that when I finish the mini-budget.

The Hon. GREG PEARCE: When you finish the mini-budget. Given the ratings agencies, at least Standard and Poor's, were so concerned about this, I find it really difficult to understand how you would not have done this sort of work earlier. Did the Government simply gamble that you would get through the sale of electricity and so that was the reason that there was no allowance for any baseload expenditure in the State infrastructure strategy, the $140 billion strategy, that was put out earlier this year? Was it just a gamble? It was a gamble that you would not have to pay for it?

Mr PIERCE: As I said in my opening statement: one, the proceeds were not factored into the budget, and, two, the fact that the investment in generation, not just generation but in the competitive sectors that would be necessary, were quite explicit; the capital program was built on that assumption. If that assumption turned out to be incorrect the capital program would have to be adjusted.

The Hon. GREG PEARCE: The capital program after the current estimates period, after 2012?

Mr PIERCE: As I say, I will know precisely the weight within the current estimates period and beyond the estimates period after I have finished the mini-budget. The two need to be consistent with one another. As I referred to before, you need a sustainable rate of growth over not just the forward estimates period but beyond. For me, is not just the forward estimates period, it is beyond and the two have to be consistent with one another. You cannot have—

The Hon. GREG PEARCE: You do not need a mini-budget to change—

Mr PIERCE: Let me finish. You cannot have debt increasing significantly with rapid rates in growth over the forward estimates period and then have the St Augustine defence of trust us, we will slow it down later on.

The Hon. GREG PEARCE: That is what you have just done in the past two budgets, at least. That is exactly what you have done with the two infrastructure strategies where you have left out electricity. That is exactly what you have done.

Mr PIERCE: Very explicitly, and the consequences of that assumption not being met was also stated.

The Hon. GREG PEARCE: Exactly. The Government gambled.

Mr PIERCE: The Government.

The Hon. GREG PEARCE: Yes, the Government, not Treasury officials. You mentioned the net financial liabilities to debt ratio. You did not actually quote what Standard and Poor's said about that, and I will quote it. They said that the trigger did not lead to the negative outlook, rather the negative outlook reflected our uncertainties surrounding New South Wales other credit metrics, specifically the State's reduced fiscal flexibility, potential upside risk to the State's expenditure projections, negative operating position, weakening economy, historical difficulty and obtaining operating costs within budget, and so on.

Mr PIERCE: They are factors that I have also referred to.

The Hon. GREG PEARCE: You did refer to them in passing. These things have been concerns of the rating agencies for several years, in terms of the way that the budget has been managed.

Mr PIERCE: If you go back more than three years ago, the judgement would have been that the aggregates are fine, more than fine, but they were raising issues about the difference between budget and actual expenditure, not because that tendency at that time was having a material effect on the aggregates. They were raising that as the rate of growth of revenues slows, the bottom line will be affected by that difference between budget and actual expenditure and, as I said, over the past three years essentially those two things have been brought in line—the difference between those two numbers has been extremely small and the change in that trend from there being differences between the budget and actuals having three years whereas they were essentially the same has been raised with me by both the rating agencies as something that underpins the strength of the credit. It would be natural from their perspective to raise concerns about that; i.e. that it continues. In fact, Moody's in particular has asked whether the new Treasurer and Premier will be as diligent about that as the previous Premier and Treasurer.

The Hon. GREG PEARCE: They never achieved it.

CHAIR: Mr Pearce, what is the document you are referring to?

The Hon. GREG PEARCE: It is the same document that Mr Pierce quoted from, the Ratings Direct Report, dated 23 September 2008.

Mr PIERCE: This difference between budget and actual expenditure is reported in each budget paper in appendix D and is written about in the front of the budget papers.

The Hon. GREG PEARCE: We will come back to that, my colleague may ask you about that. You mentioned that the State's fiscal strategy which in the medium term was to sustain services by allowing debt to fluctuate when financial circumstances change, which is exactly what is happening now.

Mr PIERCE: Yes.

The Hon. GREG PEARCE: Why is it that current problems are not been addressed by your medium-term fiscal strategy, which you explained at length before and instead you will have to have a mini-budget?

Mr PIERCE: The main reason is because what we are facing is not just a cyclical event; it is also the structural issues associated with the electricity investments on the one hand and—and this is something we are still assessing—the time period that we could expect a cyclical event to endure for. If we had a structurally balanced budget, balance sheet, that could be sustained for quite a time. But we are still assessing how long we might expect—

The Hon. GREG PEARCE: Would that have been the case if the Government had complied with its targets, is fiscal responsibility targets, its legislative targets, and stuck to the strategy?

Mr PIERCE: One point to note is the fiscal strategy targets, the Fiscal Responsibility Act targets, are for the general government sector. They exclude the public trading enterprises sector—

The Hon. GREG PEARCE: So it is worse with public trading enterprises?

Mr PIERCE: —and what the ratings agencies are looking at. Really, it is only this year that they have been explicit about the total financial liabilities of revenue ratio with us and with other jurisdictions. So, the target we are working to at the moment is a total State target rather than a general government target. It is conceivable that even with achieving the Fiscal Responsibility Act targets for the general government sector, given what is happening in the public trading enterprise sector [PTE]—i.e. electricity, and also potentially other investments in other PTEs—that even with that general government target having been met—

The Hon. GREG PEARCE: But you have not met the target.

Mr PIERCE: Yes, I am explicit about that. The rating agencies would still raise concerns because the build-up in Capex is primarily driven, not solely, but the rate of growth certainly over the next couple of years is projected to be in the public trading enterprise sector and the electricity sector is obviously in the PTE sector, and the—

The Hon. GREG PEARCE: You speak as if this is a surprise. This has been your budget for the past three years, at least?

Mr PIERCE: No, I thought I went to pains to point out that this is not a surprise, it was indicated and talked about at least for 12 months beforehand.

(Short adjournment)

Dr JOHN KAYE: Mr Pierce, you spoke about the 1991 downgrading of our credit rating, the State's credit rating—

Mr PIERCE: No, if I may. We were on credit watch. We did not get downgraded.

Dr JOHN KAYE: You said part of the cause of that was that the public sector debt, which includes the government trading enterprises, or their equivalents in those days, blew out to 14 per cent of gross State product. I think shortly after that you had a job with what was known as the Electricity Commission of New South Wales and I seem to recall the reason for that was overexpenditure on two large base load generators, Bayswater and Mt Piper. At that stage Mt Piper was sitting by unused. Is it not true that that particular episode with our credit rating was a result of people getting overenthusiastic about the need for base load generators and borrowing to build those base load generators and blowing out the total public sector debt?

Mr PIERCE: As I think you would be aware, Dr Kaye, in the mid-1980s—1986 from memory—there was a thing called the McDonell inquiry. Peter Cox was the energy Minister at the time, and he commissioned an inquiry to review the investment plans for electricity generation at the time.

Dr JOHN KAYE: Actually, it was the late 1980s.

Mr PIERCE: I think the report was 1986.

The Hon. GREG PEARCE: Who was the author again?

Mr PIERCE: Gavan McDonell.

The Hon. GREG PEARCE: A relative of Professor Owen?

Mr PIERCE: No.

Dr JOHN KAYE: The other side of the equation, independent of Treasury.

Mr PIERCE: The result of that was to shelve a number of power stations that the Electricity Commission was planning to have constructed at the time.

Dr JOHN KAYE: And to put Mt Piper into mothballs.

Mr PIERCE: One of the outcomes of that was that Mt Piper, rather than being planned as four by 660, was cut in half effectively. It became two by 660 because the contracts had already been let for the first two. There were discussions with Victorians over Loy Yang, and an attempt made to use the excess generation capacity in New South Wales to supply to Victoria. That did not happen and it was really the Genesis of why we now have a national electricity market to share the generation capacity—

Dr JOHN KAYE: The point being it did leave the State—

CHAIR: Let the secretary finish his answer.

Mr PIERCE: The Curran inquiry into State finances, the audit that followed that, did comment on the debt associated with the electricity sector. That is true. The number was $6 billion, if I recall, and that would have been in the numbers associated with the early 1990s. But, like now, and this needs to be emphasised, it was not the only thing that was going on. I am not as familiar with what was happening with the rest of the public sector, although Mr Ronsisvalle certainly lived through that, but it was also the beginnings of an economic slowdown, what I refer to as a fair dinkum recession, during that time. So, it is a compounding effect of those three things that was the trigger for us being put on credit watch at that time rather than contributing it to any one single event.

Dr JOHN KAYE: If the private sector were to build a power station—let us play your game and the Owen game for a minute—and say there is a need for a new base load power station, or there might be a need for new base load power station—

Mr PIERCE: Might be, yes.

Dr JOHN KAYE: Is it not true that if the private sector were to build that power station, they would only do so in the anticipation that the debt they raised to pay for the power station, the $2 billion or the $4 billion, depending on the size, they would only raise that debt in anticipation that they would make enough money by selling the electricity to the national electricity market in order to service that debt and to make a profit?

Mr PIERCE: Yes, they would, as you say, but they would not view—and this is another key point—it as a single, isolated investment. They would consider it in terms of either the effect on their portfolio of generation capacity, if they had a portfolio, what the increment of that capacity did to the value of the total portfolio, or if they had a retail customer base that would assist them to manage the risk associated with them supplying retail.

Dr JOHN KAYE: We are talking about base load here, not peak plant.

Mr PIERCE: Sure, but that depends on the nature of the retail book they are managing. The retail people will have a base load of contracts underpinning their retail book. How much of that and for what duration is a function of the size of their retail book.

Dr JOHN KAYE: My point is if the private sector can make it a self-sustaining investment, what is the reason the public sector cannot make it a self-sustaining investment, given that the public sector already has a substantial portfolio?

Mr PIERCE: In principle, it could. The Government could act as a commercial investor, if you like, in that regard. The issue is that those private investors would not be triple-A. This is a sure way of saying that the credit risk associated with that investment is below what you have in the public sector and that the issue then becomes whether the public sector feels it appropriate to undertake those sorts of investments, that is, to take on those sorts of risks. To give you an example, and this is an example that has been quoted to us by Standard and Poor's, if there were two New South Waleses and both had exactly the same total State aggregates—aggregate revenues, expenditures, capex—and its expenditures were Health, Police and the rest of it, and the other one was where there was a large public trading enterprises sector within it, the risks associated with the public trading enterprise element, the commercial element if you like, are greater than the general government element, and the debt carrying capacity of New South Wales one is higher than the debt carrying capacity of New South Wales two because of the presence of the public trading enterprise sector.

Dr JOHN KAYE: Sorry, remind me again, one had the big—

Mr PIERCE: One was just general government.

Dr JOHN KAYE: And two was—

Mr PIERCE: General government and PTE, but the aggregates were all the same.

Dr JOHN KAYE: And you are saying that one has a higher debt carrying capacity?

Mr PIERCE: This is the argument of the rating agencies—

Dr JOHN KAYE: It is not.

Mr PIERCE: It is. There are two ways of looking at this.

Dr JOHN KAYE: There is. There is Treasury's way and the rest of world's.

Mr PIERCE: Let me finish. This should not be up for debate. We contract with rating agencies, I think the current contract is with a firm called Fitch, another rating agency, to do stand-alone ratings of our businesses, as if they were not part of the public sector. When you look at these businesses as standalone, they are all rated below triple-A. We do it for the purpose of charging a guarantee fee.

The Hon. MELINDA PAVEY: That is just for PTEs, though?

Mr PIERCE: Yes.

The Hon. GREG PEARCE: It is not the electricity companies, is it?

Mr PIERCE: Yes, it is the electricity companies.

The Hon. GREG PEARCE: The generators?

Mr PIERCE: Yes. They get a stand-alone rating, which we get done in order to price effectively the value of that triple-A rating to them as a stand-alone business.

The Hon. MATTHEW MASON-COX: Compared to neutrality?

Mr PIERCE: Yes, exactly. The argument from the rating agencies and, I would have to say, I debate this with them because the ratings are not just about the debt levels, it is also about the revenue that you have to support those debt levels. Their argument is that the revenues that come in the general government sector—Commonwealth grants and taxes—are more stable and secure than the revenues that are earned by our businesses. I argue with them that for our businesses that operate in a regulated fashion and have their prices determined by IPART in the electricity case the network businesses and the Transgrid businesses, that their revenues should not be seen—the weakest argument we make, the weakest condition would be—as no more volatile, no more insecure as our tax revenues. But that is not an argument that I can mount when you are talking about our businesses that operate in competitive markets, and generation and retail are the two biggest types of examples.

Dr JOHN KAYE: It is unfortunate that Moody's happens to disagree with you in relation to that matter. On 3 September it explicitly said "Moody's view New South Wales guaranteed electricity sector debt as self-supporting". So Moody's sees the electricity sector as self-supporting and plenty of evidence is out there of the rating agencies seeing the electricity sector as self-supporting. I suspect you are trying to have an each-way bet?

Mr PIERCE: No, you have to understand, Moody's and S&P do have slightly different methodologies but the principles are the same. When Moody's use the term "self-supporting" they are distinguishing between, say, the electricity businesses and RailCorp. Self-supporting to them means "We expect the revenues to be able to service that debt"—that is true, so do we. But in determining the rating the issue is "What is the risk associated with revenues from that source relative to the revenues in the general government sector?" We could contract with Moody's to rate those businesses on a stand-alone basis and they would still give them something less than triple-A. Most private sector people in the electricity businesses, I think the stronger ones, are around A but they go down to triple-B plus and that is inherent in the nature of that industry. This national market has not created any additional risks associated with being in this business from the days you are referring to before; it just makes it explicit.

CHAIR: As you have mentioned RailCorp I will ask about it now. If there is a change in the structure of RailCorp so that it comes under direct Ministerial control rather than as an independent corporation, do you now have to consider that factor in your mini-budget? Would it mean a blow-out in the costs of rail installations in New South Wales?

Mr PIERCE: No.

The Hon. GREG PEARCE: Will it still be a PTE or will it be shifted into the general government sector?

Mr PIERCE: That is exactly the first issue I was going to raise. This is where accounting and legal status diverge. Whether it is a PTE in a legal sense, a statutory authority or, in fact, a stand-alone government department, will not change its status from PTE to general government.

The Hon. GREG PEARCE: It stays PTE?

Mr PIERCE: That sort of classification is not determined by us, it is a classification that comes from the ABS who look at the make-up of their revenue and expenses to make that classification. So just de-SOCing it will not change it from PTE to general government—point one. Point two is that irrespective of whatever that legal status is the financial management issues, the issues around keeping expenditure equal to budget, the way in which investment decisions are made, and all that—at least from the way we would look at investment decisions—is unchanged.

Dr JOHN KAYE: For the sake of Hansard would you spell de-SOCing?

Mr PIERCE: I would spell it de-SOCing, as distinct from the sock on your feet.

The Hon. KAYEE GRIFFIN: In terms of the global economic downturn how will that effect New South Wales regarding revenue outlook?

Mr PIERCE: I should state the obvious, this is probably the one point in the time that I have been in Treasury where I am glad that I am in Treasury, rather than up at the Reserve Bank in Martin Place.

Dr JOHN KAYE: Now we know what are his ambitions.

Mr PIERCE: In the pecking order of economists, monetary economists are the high priesthood. Resource economists come second. I characterise that we are seeing two things happen. One, a structural repricing or re-evaluating of risk, and that again is not a surprise given to where the costs of capital had got. But the other is quite extraordinary, this lack of liquidity within financial markets and we do not really know what the value of that repricing of underlying risk is just because people are not trading. Unless people trade you do not know what the price is. The concern that people have about the risks associated with their counterparties is pretty impossible, particularly for us, to forecast when that concern is going to dissipate and liquidity starts being freely available again.

For us, what that means in terms of our managing of State's finances there are really two effects in the main. One is because we are a participant in credit markets and we are out there issuing bonds and refinancing bonds that are maturing. In an environment where we are both increasing the quantity of bonds on issue in order to fund the capital program, and projected to increase it further, and where people are concerned about the risk associated with their counterparties, in these circumstances these would normally be the times when we would be trumping the strength of our credit, the security of our bonds and how safe it is to lend your money to us rather than to other people. It is a bit difficult for me to do that whilst we are on negative outlook.

Government bonds obviously as a class of investment compared to other things will be seen as more secure than other things but when people are making their decisions about should I invest in New South Wales, Commonwealth or Queensland bonds, being on negative outlook at the moment is not particularly helpful to us, which is one of the reasons, I suppose, we are working so hard through this mini-budget to get that negative outlook removed as soon as possible. It will obviously have an effect on investment income but again we budget on a very long-term average investment returns and that is precisely a sort of cyclical event that in normal circumstances we would be able to accommodate.

We have seen the consequences of people not being able to get credit. I do not think we should be surprised if the rather strong level of business investment we have had in New South Wales starts to taper off—this is not just a New South Wales story, it is an Australian story—as people find perhaps increasing difficulty in getting access to credit, and on the back of a slowing economy, I think we are starting to see and have seen, particularly commercial property transactions being lower than what we might have expected otherwise.

Dr JOHN KAYE: What price?

Mr PIERCE: The thing that affects our revenue numbers, we are much more sensitive to volume than we are to price movements—it is volume that drives our revenue. Part of what we do, as an aside, is look at price volume movements in different price bands to try to identify which parts of the market are moving. This is something we are assessing at the moment. If you have an increase in interest rates, at least in terms of property transactions, you normally expect what would happen is that property transactions slow down, but they do not just disappear together, they just delay the property decisions. But if people start to feel insecure about their employment at the same time as you have an increase in interest rates that is when you get very large decreases in transfer duty. So we are assessing, if you like, what the outcome is on the labour market which is a lagging indicator so we will not see the effects of what is happening now for six, maybe nine months down the track in the labour market.

We are certainly seeing a fall-off in transfer duty but one of the things we are assessing is whether the degree to which payroll tax may eventually be impacted, so that will not happen—payroll tax is holding up nicely at the moment but it may soften towards the back end of this financial year. So its effects are both in terms of our access to finance on the one hand and the price we pay for that but also in terms of our revenues principally through transfer duty and potentially through payroll tax. I should point out that when you look at the way the price of our bonds are trading at the moment, the price shot up on the announcement of the negative outlook but it has since come down to a small difference between say, ourselves and Queensland, principally because the market is saying that it believes that the mini-budget will be successful in getting the negative outlook removed. So the current price of our bonds reflects that expectation so we are not seeing in the, sort of, day-to-day operations at the moment. But if it stayed there for a long period of time, or if we were downgraded, then we would see an increase in the price of our bonds.

The Hon. AMANDA FAZIO: A lot of people really do not understand the impact that it would have on New South Wales if it were to lose its triple-A credit rating. Will you explain the importance of maintaining the triple-A credit rating for New South Wales? Will you tell us what impact, if any, the Australian dollar going down to US66¢ will have in terms of us being able to maintain that rating?

Mr PIERCE: I will think about the last part of the question in a minute. The rating, I think we should distinguish between two effects. Given the undoubted, for most people, complexity of assessing the state of State finances, the general, if you like, measure of whether it is being managed well or not is, of course, the rating. People form views about how well the State's finances are being managed based on the rating. Those views then tend to have an effect upon people's expectations about what is going to happen in New South Wales. Those expectations tend to have an effect upon the investment decisions and the employment decisions that people make.

]If you have a downgrading and you are thinking of making an investment decision in, say, New South Wales versus a jurisdiction with a secure triple-A, then one thing that at least business people tell me they think about is that if that downgrading is a signal that the things that led to that downgrading will continue and they form the view that that cannot continue forever there has to be an adjustment and that adjustment at some point in time will have to be either in terms of government service provision or taxation, and they will differentiate New South Wales from triple-A States based on the expectation of government taxation and service provision being stable versus the risk that service provision may be reduced or taxes increased in order to deal with the Government's own financial problems. So its effect in the broader economy I think is in terms of the signalling it provides about what people who are making investment and employment decisions might think will happen in New South Wales in the future.

In terms of our own finances, a downgrade means you pay more for your borrowings. The issue I have raised is that even if you were to say, "We are comfortable with double-A plus. We will target double-A plus and we are comfortable with having a higher interest bill by the amount that is implied by that", that does not mean you can continue what you are doing now. It still means you have to change because a lot of this is about rates of growth—it is rates of growth in debt that have caused the change in outlook. It would be the rate of growth in debt that would cause a downgrade and you would still need to do something to slow down that rate of growth, even if you are targeting, as I say, a double-A plus. Yes, the debt level in stock terms would be higher, but you would still have to do something to change your rate of growth; otherwise your double-A plus becomes double-A becomes single-A, boom, boom, boom down the list. People should not think that saying, "Well, we don't have to worry about the triple-A. We'll have a double-A plus" does not mean you do not have to do stuff to slow down that rate of growth in debt.

The actual trade-offs then are more than just a simple calculation of what the interest costs are; they are about the nature of those—what you have to do to slow things down, and the way in which that signals for the broader economy out to people making investment and employment decisions about what they might expect to happen in New South Wales in the future. I point out that, for instance—going back in history—when Victoria was downgraded it was downgraded a couple of notches and they were heading for a third before they slowed it down. In order to do that, if my memory serves me correctly, general government expenditure was reduced in one year—that is reduced in absolute level—by 15 per cent and reduced by 8 per cent the second year and over the next couple of years by 1 per cent or 2 per cent. What we are talking about here is changing rates of growth, not reducing the absolute level. It is in order to avoid eventually at some point having to get into that situation that these sorts of adjustments are necessary now and making those sorts of absolute reductions in expenditure levels are obviously traumatic.

CHAIR: Just to clarify your answer to the question, if the credit rating was reduced what would be the cost in extra interest? The Premier talked about $500 million per annum being the figure quoted.

Mr PIERCE: The cost is a function of two things. One is the increased interest rate we have to pay on our debt compared to, say, the Commonwealth or Queensland, and you have to make an estimate of that.

The Hon. MATTHEW MASON-COX: What would be your estimate—250 base points?

Mr PIERCE: No, hopefully 25.

The Hon. MATTHEW MASON-COX: Okay, what is your estimate?

CHAIR: Let the Secretary answer the question.

Mr PIERCE: One element is the movement in the basis point spread, and our and TCorp's estimate at the moment would be about 25. In the current environment it could be higher just because of the state of the financial markets at the moment but if you are looking longer term it is 20 to 25. Then you have to look at how much debt is maturing and how much new debt we will be issuing. When we factor that in, at the end of our forward estimates period it gets up into the range of $125 million to $110 million at the end of the four years.

The Hon. GREG PEARCE: Does that include the PTEs or just general debt?

Mr PIERCE: No, it is off the total.

The Hon. GREG PEARCE: So it is the total.

Mr PIERCE: It is the total. In the first year it is relatively small, if you like. It is in the order of, depending on when you actually issue the debt, but think in terms of say $15 million, $20 million, that sort of range, but obviously then it compounds; as the debt is maturing you are refinancing that and issuing more debt. So our estimate of an annual amount for the end of the forward estimates period is about $110 million to $125 million per annum, and that would obviously then compound. The way to think about the $500 million number which I think Premier Iemma first referred to was a cumulative number once you refinance the total debt. The other way to think about that—

Dr JOHN KAYE: Sorry, I do not understand that. I thought the $125 million was a cumulative number.

Mr PIERCE: No, it is a per annum number.

Dr JOHN KAYE: But the Premier's statement was per annum. Your words were that the $110 million to $125 million was compounded up with all the other stuff maturing behind it.

Mr PIERCE: No. The sum over four years will be more like $250 million, because we have debt that goes well beyond four years, but the per annum amount we should actually be paying in four years time would be in that range of $110 million to $125 million.

Dr JOHN KAYE: So where does the $500 million come in?

Mr PIERCE: It is the accumulation over the maturity profile of the debt.

The Hon. GREG PEARCE: How many years?

Mr PIERCE: I think the average duration of our debt is around four to five years. In terms of our benchmark bond program, there is a 2017 line out and there is a very small amount that is out over 25 years or so. The way to think about the $500 million is a cumulative amount across the total debt. The alternative way, if you like, to think about it is that there is a bunch of people out there who currently hold our bonds and they are sitting on nothing but the total stock.

The Hon. GREG PEARCE: I think you have answered the question. We are running out of time.

Mr PIERCE: I think you should understand that the $500 million is a cost to the people who hold our bonds as well.

The Hon. GREG PEARCE: I think people will gain a great deal of confidence by your explanation of that. You said the Government expected that as a result of not proceeding with the electricity privatisation there would be pressure on the ratings, and you were surprised at how quickly Standard and Poor's acted. If the Government had acted responsibly to secure electricity supply by putting funding for base load in the forward State infrastructure plan instead of gambling that they would be able to privatise electricity, would the triple-A now be on negative outlook?

Mr PIERCE: As I said in my opening statement, there are a number of issues that the rating agencies have raised with us and a number of issues were on the table when the decision was made to do the mini-budget.

The Hon. GREG PEARCE: So your answer is that we would still be on negative outlook.

Mr PIERCE: You would have to ask the rating agencies. I doubt if we would be on negative outlook—

The Hon. GREG PEARCE: You doubt that we would be on negative outlook.

Mr PIERCE: —but I am sure that they would be raising questions with us.

The Hon. GREG PEARCE: They have raised questions for years but your answer is that you doubt we would be negative outlook.

Mr PIERCE: Sure, because they have added the capital program associated with electricity on to the SISS program.

The Hon. GREG PEARCE: Which the Government irresponsibly did not do and gambled.

Mr PIERCE: Was that a question?

The Hon. AMANDA FAZIO: No, that is just a gratuitous throwaway line.

The Hon. MATTHEW MASON-COX: I have a question about some of the recent newspaper articles, in particular today's *Australian Financial Review*, which when you picked it up you might have wished you were in Martin Place. It reports that the New South Wales Premier will interrogate Treasury about why the New South Wales Government had no warning of a looming budget shortfall. It goes on to state—

Mr PIERCE: Sorry, I have not seen the paper.

The Hon. MATTHEW MASON-COX: I have a copy here and I will pass it to you in a moment. The newspaper states, "I am going to have to interrogate the Treasury down the track … If it's demonstrated that it was the result of incompetence rather than someone else, then I would expect someone to be held to account. That is not to say that heads will roll but if someone needs to be counselled on these matters they will be". I want to get your response to that specifically in that Treasury is being left holding the baby in relation to this budget shortfall of $600 million. How do you respond to the Premier in that regard?

Mr PIERCE: I will respond to the Premier directly when he chooses to have a discussion with us about that.

The Hon. GREG PEARCE: When he gets around to it? When he has the time and inclination?

Mr PIERCE: The point I make is similar to the point I made earlier: When we put the budget estimates together we were expecting a slow down in property transactions to occur this year.

The Hon. MELINDA PAVEY: When would Cabinet have been advised of that?

Mr PIERCE: For the slow down we included in the budget estimates?

CHAIR: In the budget.

Mr PIERCE: During March. We would have finalised the—the final revenue forecasts that go into the budget are based on end of March.

The Hon. MELINDA PAVEY: I have a Treasury document here that was put in as a call to papers last night, "However, revenue slowed significantly in March and for the first time since 1997 revenue in March was less than revenue in February." I think that was given to Cabinet in about April.

Mr PIERCE: So we would have had that—

The Hon. MELINDA PAVEY: Premier Rees was around the Cabinet table at that point, was he not?

Mr PIERCE: We would have had that result when we were finalising the forecast in the budget 2008-09, and if my memory serves me correctly it was one of the things that caused us to revise the final forecast down compared to earlier versions that we were looking at. I should point out that even at that stage, because of the strength of revenues in the early part of the year, even with that downturn in March, with the cumulative result for last year we were still ahead of estimates, so we had signs of a downturn, we factored that downturn into the 2008-09 results and that would have been presented to the Treasurer and the budget committee of Cabinet when we were finalising the budget, and the date of that I cannot recall.

The Hon. MELINDA PAVEY: It would have been about April.

CHAIR: Will you identify that document you are quoting from for the record?

The Hon. MELINDA PAVEY: It is the forecasting notes April 2008 from Treasury.

Mr PIERCE: We would have finalised that at the end of April, beginning of May.

The Hon. GREG PEARCE: It is all a bit of a guesstimate, is it not?

Mr PIERCE: No.

The Hon. MELINDA PAVEY: But the current Treasurer Roozendaal would very much also have been aware of the—

Mr PIERCE: The current Premier was not a member of the budget committee at the time.

The Hon. MELINDA PAVEY: But the current Treasurer is.

The Hon. MATTHEW MASON-COX: It says here that the New South Wales Government had no warning of that looming budget shortfall. You knew back in March, and they would have known back in March or April, that there was a reduction in the amount of money coming from transfer duty and that that was a result of the economic slowdown. This is not a mystery.

Mr PIERCE: You are a few months ahead there.

The Hon. GREG PEARCE: It is in your own papers.

The Hon. MATTHEW MASON-COX: The papers show it; it is here in black and white.

CHAIR: Let Mr Pierce answer the question.

Mr PIERCE: After months of being above budget, there was a month below budget. We looked at that and revised the outlook for 2008-09. However, because of what happened at the beginning the year, with that one month number we did not revise the expected outcome for 2007-08. When the next month came around, we certainly did revise the expected outcome. That was after the budget was finalised. We were saying that things were going to slow down. The question is the degree to which it slowed down. You need more data as each month comes to pass to know that it is not simply a one-off blip.

The Hon. MATTHEW MASON-COX: Yes, but we would love to get more data without it coming from the *Daily Telegraph* or the *Financial Review*. That would be excellent. I refer you to the figure itself. This article states that we are talking about a $130-million shortfall for the 2007-08 budget year. When you compare apples with apples, after accounting for AASB1049, the original budget estimate was that there would be a surplus of only $40 million in any event. That was revised over the course of the budget year. However, your original budget estimate for the 2007-08 financial year was a $40-million surplus. That is almost a deficit and, as you said before, almost a problem for the triple-A rating.

Mr PIERCE: Given that way of measuring the budget result. Of course, when the budget was brought down there was a different standard in place.

The Hon. MATTHEW MASON-COX: That is where the confusion arises: What is the budget surplus? In conforming to the new standard, it was a $40-million surplus as predicted in the 2007-08 budget. We ended up with a $130-million surplus, so we are still ahead of the game, but the Premier has said that the State has lost $600 million. It is a little bit rich to lay that at the door of Treasury. These things—

The Hon. GREG PEARCE: The $600 million was just the mid-year review.

The Hon. MATTHEW MASON-COX: Exactly. Again, that is adjusted down when the new accounting standards are factored in. Is it not a little contrived for the Premier now to say that suddenly $600 million is missing when one looks at the history of this matter? Clearly, the prediction at the start of the year was only a $40-million budget surplus, but we ended up with a $130-million surplus. We are ahead of the game.

Mr PIERCE: When you strip out all the accounting standard changes, the numbers can be compared. As you said, a $40-million surplus was the original budget estimate for 2007-08. However, when we brought down the 2008-09 budget the projection for the 2007-08 result was $700 million. We are now looking at something closer to $128 million to $130 million. The variation of roughly $600 million that you referred to is a variation of $700 million to $128 million in what we expected the 2007-08 result to be when we brought down the 2008-09 budget.

The Hon. MATTHEW MASON-COX: That is my point: We are not in a diabolical position in terms of the original budget estimate for 2007-08.

Mr PIERCE: The 2007-08 budget year is over.

The Hon. MATTHEW MASON-COX: But we are still waiting on the figures.

Mr PIERCE: I am waiting on an auditor to give me a certificate.

The Hon. GREG PEARCE: So the auditor has not signed yet?

Mr PIERCE: I am expecting it any day now. The issue for the mini-budget and today is that what happened towards the back end of 2007-08 indicates what will happen in 2008-09 and beyond that. We are dealing with that the moment and in the context of the mini-budget. I would say that the aggregate result for 2007-08 compared to the original budget prediction tells you much in terms of what we need to do to respond to today's situation.

Dr JOHN KAYE: I want to go back to the question asked by the Chair about the claims by the former Premier and the current Premier about the $500 million a year increase in annual interest payments as a result of a downgrading of the triple-A credit rating. Premier Iemma made a media statement on 7 September and Premier Rees repeated it on 10 September. They both made it clear that it was an annual $500 million increase in interest payments. What steps did you take as the State's chief Treasury officer to correct the misunderstanding of both the former Premier and the present Premier or to ensure that the public debate was not corrupted by a grossly inflated figure put out by both premiers?

Mr PIERCE: My understanding is that when Premier Iemma referred to the $500 million, it was not as a per annum amount but as an amount over time.

Dr JOHN KAYE: I can correct that. He said that the main priority was to avoid losing New South Wales' triple-A credit rating, which would mean an annual interest payment blow-out of $500 million a year. That statement was reported in the *Sunday Telegraph* of 7 September 2008. Even if he did not say that, that understanding was out there in the media. Do you not feel that you had an obligation to correct that?

Mr PIERCE: We have a number of briefs on various subjects. We provide standing briefs on issues to the Treasurer's office. Certainly, the brief on that issue put the situation correctly, and I understand the Treasurer has referred to it as roughly $100 million at the end of four years and $500 million cumulative.

Dr JOHN KAYE: So your point is that both premiers at that time should have been in possession of a document that told them that the annual interest increase in the beginning years would be somewhere between a relatively small amount of $15 million to $20 million and after four years it would increase to $110 million to $125 million. They should have been in possession of that document when they made those statements in public, or at least when they were reported to have made those statements in public and did not correct them?

Mr PIERCE: I would have to see the actual timelines and dates of when they said what and when the briefs were sent up. As soon as we became aware that a per annum number had been attached to the $500 million we spoke to the Treasurer's office and put it in the documentation. I cannot answer the question because I would have to put the timelines together.

Dr JOHN KAYE: Were you concerned that the public debate was being informed by a $500 million a year figure?

Mr PIERCE: It did cause me to cringe.

Dr JOHN KAYE: Did you translate that cringe into a telephone call to either the Premier or the Treasurer saying that that was not correct?

Mr PIERCE: We certainly discussed it with the Treasurer's office and put it in the documentation that the office would have used when talking to the Premier's office.

Dr JOHN KAYE: So, subsequent to those statements being made by one or both premiers, you did take steps to inform the Government via the Treasurer's office those statements were incorrect?

Mr PIERCE: Yes, I did.

Dr JOHN KAYE: Can you tell us on what date you did that? You cringed, so you would presumably remember the event—as we all did.

Mr PIERCE: Yes, I remember the event.

The Hon. GREG PEARCE: You referred to the briefing note earlier.

Mr PIERCE: Yes, but there is no date attached to it.

Dr JOHN KAYE: So it is an undated briefing note? That would be unusual for Treasury.

Mr PIERCE: It is easy to find out the date. It is in the system.

Dr JOHN KAYE: Will you undertake to come back to us with the exact date of the briefing note?

CHAIR: That question can be asked and answered in the estimates hearings.

Dr JOHN KAYE: Since we are concerned about a key figure being used to—

CHAIR: We will get the date on Tuesday.

Mr PIERCE: It was a cause of concern and it needed to be clarified. However, as I was trying to point out before, the debate around the triple-A rating and consequence of it is much broader than the debate about its effect on State finances. It is certainly a relevant issue, but it is not the only consideration.

CHAIR: Can you provide that date on Tuesday when we meet with you again?

Mr PIERCE: Yes.

CHAIR: In preparing the mini-budget, will you be making any recommendations, in view of the financial situation in New South Wales and even the financial crisis worldwide, about the future of the North West Metro, the Western Metro, the M4 extension or the M5 improvements?

Mr PIERCE: As I said in my opening statement, those projects—with the exception of the North West Metro project—are not in our forward capital programs. They are not in the numbers as yet. They are the specifically the things that we are discussing with Infrastructure Australia. The North West Metro is in the numbers, and therefore is part of the capital program that is being reviewed.

The criteria being applied to the review of that capital program—and rating agencies have given an indication of this—are not looking for any great slashing and burning of the capital program. That would simply store up problems for the future. Rather, it is a review looking at the quality of the capital spent and ensuring that the capital going forward will expand the productive capacity of the economy or the things that will be highly utilised; that is, that the services that come from the investment of that capital will be highly utilised. The Government has said everything is on the table, and the North West Metro is part of our current capital program.

The thing that distinguishes projects like the North West Metro from a lot of things in our capital program is the timing and the pattern of the cash flows. If the capital program includes a lot of schools, hospitals and police stations, those things tend to be built and finished in a couple of years. They then fall off and that leaves room to build other things. With the North West Metro project and projects of that type, the cash flows tend to be small for a reasonable period—in the current year and over the next two years. It is really in years four, five and six that they start to pick up.

When you commit to something with that sort of pattern of cash flow, you must be mindful of what that does to your ability to do new projects in years four, five and six in the future. That is just one example; it is a thing that distinguishes it from the normal government capital program. Again, we will have to ensure the capital review gives the Government fiscal flexibility—which is a touchstone for the rating agencies—to be able to accommodate new capital works in the future.

The Hon. GREG PEARCE: I address my question to Mr Ronsisvalle. We know why a budget comes to Parliament. There is an appropriation bill and money bills if there are tax increases and so on. Why is the mini-budget coming to Parliament? Why could we not deal with all of these things with a new State infrastructure strategy and an economic statement?

Mr RONSISVALLE: I think with the scale of the mini-budget we are actually looking at it would be appropriate for the Government to detail that as part of Parliament.

The Hon. GREG PEARCE: So there is likely to be a new appropriation bill?

Mr RONSISVALLE: Not necessarily.

The Hon. MELINDA PAVEY: Is that no or not necessarily?

Mr RONSISVALLE: Not necessarily. At this stage we are still looking at whether there will be need for legislation associated with the mini-budget.

The Hon. GREG PEARCE: So there may be legislation with new taxes or increased taxes?

Mr RONSISVALLE: At this stage we have not made the decisions on the mini-budget. We are still in the process of making those decisions.

The Hon. GREG PEARCE: But you do know that it has to come to Parliament?

Mr RONSISVALLE: No. What I know is that given the nature of what is going to be announced it would be appropriate for it to be brought to Parliament.

The Hon. AMANDA FAZIO: If it did not come to Parliament you would complain about it.

The Hon. GREG PEARCE: This inquiry is about the need for a mini-budget and I am asking why we have to have a mini-budget instead of an economic statement and a new State infrastructure strategy. It is a core question to the actual inquiry and we have not had a satisfactory answer except that it is nice to do it.

The Hon. AMANDA FAZIO: Talk about asking it at one minute to midday!

Mr PIERCE: I do not want to get caught up in the semantics but obviously there could be two reasons for it going to Parliament: just as a way of the Government explaining publicly what it has included in the mini-budget or there may, in principle at least, be legislation that is necessary to support it and it is also possible that there may not and then you would revert to the first reason for doing it. At this stage we do not know whether legislation is going to be necessary because the final decisions have not been made. It is only then that you will know whether you need legislation to back those decisions up or not.

CHAIR: It is a policy decision of the Government to have a mini-budget.

Mr PIERCE: Precisely.

CHAIR: Thank you for appearing before the Committee. We know you are under a lot of pressure in preparing the mini-budget and we trust that nothing we have done here today has delayed it from conclusion.

Mr PIERCE: Thank you for your time. As you know Chairman, I am always happy to have the opportunity to explain what we do to this Committee and hopefully it can be informative.

CHAIR: Would you be happy to leave that briefing paper with us, table it with the Committee or would you rather not?

Mr PIERCE: Which one?

CHAIR: The briefing paper of your opening statement.

The Hon. GREG PEARCE: Could we have the interest calculations?

Mr PIERCE: I am quite happy to get it typed up because I have my own handwritten stuff on it.

Dr JOHN KAYE: I would also be interested in the witness leaving behind the interest calculations briefing note that went to the Treasurer's office, the undated note. We understand it was an undated note that went to the Treasurer's office. That I think is central to the debate about the need for a mini-budget?

CHAIR: You can consider that and provide it to us at the estimates committee.

Mr PIERCE: You might allow me to check with the legal people whether it is appropriate or not. I would expect that it would be raised at the estimates committee too.

(The witnesses withdrew)

(The Committee adjourned at 12.05 p.m.)