

# Managing the Crown Balance Sheet to Raise Living Standards

Speech Notes

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Good afternoon and welcome to the Treasury.

Up front with the Secretary and I today is Brendon Doyle, the Deputy Secretary responsible for Financial Operations and Crown debt management.

As you all know, the Treasury publishes updated information on the Crown's finances most months of the year.

You utilise the *Financial Statements of the Government of New Zealand* to provide the public with insights into the financial sustainability of the state's day-to-day activities. The focus tends to be on the total Crown's operating balance position excluding gains and losses, and on the core Crown's net debt position.

This regular reporting and monitoring has played an important part in explaining why a generation of New Zealanders has come to expect governments to prudently manage public sector finances at all times.

Given that background, some of you might be wondering why the Treasury is now supplementing the *Financial Statements* with another fiscal accountability report – the *Investment Statement*.

## Managing the balance sheet to raise living standards

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- Public Finance Act 1989 amendment
- Complements FSGNZ
- Leadership in transparency and accountability
- Greater focus on:
  - How fit for purpose assets and liabilities are
  - Are New Zealanders receiving value for money
  - Sustainability of finances in an uncertain world

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One answer is that at least one aspect referenced in the *Financial Statements* has now become large enough to warrant more in-depth analysis and focus in its own right.

It is the balance sheet or, more precisely, the size, composition and trends in the Crown's portfolio of assets and liabilities.

Last year Parliament resolved that while the fiscal reporting status quo was very good in New Zealand, it was no longer good enough and it instructed the Treasury to periodically report on the past, present and future of the balance sheet.

The *2014 Investment Statement* is the Treasury's inaugural report card since the law change. It provides a large amount of information that aims to assist us to understand the degree to which the Crown's assets and liabilities are fit for the purposes for which they are held, and are delivering New Zealanders value-for-money.

Part of Parliament's motivation for changing the law, perhaps, was to better protect New Zealanders against risks on the horizon.

No one wants the New Zealand Crown to get hit with the types of unpleasant surprises that some European governments have had to contend with in recent years. This was because, in part, they did not have a proper handle of their own finances, including their public balance sheets – nor an adequate understanding of previously off-balance sheet risks that ended up on governments' balance sheets in very short order when hard economic times hit.

## Assets acquired to facilitate delivery of services

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- Represent historical Crown investment...
- ...primarily to advance social purposes
  - state highways    - social housing
  - courthouses      - police stations
  - schools            - hospitals
- Now investing for the future

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I do not need to remind Press Gallery journalists that governments have a very wide range of public policy objectives and priorities. These are constantly undergoing adjustment in response to ever-changing expectations about the appropriate role of the state in the wider economy and society.

A way to think about the size and structure of the Crown's portfolio of assets and liabilities is that it simply reflects the cumulative effect of over a century of decisions taken by governments as they advanced their public policy objectives.

Historically, the balance sheet has largely consisted of assets initially acquired for the purpose of advancing social purposes: State highways; social housing; courthouses; police stations; schools; hospitals. In more recent years, there has been a big rise in financial assets acquired and held by the New Zealand Superannuation Fund and the Accident Compensation Corporation, and in financial liabilities - largely in the form of debt issued to underpin domestic demand after the *Global Financial Crisis* and to fund the Canterbury rebuild.

Governments, of course, do not have to acquire assets as part of their efforts to advance public policy priorities. Acquiring assets has never been an end in itself, but a means to an end and some priority public policy programmes have not been accompanied by significant asset acquisition by the Crown. But in all cases the focus has been on raising living standards.

## Large, growing and increasingly complex

- \$240b+ of assets and \$170b+ of liabilities
- Much larger than 20 years ago...
- ... and will expand into the future
- Composition will become more complex...
- ...and more heavily weighted to financial assets
  - projected to rise to 45% of GDP over long term

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With over \$240 billion worth of assets and over \$170 billion worth of liabilities, the Crown's balance sheet is large, much larger relative to the economy than twenty years ago when the Treasury produced its first attempt at measuring it.

The Treasury, moreover, expects the value of the Crown's portfolio of assets and liabilities will continue to expand while its composition will become more complex, and more heavily weighted to financial assets.

## Overview of past and future on Table 3.1

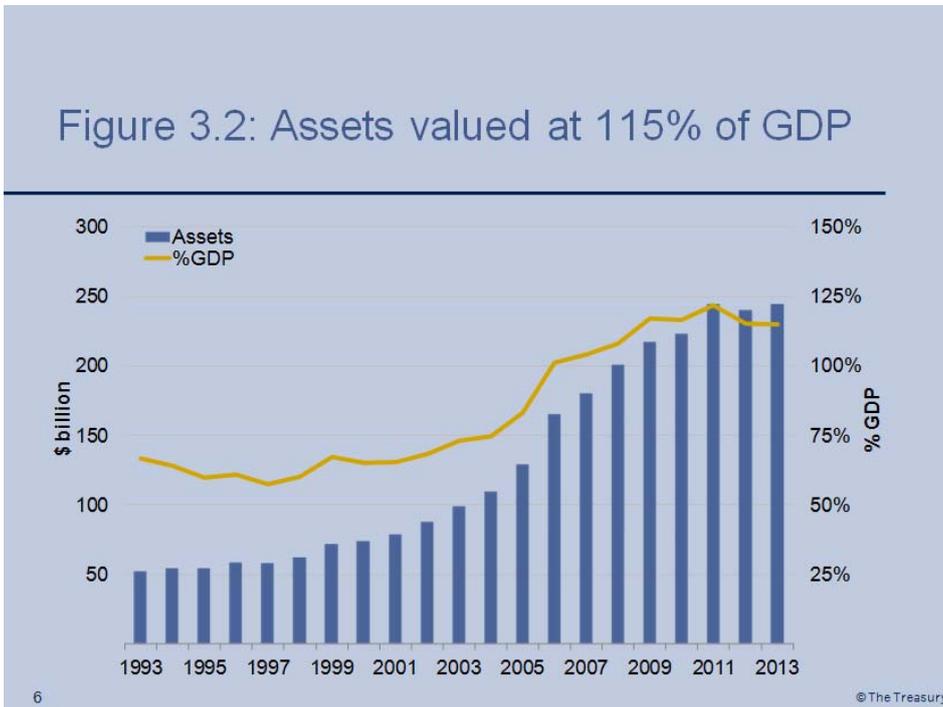
STATEMENT OF FINANCIAL POSITION as at 30 June								
	2003 Actual \$m	2008 Actual \$m	2013 Actual \$m	2014 Forecast \$m	2015 Forecast \$m	2016 Forecast \$m	2017 Forecast \$m	2018 Forecast \$m
<b>Assets</b>								
Cash and cash equivalents	2,732	3,804	14,824	10,221	9,535	9,236	9,117	9,296
Receivables	10,143	14,158	19,883	18,908	17,909	18,191	18,842	19,090
Marketable securities, deposits and derivatives in gain	16,572	41,189	44,000	44,522	40,429	46,246	53,732	52,549
Share investments	4,734	12,964	17,359	21,289	23,044	24,747	26,511	28,305
Advances	6,300	12,946	22,813	24,359	28,208	28,188	29,760	31,256
Inventory	840	964	1,140	1,148	1,189	1,296	1,267	1,283
Other assets	578	1,663	2,295	2,288	2,388	2,404	2,385	2,377
Property, plant and equipment	52,667	103,329	109,833	113,277	115,464	117,316	118,833	119,899
Equity accounted investments	4,212	8,065	9,593	9,876	10,130	10,331	10,478	10,631
Intangible assets and goodwill	1,075	1,751	2,776	2,878	2,872	2,829	2,788	2,761
Forecast for new capital spending	-	-	-	206	773	1,569	2,539	3,439
Top-down capital adjustment	-	-	-	(450)	(625)	(600)	(625)	(1,050)
<b>Total assets</b>	<b>99,851</b>	<b>200,835</b>	<b>244,416</b>	<b>248,562</b>	<b>249,354</b>	<b>260,573</b>	<b>275,147</b>	<b>279,915</b>
<b>Liabilities</b>								
Issued currency	2,895	3,530	4,691	4,936	5,084	5,237	5,394	5,556
Payables	9,208	10,895	11,180	11,955	12,103	13,238	13,971	13,395
Deferred revenue	-	1,292	1,714	1,895	1,733	1,740	1,746	1,794
Borrowings	38,285	46,110	100,087	104,354	104,808	110,532	117,271	112,282
Insurance liabilities	9,155	20,484	37,712	33,430	31,140	30,848	31,738	33,138
Retirement plan liabilities	13,857	8,257	11,903	10,880	10,501	10,192	9,925	9,669
Provisions	2,670	4,753	7,138	6,417	6,176	5,939	5,965	5,948
<b>Total liabilities</b>	<b>76,070</b>	<b>95,321</b>	<b>174,405</b>	<b>173,667</b>	<b>171,345</b>	<b>177,726</b>	<b>185,911</b>	<b>181,680</b>
<b>Total assets less total liabilities</b>	<b>23,781</b>	<b>105,514</b>	<b>70,011</b>	<b>74,895</b>	<b>78,009</b>	<b>82,847</b>	<b>89,236</b>	<b>98,235</b>
<b>Net worth</b>								
Total net worth attributable to the Crown	23,687	105,132	68,071	69,165	72,242	77,040	83,401	92,377
Net worth attributable to minority interest	94	382	1,940	5,730	5,767	5,807	5,835	5,858
<b>Total net worth</b>	<b>23,781</b>	<b>105,514</b>	<b>70,011</b>	<b>74,895</b>	<b>78,009</b>	<b>82,847</b>	<b>89,236</b>	<b>98,235</b>

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You have a vast amount of information at your disposal and I thought it would be helpful to quickly run through some of the big picture information and outline where to find the relevant graphs and tables in the *Statement*.

Chapter 3 provides an overview of what has been happening to the size and composition of the Crown’s portfolio of assets and liabilities at points in time in the past and provides a view to the future. The summary table is Table 3.1.



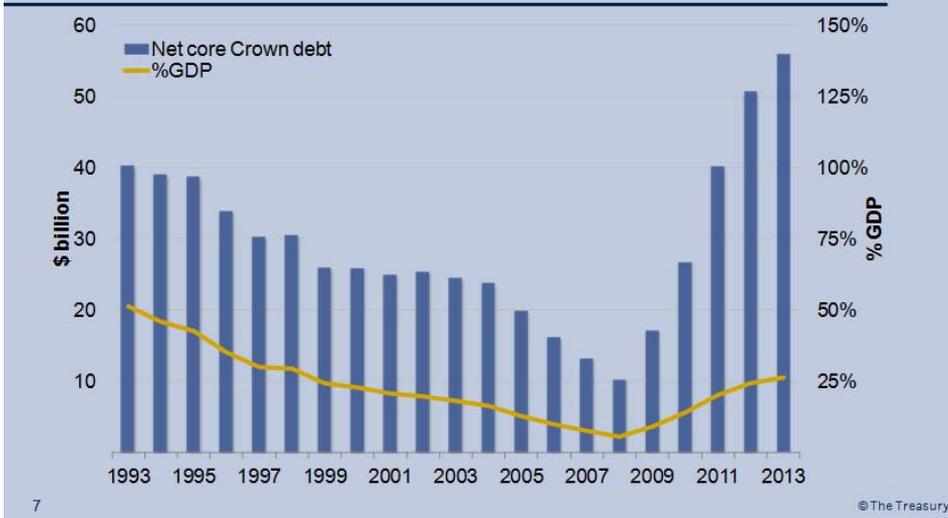
Looking at the asset side of the ledger at the end of the last financial year, that large number - over 244 billion dollars - was equivalent to around 115% of GDP at the end of June 2013— see Figure 3.2.

So how big is this:

- ▶ Conservation land accounts for a third of New Zealand’s land mass;
- ▶ Housing Corporation owns 4%-5% of total New Zealand dwellings;
- ▶ School property sits on around 7,000 hectares and
- ▶ Landcorp owns over 160,000 hectares of farmland.

The value of Crown assets alone is now around three times greater than the market capitalisation of the New Zealand stock exchange.

Figure 3.3. Net core debt at 26% of GDP



Government borrowings form the biggest component of the Crown's total liabilities and, at the end of the last fiscal year, net Core Crown debt of just under \$56 billion was equivalent to just over 26% of GDP - see Figure 3.3.

Figure 3.4: The balance between the two

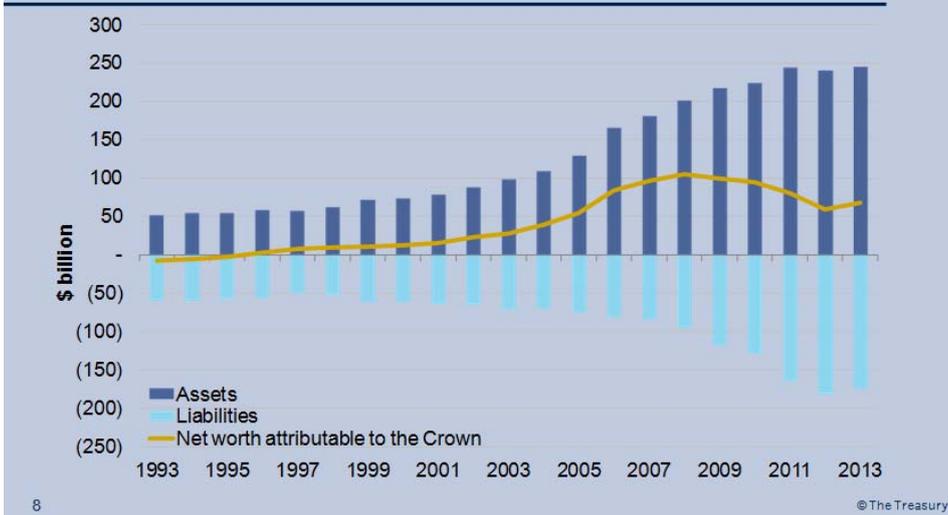
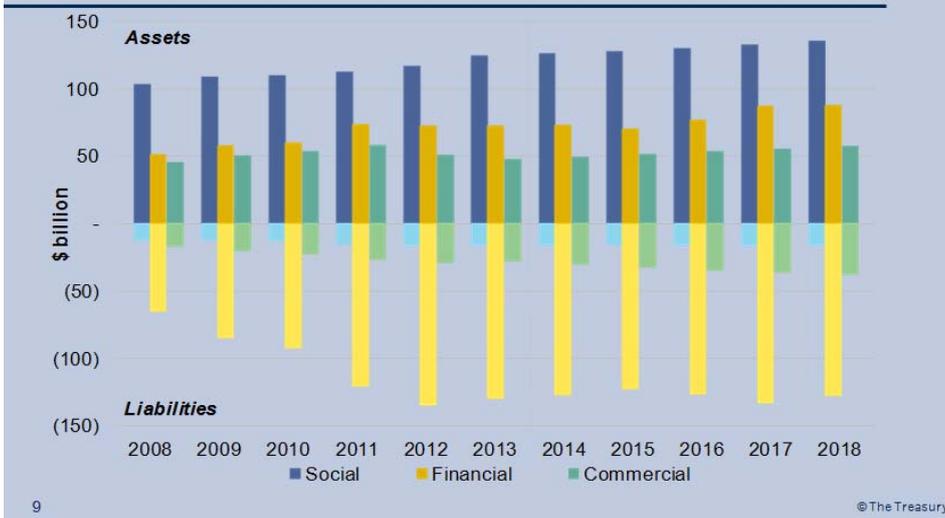


Figure 3.4 captures the balance between all those assets and liabilities – you can see net worth attributable to the Crown, which was in a negative position 20 years ago, has been positive and strengthening for most of the last two decades. You can see the temporary negative impact of the global financial crisis between June 2008 and June 2012.

Figure 3.1: Forecasts by functional class



For the analytical purposes of the *Investment Statement*, we classify the balance sheet into one of three broad functional categories – Social, Financial or Commercial – selected to capture the primary purpose for holding the asset or liability.

By far the most attention in the *Statement* is focused on Social assets – mainly property, plant and equipment held to facilitate the delivery of social programmes. The reason for this is that assets held primarily to facilitate social outcomes – as opposed to financial and commercial purposes - are the largest segment of the Crown’s asset portfolio – see Figure 3.1 and due to their nature tend to have a wider variety of ways in which performance can be measured.

Figure 3.5: Financial assets to drive rise in net worth to 2018

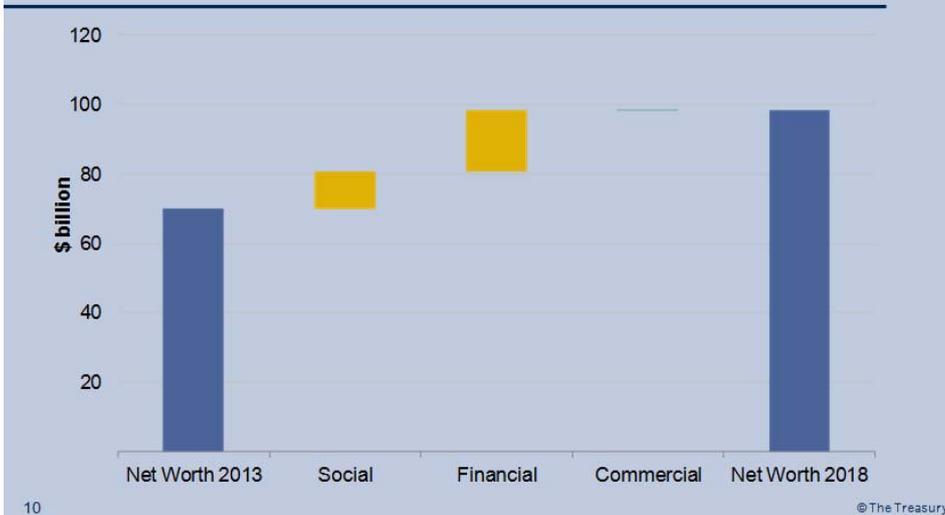
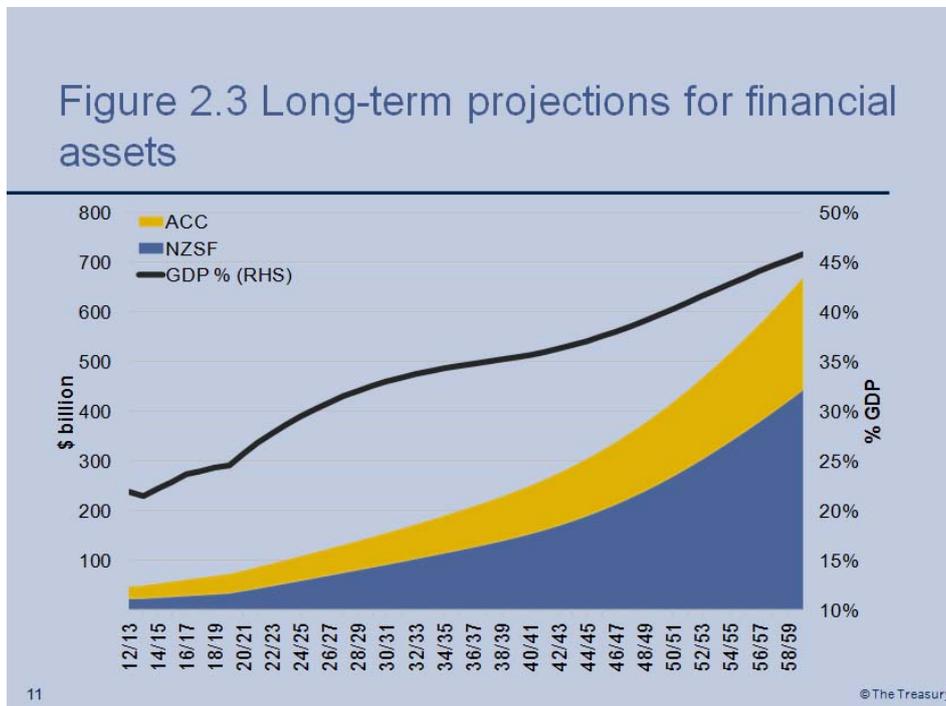


Figure 3.5 captures the forecast information from a different angle. It shows that the Crown’s net worth position is expected to strengthen by June 2018 and these gains will be reinvested largely in the financial portfolio. The value of social assets is also expected to rise, while the contribution of commercial assets is very small.



In terms of the very long-term outlook, the Treasury’s projection is that financial assets will grow from under 25% of GDP at June 30, to over 45% of GDP in 2057/58. Figure 2.3 outlines the extent to which the financial assets held by ACC and NZSF are anticipated to grow in the decades ahead.

### Why is the Balance Sheet so large and growing?

- Financial assets: Grow as Crown part pre-funds anticipated costs future governments face
- Physical assets: Crown acquires and disposes of assets but additions exceed disposals over time:
  - 2011 - \$5.4 billion
  - 2012 - \$5.6 billion
  - 2013 - \$4.3 billion

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In summary of the big picture, the Crown's balance sheet is large and growing because it captures the cumulative effect of over a century of individual decisions to make capital investments mainly in physical assets, combined with the tendency of the Crown to acquire more along the way in terms of assets than it disposes. Financial assets, meanwhile, are projected to grow as governments pre-fund some of the anticipated costs to future governments arising out of our ageing population and the need to pay for New Zealanders' on-going access to income in retirement.

The slide captures how the Crown's property, plant and equipment (PPE) acquisitions outpaced disposals of redundant PPE in the last three financial years. The dollar amounts are not large in the scheme of things, but it all adds up over time.

I have gone through these first 12 slides quickly to recap the big picture. This information is already public and covered in the *Financial Statements*, the *Half Year Economic and Fiscal Update* and the *Long-term Fiscal Statement*.

The 2014 Investment Statement builds on what is in the public arena to provide a deeper understanding of what the Crown owns and owes, and the implications of this.

## Outlook means asset performance measures need to be excellent

- The size, changing composition and outlook means quality of management of assets and liabilities has growing implications for security and living standards
- Owning the right assets, managing them well and funding them sustainably are critical ingredients to ongoing provision of high-quality and cost-effective public goods and services

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The size, changing composition and outlook for the balance sheet means that the quality of the management of the Crown's assets and liabilities will have growing implications for the security and living standards of New Zealanders in the future.

Owning the right assets, managing them well and funding them sustainably, are all critical ingredients to securing the ongoing provision of high-quality and cost-effective public goods and services that New Zealanders value.

It is this outlook that makes it increasingly important to ensure New Zealanders are receiving value for money from these significant and growing holdings, and to ensure that they are fit for the purposes for which they are being held in the context of future challenges to our society.

Having high quality asset performance measurement and practice in departments and agencies of the Crown will improve not only those entities' performance but it will also support efforts to improve understanding of the strengths and weaknesses on the Crown's overall or aggregate balance sheet.

## Real progress in agencies' asset performance monitoring

- In recent years there has been progress on
  - Capital Asset Management Framework
  - Four Year Plans
  - Public sector acting more like a network, less like a lot of separate hierarchies
  - More focus on opportunity costs of decisions
  - More attention to ongoing operating expenditure implications of capital investment decisions

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The information collated for Chapter 4 marks real progress in agencies' asset performance monitoring in New Zealand. Agency understanding of their assets and liabilities has improved, but there is still room for greater improvement – as is the case for large organisations in the private sector.

When the first Crown balance sheet was introduced we lived in different times. Our ability to collect, analyse and interpret data has improved significantly with technological innovation.

In recent years, a much greater focus has been placed on scrutinizing the capital side of the budget – bringing transparency and accountability standards over the Crown's use of capital investments and holdings up to the high standards New Zealand public finances have in relation to departments' and agencies' operating expenses.

## Increasing transparency to improve results for New Zealanders

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- Increasing transparency will enable us – agencies, Parliament and the wider community – to progressively strengthen our ability to work collectively to get the most out of what we have and will have in the future
- We are in early stages in a long-term journey – one that requires us to constantly aim to better identify and understand what we have so that we can then utilise it and make better choices

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We know we still have a lot of work to do in this area. Increasing transparency should enable us – agencies, Parliament and the wider community – to strengthen our ability to work collectively to get the most out of what we have, and will have in the future, to achieve the best outcomes for New Zealanders.

This is early stages in a long-term journey: A journey that requires us to continuously aim to better identify and understand what we have so that we can then utilise that more robust information to inform better decision-making and more evidence-based choices. The change will not be instant and the benefits of this will be seen over the long term, not the short term.

## Robust information will highlight opportunities to do better ...

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- Improvements in quality of asset performance management may identify opportunities to more effectively utilise the balance sheet to free resources not being well utilised to:
  - Higher priority purposes
  - Assist with efforts to meet the long-term fiscal challenges

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Improvements in the quality of asset performance management may, in time, help identify opportunities to more effectively utilise the overall Crown balance sheet to free up resources that are not being well utilised to assist with efforts to meet the fiscal pressures on the horizon.

## ... and permit more robust assessment of risks

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- Greater understanding of risks to the balance sheet reduces the potential for unexpected surprises

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Improvement in the quality of asset performance management will also help us to better understand risks lurking on - or to - the Crown's balance sheet – risks that can impact on the ongoing financial sustainability of the Crown. We need to reduce the likelihood and impact of potential adverse surprises, and be well positioned to handle negative shocks when they hit.

## Biggest focus is on assets held to advance social priorities

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- Chapter 4 surveys measures of performance management over Social assets
- Includes comprehensive assessment of utilisation of these assets and their effectiveness in facilitating the delivery of policy outcomes
- There is also an overview of Financial and Commercial portfolio performance

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This *Investment Statement* goes beyond simply providing data on the size and shape of the Crown’s balance sheet.

It provides a view on our current understanding of our assets and liabilities, whether are fit for the purposes for which they are held, and the extent to which they are delivering New Zealanders’ value-for-money.

By far the majority of this report is focused on assets held by agencies to advance social priorities and programmes

## No “One Size Fits All” approach

	State Highways	Schools
Age:	Not as applicable	Average Age
Condition:	Smoothness Skid resistance Rutting	10-year cost assessment
Utilisation:	Vehicle kilometres	Children per classroom
Functionality:	Road safety	Modern Learning Environment

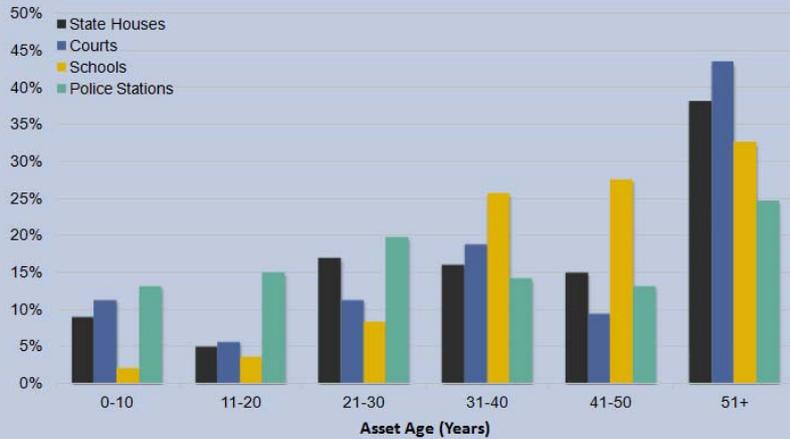
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Chapter 4 includes a significant amount of non-financial performance management information on property, plant and equipment held to advance social policy outcomes. There is no “one-size fits all” approach to this, as our assets serve a very wide range of purposes, and so you will see different measures for different assets.

So what does the information collected tell us?

## Good understanding of asset age profile...



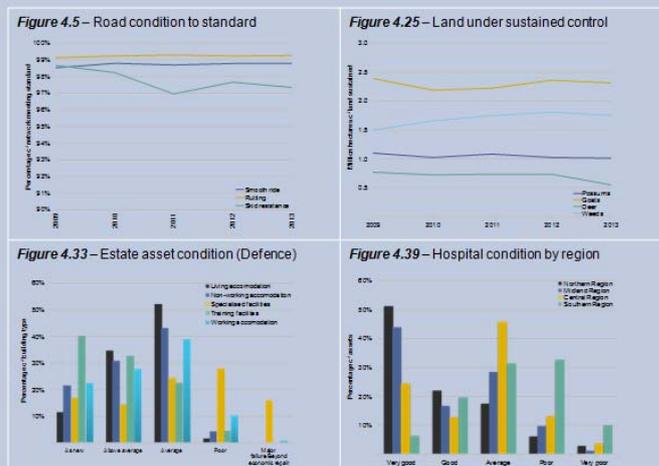
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The slide above shows that in general we own a lot of older buildings. Most buildings owned by the Crown tend to be over 30 years old, which brings with it obsolescence risks, as well as being more likely to require maintenance or significant replacement capital spend.

Clearly, an ageing population (a declining ratio of school-age people relative to the total population), together with ageing social infrastructure, means we will need ever-more astute management of assets to meet the social and fiscal challenges in the decades ahead.

## ...and assets' condition

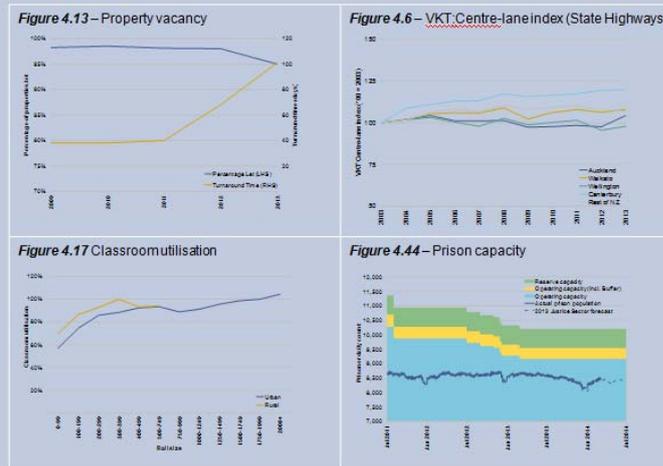


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Despite this age, in general the Crown assets seem to be in a reasonable condition. However, as the assets age the costs to maintain them tends to increase.

## Reasonable understanding of utilisation

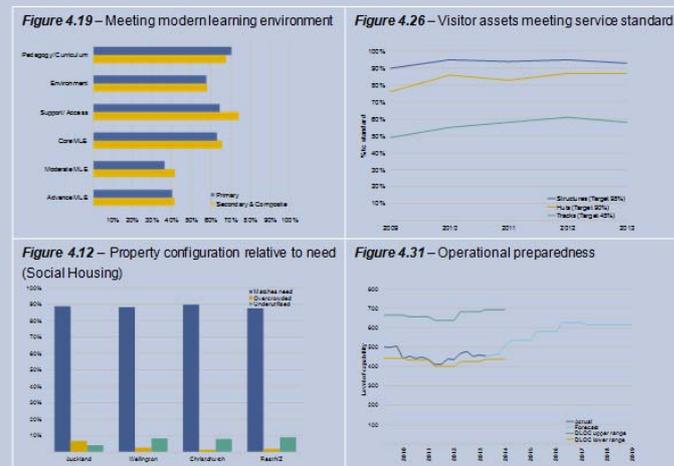


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We have a reasonable understanding of how well our assets are being utilised. But this does not necessarily apply to all of the agencies and there is some scope for improving information and understanding around this area.

## Weaker on functionality & fit for purpose



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Understanding functionality and how well assets fit their intended purpose tends to be weak. This shows how well an asset meets needs, but is one of the more difficult areas of performance to understand and measure for an asset base, especially where the assets act as an enabler rather than a driver of outcomes. We do have a reasonable understanding in a few agencies, but there is a lot of room for improvement across the Crown as a whole.

## How does this facilitate better decisions?

- Most home-owners have a strong understanding of their home and mortgage
- The Crown also needs to have an excellent understanding of its assets and liabilities to ensure taxpayers are not misallocating or wasting resources on things that do not contribute to higher living standards now and in the future

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To assist you in understanding why this is important I'd like to use an analogy familiar to many New Zealanders – the family home.

Most home-owners have a strong understanding of their home. They know that as it gets older they need to paint it, or replace the roof. And they understand all those little bits of maintenance that need to be done on the weekend to keep it up to a reasonable standard. Keeping a careful eye on all the little jobs assist in preventing potential massive costs in the future.

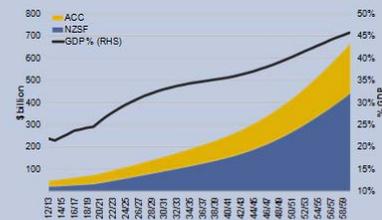
People starting a family may buy a home with one or two spare rooms for when their children come along – the Treasury would call that *building a buffer!* Over time, children grow up and leave home, leaving extra rooms no longer needed so the homeowners may eventually downsize their home and use that money for other things that they may want instead.

And as things change, people will upgrade their property as it no longer meets their needs. A big back yard will turn into a garden. Ultrafast broadband will replace dial-up.

This is what the Crown needs to do on an asset by asset basis, across billions of dollars worth of assets, to ensure that we are not wasting resources on things that do not promote higher living standards.

## Financial portfolio

- Financial portfolio is projected to grow
- This will have implications for the risks the Crown faces and long-term sustainability
- Part 3 of the Investment Statement covers these issues



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If we move on to look at the financial portfolio, the big story here is its growth projections. Financial assets now make up a greater proportion of the Crown's balance sheet than ever before, and, as the graph outlined earlier, these are projected to be even bigger in the future.

This growth means that the Crown now faces different risks to what it has traditionally been subject to, and has implications for long-term sustainability. Part 3 of the Statement discusses such issues in more detail.

## Commercial portfolio

- Reorganised approach to Commercial Operations
- Programme to look at structures and incentives to support closer engagement with boards, governance processes and potential new monitoring approaches
- To get deeper understanding of entities that we work with

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I wanted to say a few words about the commercial portfolio even though it is a relatively small part of the Crown's overall balance sheet and the Treasury has recently published its 2013 Annual Portfolio Report which covers this sector.

In 2012, we initiated a programme looking at the structures and incentives needed to support closer engagement with boards, governance processes, and potential new monitoring approaches. Recently we have made a number of changes internally that are intended to enable us to be more flexible in how we go about our work and tap on expertise – including from outside of the Treasury - to get a deeper understanding of the entities that we work with.

## Areas of increasing focus for the Treasury and agencies

- A need for systematically collecting better agency information on performance and risk
- This would facilitate better agency and cross-Crown decision making

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The *2014 Investment Statement* identifies areas where the Treasury and Crown entities need to work harder to improve the quality of public sector asset and liability management practices.

I will not go through them all as they are listed in the Executive Summary and my colleagues and I are happy to take any questions that you have on them but I would like to briefly discuss one to highlight what it might imply in terms of next steps for the Treasury and agencies.

One management recommendation is that Treasury work with agencies to develop more systematic and robust mechanisms for the collection of better quality and higher utility non-financial asset performance information. Agencies and the Treasury will need to work closely together to agree on new enhanced performance management measures, and within agreed timeframes.

We need to ensure Crown agencies have good asset schedules and high quality asset management plans which can then be implemented effectively. Eventually, perhaps these schedules and plans should be put in the public arena.

## Conclusion: effective management underpins living standards

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- If the balance sheet is well-managed, social services will be provided cost effectively and efficiently and taxpayers will be assured they are receiving value for money
- If the balance sheet in aggregate is well-managed, we will also be able to be confident that it is providing society with in-built resilience to the next big economic, financial or natural disaster shock

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Effective Crown balance sheet management should always serve two important roles.

First, it should facilitate the efficient and effective delivery of public goods and social services. Secondly, it should empower governments' efforts to buffer society and the wider economy from potential shocks in the future.

If the overall balance sheet is well-managed, social services will be provided cost effectively and efficiently and taxpayers will be assured that they are getting value-for-money out of the assets they own via the Crown.

If the balance sheet in aggregate is well-managed, we will also be able to be confident that it is providing our society and economy with in-built resilience to inevitable next big economic, financial or natural disaster shock that comes along.

That means that managing the overall balance sheet, and its varied and diverse components, is vitally important to efforts to underpin New Zealanders' living standards now and in the future and will be an area of work of high priority to the Treasury in the years ahead.

Thank you. The Secretary to the Treasury, Gabriel Makhlouf, Deputy Secretary responsible for debt management and Financial Operations, Brendon Doyle, and I are very happy to take any questions.