DISCUSSION PAPER

A Brief Analysis of the "Net Cost" of Improved Indexation

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This brief discussion paper attempts to fill the void left by the Matthews' Review in analyzing the true "net cost" of improved indexation for Commonwealth and Military Superannuation. The analysis is embryonic in nature but provides a plausible solution for the Government to consider (if validated by the Australian Government Actuary) in utilising excess Future Fund profits as an offset to the increased liabilities that would occur under improved indexation.

INTRODUCTION

This brief discussion paper provides additional information that has been considered since my response to the Matthew's Report[1]. It is offered to all Special Interest and Political representatives as background research to help with the realisation that improved indexation for Commonwealth and Military superannuants is affordable within current Commonwealth resources.

This analysis is embryonic in nature but I believe it is well enough advanced to allow the reader to consider the merits of the proposal within and to encourage the Government to commission the Australian Government Actuary[2] (AGA) to validate the proposal and formulate robust and transparent options. Armed with this information, I believe the Government and the Parliament more generally would be well placed to consider, debate and agree upon recommended improvements for its former employees.

GENERAL

As I stated in my response to the Matthew's Review, Mr Matthews failed to provide the Government with a "net cost" figure that was required of him in the 4th item of the Terms of Reference. Instead, Mr. Matthews / Finance only focused on the liabilities side of the balance sheet giving little or no credence to "clawback" and remained mute with regards to the performance of assets contained in the Future Fund.

In response to this blatant deficiency, Figure 1., attempts to provide a basic graphical representation of the data and assumptions contained in Annex A[3]. The graph ties together a number of projections in order to paint a better picture of the true interraltionships between the projections of:

- current unfunded liabilities[4];
- future liabilities if improved indexation is applied[5];
- "clawback" as calculated in 2005 by the Australian Government Actuary; and
- a number of forward projections based upon the mandates and the likely growth of the Future Fund.

[1] Thornton's letter to the Minister of Finance and Deregulation, dated 4 September 2009.

[2] Unfortunately, I together with many representative organisations have lost faith in the accuracy of Finance derived figures, and as such, would request the Government to commission the AGA to fill the huge gap left by the Matthews Review.

[3] Annex A has a supporting Excel Spreadsheet that the author is more than happy to provide electronically upon request.

[4] Initial data for the projection was extracted from Future Fund Actuary Letter., *Target Asset Level Declaration,* dated 8 May 2008.

[5] I have used the higher of CPI/MTAWE, because our superannuation is not welfare and retirees should be afforded something better than the indexation mechanism of welfare. We should maintained strong adherence to a mechanism better than welfare because this was the stance Representative Organisations took in the 2001 Senate Inquiry (Page 24-25 of the Inquiry Report refers).

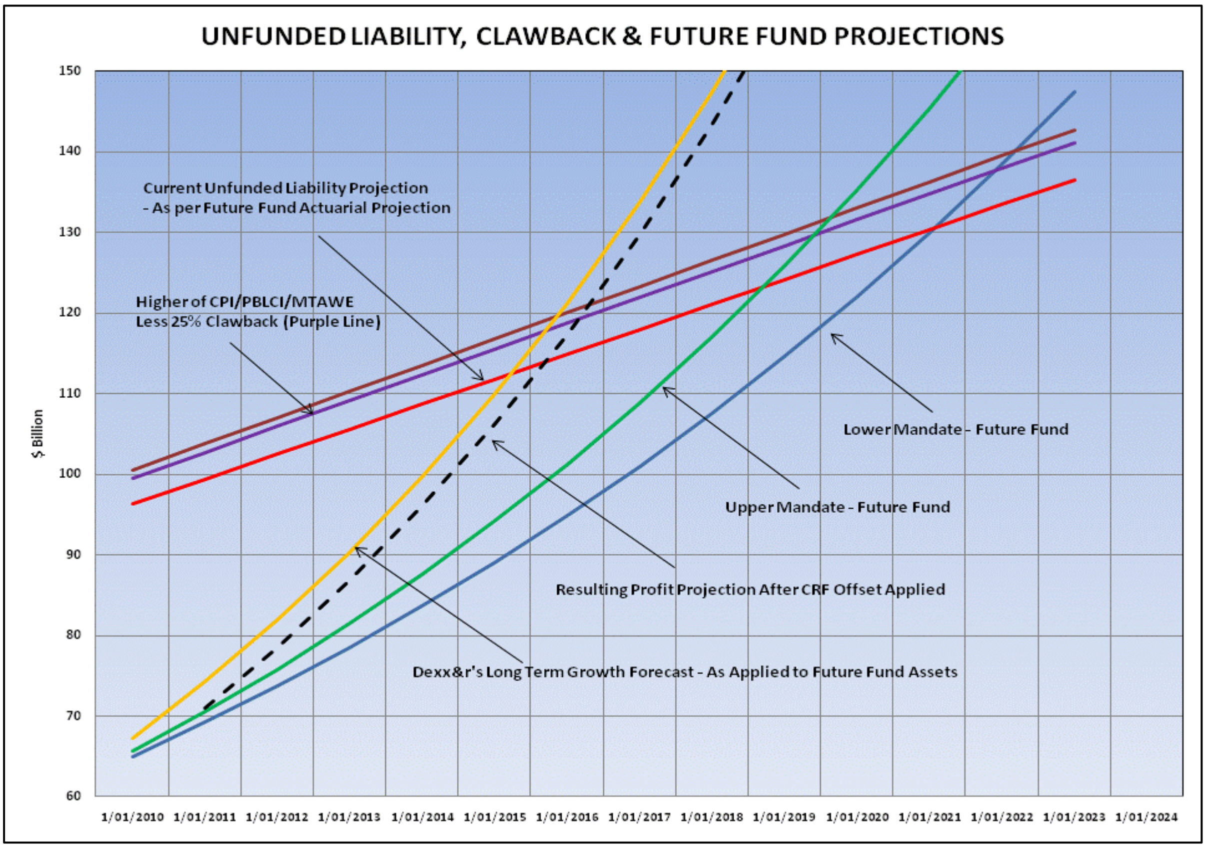

Figure 1

As can be seen above, the Red line shows the current unfunded liability projected over time[6] and the Brown line shows the gross adjusted projection of the unfunded liability if indexation was to be increased to CPI or MTAWE, whichever is the higher[7].

The Purple line illustrates the resulting projection if a "clawback" of 25% is applied[8]. If "clawback" approached the 2002 NATSEM figure of 37-58% then the Purple line would move closer to the Red line and would therefore reduce the annual "unfunded" cost out of the Consolidated Revenue Fund (CRF).

If this issue is to be resolved to everybody's satisfaction then it is imperative that a valid and substantiated "clawback" figure be independently derived and verified[9].

The opposing and upward projections show a number of scenarios pertaining to the earnings projections of the Future Fund over time. The Green and Blue lines are the upper and lower

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[6] The projection is derived from the original data presented to the Government by the Actuary (Dr. Knox) of the Future Fund. The initial data presented by Dr Knox shows a linear progression of $3.1p.a. Irrespective of improved life expectancies, I believe this is likely to remain linear over the next 10 years or so.

[7] This is 4.6% above current liabilities as per the Finance figure stated by Matthews. Again this projection is linear because it is assumed that entrants and exits from retirement will remain constant over the period examined.

[8] This figure was derived from the 2005 Long Term Cost Report as generated by the AGA.

[9] Clawback figures ranging from 15-58% are unacceptable when we are talking about cost in the Billions of dollars. Is it any wonder Politicians go weak at the knees when confronted by these cost issues and reinforces the proposal to engage the Australian Government Actuary to complete the analysis.

investment mandates respectively, which are the key performance indicators required of the Future Fund as per the enabling legislation.

The Yellow line is Dexx&r's Long Term Growth Forecast for Superannuation assets up to 2017[10]. Whilst this growth rate is used for illustrative purposes only, the projection is not beyond the realm of possibilities when you consider that the Australian Fixed Interest return as measured by the UBS Composite All Maturities Bond Index was 9.22% for the last 12 months (as measured up to 31 July 2009) and 20.61% for the past 3 years[11]. The current annualised return of the Future Fund (as demonstrated over the last quarter) was approximately 9.5%. This together with the fact that the Future Fund was not fully divested at the onset of the Global Financial Crisis positions the Fund to take significant advantage of lower priced assets and future growth opportunities from here on in[12].

With the foregoing projections as a foundation, the Black dotted line represents the prospective situation (and my proposal) where the Government takes excess profit from the Future Fund (i.e. above the "upper mandate") to offset[13] and neutralise any cost increase in the CRF due to improved indexation.

Based upon the Yellow line projection and the 25% "clawback" figure used, it is estimated that a $1.5B gross liability (i.e. not taking into account contributions) would be incurred in the first year (2010/11) because all outer years show a net profit above the Upper Mandate and the 100% offset required.

Clearly if a higher "clawback" figure was deduced by the AGA then the first year and outer year liabilities would be lessened even further.

Whilst using excess profit above the Upper Mandate as an offset would require a legislative amendment, I believe a change would be defensible because the original constructs of the Future Fund would remain intact (i.e. the mandates required to reduce the total unfunded liabilities of Government provided superannuation by 2020 would still apply).

[10] Please be aware that this growth rate also includes contributions and therefore does not reflect a true earnings growth rate per se. However, in the last quarter the Future Fund did produce an annualised return of approximately 9.5% so an excess profit projection over time (i.e. above the Upper Mandate) is not unreasonable.

[11] http://www.australiansuper.com/resources.ashx/formsandpublications/802/File/278AD85DAFD4FFAB4E1BEF1568BC9C4A/July_09_Monthly_Member_Update_V2_(2).pdf, page 2.

[12] The Future Fund was lucky in the fact that it had not yet fully divested its assets and that it is substantially held in cash at this time. Even if it remained invested in diversified fixed interest and corporate bonds it would generated a return of approximately 8-10% pa.

[13] The CRF should only be supplemented with an amount of Future Fund profit required to offset 100% of the liabilities incurred for improved indexation.

CONCLUSION

This embryonic analysis is provided to representatives (both Special Interest and Political) for their respective consideration and collective positioning in engaging the Government in our campaign for improved indexation of Commonwealth and Military Superannuation.

This analysis further substantiates the call for the Government to commission the AGA to validate the confluence of "clawback" and excess Future Fund earnings as an offset to the prospective liabilities incurred under improved indexation. The commissioning of the AGA would fill a huge gap left by the Matthews' Review and redress the deficiencies (in part) of his analysis.

The utilisation of excess Future Fund earnings as an offset for improved indexation would be defensible from all sides of the political spectrum because the original constructs of the Future Fund would remain intact and all political persuasions would, once and for all, help to rectify the long held injustice and economic discrimination labelled at former Government employees.

ANNEX A

Date	Future Fund Projection - Earning Rate 4.5% above CPI	Future Fund Projection - Earning rate 5.5% above CPI	Dexx&r's Long Term Growth Forecast (10.3%)	Current Unfunded Liability Projection	Unfunded Liability to higher of CPI/PBLCI/MTAWE	Unfunded Liability to higher of CPI/PBLCI/MTAWE less 25% Clawback	Dexx&r's Profit added back to Upper Mandate Projection - After CRF Offset Applied
30/06/2009	61.04	61.04	61.04	93.2	97.4872		
30/06/2010	65.0076	65.618	67.32712	96.3	100.5872	99.5154	
30/06/2011	69.233094	70.53935	74.26181336	99.4	103.8298	102.72235	70.93946336
30/06/2012	73.73324511	75.82980125	81.91078014	102.5	107.0724	105.9293	78.48148014
30/06/2013	78.52590604	81.51703634	90.34759049	105.6	110.315	109.13625	86.81134049
30/06/2014	83.63008993	87.63081407	99.65339231	108.7	113.5576	112.3432	96.01019231
30/06/2015	89.06604578	94.20312512	109.9176917	111.8	116.8002	115.55015	106.1675417
30/06/2016	94.85533876	101.2683595	121.239214	114.9	120.0428	118.7571	117.382114
30/06/2017	101.0209358	108.8634865	133.726853	118	123.2854	121.96405	129.762803
30/06/2018	107.5872966	117.028248	147.5007189	121.1	126.528	125.171	143.4297189
30/06/2019	114.5804709	125.8053666	162.6932929	124.2	129.7706	128.37795	158.5153429
30/06/2020	122.0282015	135.240769	179.4507021	127.3	133.0132	131.5849	175.1658021
30/06/2021	129.9600346	145.3838267	197.9341244	130.4	136.2558	134.79185	193.5422744
30/06/2022	138.4074368	156.2876137	218.3213392	133.5	139.4984	137.9988	213.8225392
30/06/2023	147.4039202	168.0091848	240.8084371	136.6	142.741	141.20575	236.2026871
30/06/2024	156.985175	180.6098736	265.6117062	139.7	145.9836	144.4127	260.8990062

Table 1

Notes:

1. Future Fund Balance as at 30 June 2009 = $61.04B[14].
2. The figures presented for 2009-11 in red were derived from the Future Fund Actuary Letter., *Target Asset Level Declaration*, dated 8 May 2008. The projections highlighted in this column are incremented by $3.1B p.a. as per original projections performed by Dr. Knox. A linear projection is provided because it is assumed that entrants and exits into and out of Commonwealth and Military Superannuation will remain relatively constant over the projection period.
3. CPI is assumed to be 2% p.a. over the long run. However, irrespective of the CPI, given that the Future Fund Mandates are percentages above CPI then the growth projections will be directly proportional in percentage terms over time.
4. The 'Unfunded Liability to higher of CPI/MTAWE' figures have been projected at 4.6% p.a above the "Current Unfunded Liability Projection". This figure (derived from Matthews / Finance) is used to bridge the gap between the Matthew's Report and this analysis.
5. As can be seen in green, if the Future Fund's earning rate is at the upper end of its mandate then unfunded liabilities will be extinguished by 2019.
6. As can be seen in yellow, if the Future Fund's earning rate is consistent with Dexx&r's Long Term Growth Forecast for superannuation assets, then unfunded liabilities will be extinguished in 2015-16.
7. As can be seen in blue, in the unlikely event that the Future Fund earning rate only achieves the lower end of the mandate then unfunded liabilities will not be extinguished until 2021.
8. The red hashed area represents a $1.5B shortfall in the CRF for the first year of improved indexation. A small price to pay for the improved retirement outcomes of 600,000 former and current employees!

[14] Future Fund Website, *http://www.futurefund.gov.au/*.