An Assessment of Public Policy Implications of Decisions in relation to the NSW Generations Fund and NSW Government Debt

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Executive Summary

This paper finds that there is a reasonable basis to believe that the NSW government is raising debt to invest in the NSW Generation Fund's Debt Retirement Fund (DRF). Past contributions to the DRF have primarily come from NSW reserves and the proceeds of the sale of 51% of WestConnex.

Raising more debt than is required to meet the NSW budget deficit financing requirement appears to be in conflict with the intended purpose of the DRF to reduce the State's debt.

Although the NSW Budget focuses on net debt, gross debt is an important measure of financial sustainability. Incurring higher levels of gross debt than necessary is a problem for intergenerational equity, exposing future generations to higher risks in the face of adverse interest rate movements.

So far the NSW Generations Fund (NGF) has failed to fulfil its intended "dual-purpose" of (1) repaying debt and (2) using up to half of the investment returns to enable the MyCommunity Dividend program. It would appear that only a very small fraction of the NGF's earnings has been dedicated to community projects.

In the current climate of the NSW government running a budget deficit and high levels of debt, a more cautious and prudent risk management approach would be to use the NGF for its intended purpose of reducing debt and funding community projects. I also note that it appears that the cost of NSW government debt is rising because of the sheer quantity of debt that NSW is proposing to issue.

As a policy response, it would be straightforward and reasonable for the Treasurer, as the responsible NSW Minister, to clarify that the government does not intend to raise additional borrowings solely for application to the NGF's DRF.

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[1] Note: This paper does not constitute legal advice, and does not purport to address legal issues. It is based on my expertise in public policy and finance, with experience in senior positions advising on budget and fiscal policy and related issues at both Commonwealth and NSW level.

Introduction

I have been asked to consider a number of questions in relation to the recent announcement of a much larger-than-anticipated increase in NSW debt following the release of the 2021-22 NSW government budget and the nexus between this increase in debt and what appear to be debt-funded contributions the NSW government is proposing to make to its NSW Generations Fund (NGF), and the NGF's Debt Retirement Fund (DRF) more specifically.

The TCorp borrowing program announced on 22 June 2021 includes new loans in 2021-22 amounting to $A31.1bn. According to market participants this was significantly higher than the consensus estimates prior to this announcement of approximately $18bn to $22bn.

This debt funding task is notably substantially higher than the $24bn of debt TCorp issued in 2020-21 when NSW was running larger budget deficits than those forecast in 2021-22.

This is in contrast with the debt programs announced by the Commonwealth and other State governments. Notably, the Commonwealth's debt agency, the Australian Office of Financial Management, informed market participants at a KangaNews conference on 29 June 2021 that it will shortly further downgrade its debt issuance for 2021-22 because of an improvement in budget outcomes.

I have been advised that a number of market participants believe, based on advice from TCorp and the NSW Treasury, that one motivation behind this increase in NSW borrowing is to direct additional funds to NGF for investment in speculative and equity-dominated asset-classes.

The NSW budget does not explicitly indicate that this is the intended strategy. However, there are elements of the budget that can be read as endorsing such an approach. For example:

> *Over the last decade, the NSW Government has led the nation in balance sheet management, pioneering reforms such as asset recycling, cash and investment optimisation, and the establishment of a state sovereign wealth fund. This Budget continues that momentum with a strategy to borrow at sustainable levels while interest rates are low… (Budget[2], p3-1)*

The budget papers explicitly state that part of the funds raised by TCorp will be used to make additional contributions to the NGF:

> *"Financial assets included in the calculation of net debt are forecast to grow to $68.0 billion at June 2025. This increase is driven by the growth of the*

[2] References to "Budget" mean the 2021-22 NSW government budget unless otherwise stated

> *State's investment funds, due to the expected investment returns and additional contributions into these funds"* (Budget, p 6-3, emphasis added)

This is also confirmed in the budget discussion in Chapter 6, which, amongst other things, states the NGF is forecast *"to increase to around $40bn by June 2025"* (Budget, p. 6-7).

Note also that in the 2020-21 Budget "the NSW Government announced its intention to grow the NGF to over $70bn by the end of the decade" (see NSW Generations Fund Annual Report 2019-20). The 2021-22 budget states: "The NSW Generations Fund (NGF) is forecast to grow to more than $90.0bn by June 2031" (Budget, p.6.1). This is some $20bn more than the figure the government indicated in its previous budget it intended to reach by December 2029.

The 2021-22 Budget papers reveal a substantial forecast increase in NSW's investments in "financial assets", which includes the NGF, over the forward estimates, totalling some $19bn to $20bn. The Commonwealth Bank of Australia (CBA) highlighted these unusual "financial asset" investments in their research following the latest NSW budget.

Since the budget is in substantial deficit, these investments must be debt funded barring a large number of undisclosed new privatisations. Financial assets included in the calculation of net debt are projected to be $49.8bn as at June 2021. These assets include the State's "cash, investment funds and other assets". (Budget, p 6-3). TCorp has advised market participants in writing that the budget will be directing additional capital towards the NGF to expand this vehicle's funds under management, which again is likely debt funded.

According to market participants, TCorp's CEO, David Deverall, publicly advised the CEDA 2021-22 budget lunch that raising the large quantity of additional NSW government debt in 2021-22 was not a problem as long as the NGF's returns covered the cost of this debt. According to attendees, NSW Treasury Secretary Mike Pratt echoed these sentiments in responses to questions from CBA at the same event. TCorp has also advised market participants in writing that there is no current plan to use the NGF's significant capital, which is estimated to be around $14bn currently growing to $27bn once the final tranche of WestConnex has been sold in October 2021, to reduce NSW's record debt burden nor the associated interest repayments.

Based on these indicators, it appears that the conclusion of market participants is correct. They have noted that in effect NSW is raising more debt than it requires to meet its immediate deficit financing requirements, and applying the additional funds raised to the NGF. On the face of it, taking on more debt than needed, and then applying those monies to a debt reduction fund, appears contradictory. From a policy perspective, this also appears to contradict the intended purpose of Division, 3 Section 8 of the *NSW Generations Fund Act 2018*, which states:

> *The purpose of the Debt Retirement Fund is to provide funding for reducing the debt of the State in accordance with the principles of sound financial management set out in section 7 of the Fiscal Responsibility Act 2012.*

What appears to be driving this approach is firstly the fact that the funds held by the NGF are classified as an offset to gross NSW government debt, and secondly, that buying equities (assuming this is the intention of further investments in the NGF) while the cost of debt is near record lows is apparently seen as a good trade for taxpayers.

In the year to April 2021 the NGF achieved a return of 15.5% (Budget, Table 6.2, p6-4), although it lost money in the 2020 financial year as equities performed poorly. While it might on the surface appear attractive for a government to borrow at low interest rates and gamble some, or all, of the proceeds on the stock market to earn higher returns, this approach entails high risk. It is quite common for equity markets to fall by 50% or more (as seen in 1987, 2001, and 2008-09); volatility is one of the defining characteristics of equities markets.

If the value of the NGF falls sharply, this will materially increase NSW's net debt given that the NGF is currently treated as an offset to NSW government gross debt in the NSW Budget and by the credit rating agencies. It will further raise questions about the ability to use the NGF to repay NSW debt, which could then increase the cost of NSW government debt. This could in turn threaten NSW's AA+ credit rating from ratings agency Standard and Poors, which was downgraded from AAA in December 2020 because of the large increase in gross government debt.

The *NSW Generations Fund Act 2018*, stipulates that the DRF is to "provide funding for reducing the debt of the State in accordance with the principles of sound financial management set out in Section 7 of the *Fiscal Responsibility Act 2012"*.

The principles include references to risk management practices and require policy decisions to be made having regard to their financial effects on future generations.

Whether or not these principles are being observed is a legal question, outside the scope of this paper. I have been asked to address a range of policy questions relating to the NGF, as outlined in the following section of the paper.

Questions on the NGF

1/ Is the Debt Retirement Fund being used for its publicly stated original purpose of reducing budgetary risk?

When the NSW Treasurer established the Debt Retirement Fund (DRF) he said it would

> *"offset debt and insure against the $17 billion fiscal gap forecast by 2056. Securing our State's finances today—and into the future."*
> (Legislative Assembly Hansard – 19 June 2018).

The 2018-19 Budget papers also provide information on the purpose of the Fund:

> *With the State's balance sheet in a position of unprecedented strength, the Government will seed the NGF with $3 billion sourced from balance sheet reserves and ensure these funds can only be used for debt retirement. Over time, growth in the NGF – from investment earnings and future contributions – will help the Government to maintain sustainable debt levels consistent with a triple-A credit rating. (2018-19 NSW Budget, p 1-2)*

Reducing budgetary risk was not referred to in the second reading speech or the 2018-19 Budget papers, but can be inferred from fund's enabling legislation, the *NSW Generations Fund Act 2018*. Under that Act (s.8) the purpose of the Debt Retirement Fund is *"to provide funding for reducing the debt of the State in accordance with the principles of sound financial management set out in section 7 of the Fiscal Responsibility Act 2012."*

Section 7 of the *Fiscal Responsibility Act 2012* sets out three principles for sound financial management:

- *responsible and sustainable spending, taxation and infrastructure investment,*
- *effective financial and asset management, and*
- *achieving intergenerational equity.*

Of particular note is a requirement for risk management practices (s.7(3)(d)) and that policy decisions are made having regard to their financial effects on future generations (s.7(4)(a)).

Taking on debt to invest in equities is inherently high risk for any entity, including a government agency. There is no guarantee that the return on investment from equities will always be higher than the cost of debt. Because both interest rates and share prices are subject to high volatility the risks involved in this kind of strategy can compound - for example, if interest rates were to rise at the same time as share values fell, compelling an entity to refinance its debt at higher cost (assuming it could find willing lenders) and/or divest itself of shares at a disadvantageous time. The NSW government is exposing taxpayers to this type of risk.

It is a risk well understood by private investors - incurring debt to buy equities has led to many individual and corporate bankruptcies. While a State cannot declare bankruptcy, it can suffer severe adverse consequences if a risky financing strategy goes awry. A salutary case study is the collapse of the State Bank of South Australia in 1991 due to its mismanagement of its loan portfolio - especially, loans to property development projects that promised high returns and did not deliver. Although the State Bank - like the NGF and TCorp in NSW - was an arms length entity, the South Australian government as the ultimate owner and backer of the Bank picked up the bill. The collapse had a negative fiscal impact on South Australia for decades.

It should be noted that as a general rule sovereign wealth funds globally do invest in equities, among other assets, as does the NGF. The difference is that typically sovereign wealth funds are established when governments have low debt or surplus cash, including gains from asset sales or budget surpluses.

This indeed was the case when the NGF was established with an initial investment of $10bn comprising $7bn from the sale of 51% in WestConnex and $3bn from reserves. At the time of its establishment NSW was running a surplus budget, and had prospects of additional unexpected revenue (so much so that the NFG legislation explicitly provides (s.9(2)) for the Treasurer to direct “windfall tax revenue” to the Debt Retirement Fund). In announcing the NGF the Treasurer noted the State’s balance sheet was “in a position of unprecedented strength”.

That is not the case at present. NSW has a budget deficit and rising net debt over each of the forward estimates years. In this climate, a cautious approach to fiscal risk management would be to take on as little additional debt as possible and use the income from the NGF for its intended and legislated purpose of debt reduction.

In almost all instances observed internationally, sovereign wealth funds are established to manage a country’s or state’s excess revenues when the jurisdiction is running strong surpluses or has large gains from selling assets or natural resources.

The sovereign wealth fund is in effect a “future proofing” strategy, storing funds to be applied to repayment of future debts if the jurisdiction finds itself in deficit. This is a more prudent long-term strategy than spending a surplus on immediate handouts. This was explicitly behind the establishment of the Commonwealth’s Future Fund - then Treasurer Peter Costello did not want to see his budget surpluses frittered away on current spending, and created the Future Fund as a mechanism to provide for meeting long term liabilities[3].

[3] Peter Costello, Budget Lockup Press Conference, 10 May 2005

A significant risk to governments is their overall level of indebtedness, or gross debt. The NSW 2021-22 Budget provides figures only on net debt - that is, gross debt less financial assets[4]. Net debt is improving compared with previous forecasts. The Budget papers note:

> *…net debt in June 2021 is projected to be $40.6 billion, an improvement of $4.8 billion since the 2020-21 Half-Yearly Review. This is being driven by an improved revenue outlook (reducing the State's borrowing requirements) and higher-than-expected performance of the State's investment funds, particularly the NGF. (Budget p.6-3)*

Gross debt is however an important metric. Higher gross debt exposes a government to increased risk from movements in interest rates. Over the long term it is desirable to reduce both gross and net debt.

The Commonwealth government's recently released 2021 Intergenerational Report (IGR) makes the observation *"Gross debt is an important indicator of fiscal sustainability."* (IGR, 28 June 2021, p.78). In line with this observation, the Commonwealth IGR says:

> *"A key focus of the Government's medium-term fiscal strategy is to grow the economy in order to stabilise and then reduce debt [ie gross debt] as a share of the economy." (IGR, p.79).*

A key word in that sentence is stabilise. Higher than needed levels of gross debt lead to greater instability in the face of interest rate movements, and therefore to a higher fiscal risk for the State.

Levels of debt are already at a record high, not only in NSW but in every Australian jurisdiction, due to the economic impact of the COVID-19 pandemic. A strategy to reduce fiscal risk would involve lower rather than higher than levels of gross debt. Clearly while the State is in budget deficit it requires borrowing - but a prudent fiscal risk management strategy would be to avoid discretionary increases in new debt. This is particularly so if the increase in debt is applied to investments in equities, a strategy that could amplify fiscal risk in any major downturn.

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[4] Net debt equals the sum of financial liabilities (deposits held, advances received, loans and other borrowings) less the sum of financial assets (cash and deposits, advances paid and investments, loans and placements). (Budget, Glossary)

2/ Is the NGF's second community infrastructure fund being used for its publicly stated original purpose?

In introducing the NGF the Treasurer established both a Debt Repayment and a Community fund. He stated

> *In a world first up to half of the investment returns will enable the new MyCommunity Dividend program…communities will decide how that money is spent to make their neighbourhoods healthier, happier and better places to live.*
>
> (Legislative Assembly Hansard – 19 June 2018)

The Community Services and Facilities Fund (known as the Community Fund) is established under Division 3 of the *NSW Generations Fund Act 2018*. Its purpose (s.12) *"is to provide funding for cost-effective facilities and services throughout New South Wales that improve the wellbeing of communities and the lives of the people of New South Wales"*.

There has been little spending from the Community Fund to date. According to the latest published NGF Annual Report for 2019-20 *"a total of $19.7m has been paid out of the Community Fund. At the time of writing [2 November 2020], 24 projects had been completed."*

A brief examination of the types of projects that have been funded suggest that by and large they could be expected to deliver community benefits. They include sports facilities, playgrounds, walkways, mental health initiatives, shade sails, community gardens, shared kitchens and so on. Most projects are not yet complete, so yet to be evaluated. The small size of each individual project, and the relatively small expenditure from the Community Fund to date, means it is hard to determine the extent to which the funds are being used for their stated purpose. In any case, whether or not a funded activity represents a real community benefit is very much dependent on the perspective of the community concerned.

As with any other program that distributes public funds, the Community Fund is subject to audit by the NSW Auditor General. When the spending from the fund is audited, the Auditor can be expected to provide a view on the Fund's effectiveness. In the absence of that kind of detailed audit information there is no basis on which to say the fund is not achieving its stated purposes.

What can be said, though, is that very little of the NGF income from its investments is being directed to community fund purposes. By far the majority is applied to debt reduction - although it should be noted this not directly through debt repayments (a TCorp responsibility), but in an indirect fashion through the offset to net debt represented by growth in the value of NGF investments.

When the NGF was established there was clearly an intention that debt reduction and community facilities would be roughly equal in priority. As noted earlier, the Treasurer in introducing the bill for the NGF said: *"up to half of the investment returns will enable the new My Community Dividend program"*.

The NGF Annual Report for 2019-20 also emphasises the dual nature of its mandate, setting out two objectives:

1. *Support the State's credit rating by helping keep debt levels manageable over the medium term and promoting intergenerational equity over the longer term*
2. *Assist the NSW Government to provide for today's communities and plan for the future by responsibly delivering infrastructure and services to NSW residents without overly burdening future generations with unsustainable debt.*

To date - acknowledging that community projects take time to get off the ground - it does not appear the NGF has dedicated anything near half its investment returns to such projects, so has not as yet fulfilled that particular element of the public purposes for which it was created.

3/ Is investing the circa $10bn WestConnex first tranche sale proceeds, plus the expected $13bn of second tranche proceeds due to be realised in October 2021, in the Debt Retirement Fund's asset allocation dominated by equities and equity-like assets while concurrently compelling NSW taxpayers to raise large amounts of additional debt to replace this funding to pay for the NSW government's future cash deficits consistent with the intended purpose of the NGF to either repay debt or fund new infrastructure?

First, it is important to note that dollars are fungible. A decision to not pay off debt - when that is possible - is equivalent, with minor variations at the margins, to a decision to take on more debt. Placing the WestConnex sale proceeds in the NGF to support NGF investments means those monies are not available to help meet the costs of financing the NSW budget deficit.

In cases where a government has net debt, the proceeds from asset sales are commonly used to reduce that debt. Debt reduction has been one of the main justifications advanced for asset sales over the past half century. Not using the WestConnex proceeds to reduce debt is at odds with this normal practice.

As an alternative, proceeds from an asset sale may be used to fund new infrastructure, reducing the need for a government to take on new debt.

Using the WestConnex proceeds in this way to fund new infrastructure has been foreshadowed by Treasurer, Dominic Perrottet:

> *Mr Perrottet said proceeds from any future [WestConnex] transaction would be used to extend the Government's unprecedented $97.3bn infrastructure program. "Our priority is providing the schools, hospitals, roads and rail NSW needs. The Government's asset recycling strategy has enabled us to do that and create tens of thousands of jobs in the process," he said.*
>
> *NSW Treasury Media Release, November 2020*

Australia has a long history of privatisation of public assets, at both Commonwealth and State level and under both Coalition and Labor governments. As the Reserve Bank of Australia (RBA) has observed *"proceeds of sales have been used largely to reduce government debt, with a resulting fall in the value of government bonds outstanding."* ('Privatisation in Australia', *RBA Bulletin* December 1997).

In the same bulletin the RBA also noted *"Financial markets in Australia have coped well with the large program of privatisation in the 1990s. This is not surprising as, in large part, Governments have used the proceeds to retire, or contain a rise in, debt"*.

That is, use of proceeds from a privatisation like the sale of WestConnex to retire debt would be in line with precedent and would not distort financial markets.
The RBA therefore would be unworried about a State using privatisation to rein in excessive debt or to invest in new infrastructure.

Ratings agencies would take a similar view. For example, in an interview with the Australian Financial Review (August 25th 2020) S&P Global Ratings analyst Anthony Walker said *"Privatisations provide states with an alternative funding source for new infrastructure, reducing deficits and the need for new borrowings…NSW has had success with "asset recycling", receiving high prices for government assets and using that money to build new infrastructure."*

On the other hand, applying the proceeds of a privatisation to other ends, while at the same time raising debt, is not normal practice. It could be expected to raise concerns among financial regulators and ratings agencies alike.

4/ Does the current use of the NGF's capital at a time when the NSW government is raising record amounts of debt and running record budget deficits, which are forecast to continue over the forward estimates, comply with the Fiscal Responsibility Act's requirements in terms of intergenerational equity?

The risks associated with borrowing to purchase equities, discussed previously, affect not only the current fiscal position but also future generations. While it is impossible to predict peaks and troughs in share markets[5], severe downturns involving losses of 50% or more happen periodically (for example, in 1987, 2001, 2008-09) as do smaller yet still very significant falls. They are inevitable even if their timing cannot be predicted.

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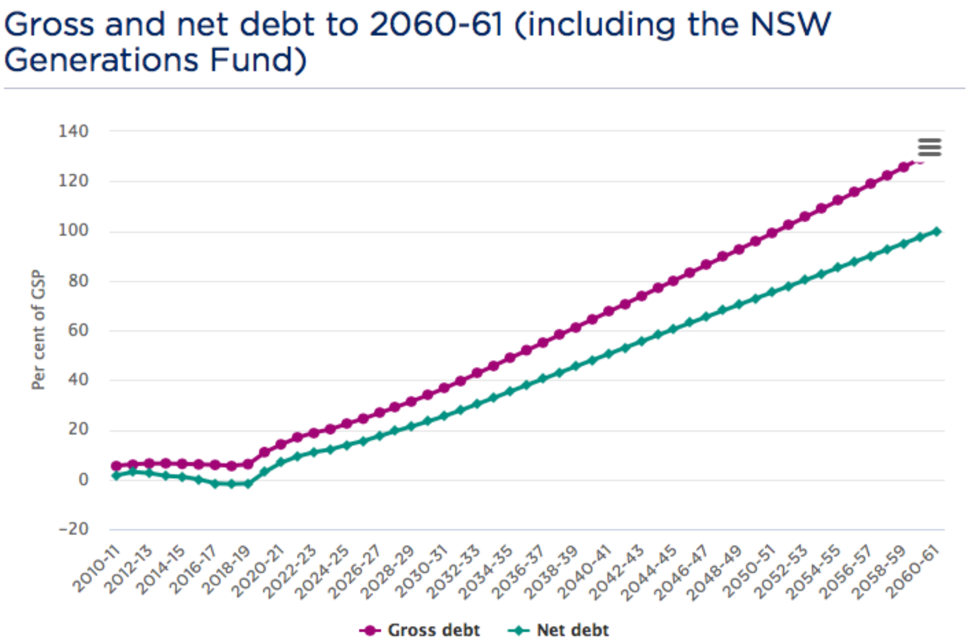
[5] Stibel, J. (2009) 'Why We Can't Predict Financial Markets' *Harvard Business Review*, Harvard, Mass.

When a downturn happens, future generations will be more exposed to fiscal risk than they would have been had the NSW government not taken on additional borrowings to invest in the NGF.

The rapid rise in gross NSW debt is also an issue for intergenerational equity. The NSW Intergenerational Report of June 2021 highlights that gross debt is growing faster than net debt over the period to 2060-61. The difference is primarily due to the investments made into and by the NSW Generations Fund. The NGF is a "net offset" against gross debt, although it may become increasingly difficult for NSW to liquidate its assets in an orderly fashion to repay debt simply because of the sheer size of its investments, some of which could become illiquid.

State contributions to the NGF include *"distributions from the State's minority interest in WestConnex, Ausgrid and Endeavour; dividends, income tax equivalents and government guarantee fees received from state-owned corporations; and from the State's mining royalties."* (NSW IGR, June 2021, p.106)



Source: NSW IGR, Chart 6.2, p105

Net debt provides a potentially more accurate picture of the State's fiscal position than gross debt, if the underlying assets can be valued properly, and is therefore important to measure and report. However, as previously noted, gross debt is also an important measure of fiscal sustainability, which crucially credit rating agencies assess in addition to net debt, and increased gross debt is a source of risk.

In terms of intergenerational equity, use of borrowing to fund the NGF means future generations are exposed to a higher level of risk of adverse interest rate movements than are current generations.

Raising increased debt also increases the cost of borrowings. This has already been observed in relation to the cost of NSW debt, which (based on publicly available financial market data) has become the highest of all Australian States.

5/ Is raising large amounts of NSW government debt to fund the Debt Retirement Fund consistent with its intended public policy purpose?

At issue here is the interaction between TCorp, NSW Treasury and the NGF. NGF is operating within its mandate by investing the funds entrusted to it in a range of assets, including equities and a variety of other asset classes. However, the question is whether it is appropriate to direct large amounts of funds raised by TCorp debt issuance into the NGF.

It is clear from the budget papers that part of the funds raised by TCorp will be used to make additional contributions to the NGF:

> *"Financial assets included in the calculation of net debt are forecast to grow to $68.0bn at June 2025. This increase is driven by the growth of the State's investment funds, due to the expected investment returns and additional contributions into these funds"* (Budget, p 6-3, emphasis added)

The NGF can and presumably will continue to operate within its legislated parameters, regardless of where its incoming funds are sourced. It will make use of these funds to grow the size of the fund over many years, as shown by the chart reproduced from the NSW IGR under the previous heading.

As long as the NSW government applies those funds to debt repayment or to the Community Fund, as required under the *NSW Generations Fund Act 2018*, the NGF *considered in isolation* can be described as acting in consistency with its intended public policy purpose.

If, however, the Debt Retirement Fund is considered alongside the TCorp borrowing program - that is, as a suite of interrelated government activities, *not* in isolation - it is far less clear that it is achieving its purposes as described previously - namely, debt retirement and helping the Government to maintain sustainable debt levels consistent with a AAA credit rating.

If ratings agencies become concerned about the apparent anomaly of raising additional debt to fund an agency set up for debt reduction, the public policy purpose of a AAA credit rating (already downgraded by Standard & Poor's to AA+)[6] is potentially put at risk.

This is a particular concern given that Standard & Poor's evaluate NSW's gross and

[6] See *The State's Credit Rating*, NSW Treasury, at www.treasury.gov.au viewed 30 June 2021

net debt positions. When S&P downgraded NSW from AAA to AA+ in December 2020 it commented:

> *"The economic shock caused by the COVID-19 pandemic will see NSW lose billions of dollars in forecast revenue, while cushioning the economy through fiscal stimulus and a large infrastructure program. The state will post historically large operating and after-capital-account deficits this fiscal year. As a result, debt will rise sharply, even if prospective asset sales eventuate. We are consequently lowering our long-term issuer credit rating on NSW to 'AA+' from 'AAA'."*
>
> *Standard & Poor's, December 2020*

S&P specifically highlighted new NSW gross debt issuance, commenting:

> *"New borrowings will see NSW's debt rise substantially, to levels consistent with 'AA+' rated peers. While the state's infrastructure pipeline will be partially funded by financial assets previously accumulated in the NSW Infrastructure Future Fund, substantial new borrowing will be needed for future projects and to bridge the transitory operating deficits."*
>
> *Standard & Poor's, December 2020*

This suggests that by reducing gross debt issuance, the NSW government would be likely to directly improve its S&P credit risk profile by reducing gross debt outstanding and gross interest repayments as a share of operating revenue. Improving these debt risk metrics would be likely to improve the chance of S&P considering returning NSW to a AAA rating.

Another broader public policy concern arises when equity investment is funded through debt. While investment in equities is becoming increasingly common through sovereign wealth funds (SWFs) around the world, there are concerns about the potential negative impact of funds being financed by debt. It is not a practice seen in most developed country SWFs.

A commonly advanced rationale for SWFs themselves to issue debt is to encourage development of a bond market in underdeveloped countries - see Lugo and Bertoni[7]. That situation does not apply in NSW, which benefits from a liquid domestic government bond market worth over $A1 trillion. The same authors also observe *"use of debt is less common among SWFs from democratic countries, where it can entail higher political risk"*.

6/ Is the Debt Retirement Fund's asset allocation in its latest Annual Report and CPI + 4.5% return target consistent with the intended public policy purpose of repaying debt?

[7] Lugo S, Bertoni F 'The Use of Debt by Sovereign Wealth Funds', *Oxford Handbook of Sovereign Wealth Funds*, at oxfordhandbooks.com viewed 30 June 2021

The NGF has a return target of CPI + 4.5% (Budget, Table 6.2, p. 6-4). This is a higher target rate than can be achieved through investment solely in low risk assets. It is higher than the rate of return one would expect from a liquid portfolio of cash and high-grade bonds intended to offset debt in a very low risk fashion. The NGF's return target means that it inevitably has to have a high proportion of equities in its investment portfolio, rather than safer but lower return assets such as cash.

The NGF outlined this in its 2019-20 Annual Report, saying its *"long-term investment horizon means the Debt Retirement Fund can be more return-seeking than other State investment funds while adopting a well-considered level of risk…can invest more in growth- oriented assets...maintained a 40 per cent allocation to listed equities across Australian and international markets in 2019-20"*.

The table below taken from the NGF 2019-20 Annual Report shows its asset allocation:

The actual asset allocation of the Investment Trust as at the reporting date:

Asset class	Strategic Asset Allocation (%)	Actual Asset Allocation (%)	Value ($'000)
Australian Shares	14.0	14.0	1,576,741
International Shares	20.0	20.1	2,263,750
Emerging Market Shares	6.0	6.0	675,746
Alternatives	22.5	22.5	2,534,048
Unlisted Property & Infrastructure	7.0	6.0	675,746
Opportunistic	5.0	5.0	563,122
Emerging Market Debt	6.0	6.1	687,008
Bank Loan	5.0	5.2	585,647
High Yield	3.0	2.9	326,610
Cash	11.5	12.2	1,374,017
Total	**100**	**100**	**11,262,435**

Forty per cent is invested in Australian, international and emerging market equities. However the category "alternatives" is also likely to include private equity and hedge funds, so will entail a similar exposure to share market fluctuations as direct investments in equities. Emerging market debt, high yield debt and unlisted property and infrastructure are also potentially risky and could fall significantly in any more general economic downturn. It is not clear what is included in the "opportunistic" category.

The CPI + 4.5% level of return is comparable to that of the Commonwealth Future Fund. The *Future Fund Investment Mandate Direction 2017* issued to the Future Fund Board on 15 May 2017 requires the Future Fund Board adopt a benchmark average return for the Future Fund of "at least the Consumer Price Index (CPI) + 4.0 to + 5.0 per cent per annum over the long term".

A study by the Natural Resource Governance Institute[8] of a selection of international SWFs that reported publicly (at least half do not) found, not surprisingly, that higher returns correlated with higher volatility or risk of loss. Some funds with high returns also reported years where returns were zero or negative. This reinforces the dangers of debt financing for a SWF.

Indeed, in 2020, the NGF itself lost money for NSW taxpayers, highlighting that the NGF can become a risk amplifier for the NSW budget.

As a return target, the NGF's CPI + 4.5% appears in line with Australian and international sovereign wealth funds. As noted in the previous section, the area of arguably greater public policy concern arises from the interaction between the NGF and TCorp borrowings.

7/ Would it be more fiscally responsible, and consistent with the intended public policy purpose of the NGF, for the WestConnex sale proceeds in both tranche 1 and tranche 2 to be applied for either the replacement of additional gross debt issuance and/or the funding of the infrastructure investment program proposed by the NSW government, which is one driver of the large forecast deficits?

See answers to questions above. In summary, a more cautious approach to risk would see WestConnex sale proceeds applied either to debt reduction or to offset the costs of new infrastructure. In relation to the latter option, note that NSW has to date been a leader in the practice of what is known as asset recycling, selling some assets in order to invest in others where identified benefits to the State are higher.

8/ What simple policy changes would you recommend to remedy any problems you have identified with the NSW government's current use of the NGF and its Debt Retirement Fund?

It would be straightforward and reasonable for the Treasurer, as the responsible NSW Minister, to clarify that the government does not intend to raise additional borrowings solely for application to the NGF's DRF.

It would also be possible for the Treasurer to reaffirm that the intention with the proceeds from the sale of the State's remaining interest in WestConnex is to invest in new infrastructure, reducing the need to take on additional debt for the government's proposed new infrastructure projects.

Both decisions would materially reduce the fiscal risk the State faces, and that which confronts future generations. They would also likely be welcomed by investors, reassure ratings agencies, and thereby reduce the cost of NSW's debt servicing obligations.

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[8] Bauer, A (2018) *How Good are Sovereign Wealth Funds at Investing money Made from Natural Resources*, Natural Resource Governance Institute, at resourcegovernance.org viewed 29 June 2021

The standing and reputation of the NGF would not be adversely affected by such a move, and may be enhanced. Over the long term the performance of the NGF is likely to remain solid regardless of whether or not it obtains additional contributions in the 2021-22 NSW Budget, or future debt-funded contributions. The expected $27bn that will sit in the NGF by the end of 2021 already represents about one-third of NSW's total public debt outstanding, which is approximately $95bn.

There are also measures the NSW government could take to improve transparency in the operations of the NGF and its DRF, including regular online reporting on its decision-making, in particular in relation to its investment strategies, and greater disaggregation of information it provides on its investments. The level of reporting by the Reserve Bank of Australia provides a model for transparency in public financial institutions that could usefully be followed by the NGF.