Supplement to the 2010 Investment Statement of the Government of New Zealand

Hon Bill English, Minister of Finance

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Guide to the Budget Documents

A number of documents are released on Budget day. The purpose of these documents is to provide information about the wider fiscal and economic picture and the Government's spending intentions for the year ahead. The Budget documents are as follows:

Executive Summary

The *Executive Summary* is the overview of all the Budget information and contains the main points for the media and general public. This section summarises the Government's spending decisions and main issues raised in the *Budget Speech*, the *Fiscal Strategy Report,* the *Supplement to the 2010 Investment Statement* and the *Budget Economic and Fiscal Update*.

Budget Speech

The *Budget Speech* is the Minister of Finance's speech delivering the Budget Statement at the start of Parliament's Budget debate. The Budget Statement generally focuses on the overall fiscal and economic position, the Government's policy priorities and how those priorities will be funded.

Fiscal Strategy Report

The *Fiscal Strategy Report* sets out the Government's fiscal strategy and measures how the Government is going against its overall goals in areas such as the balance between operating revenues and expenses, and achieving debt objectives. The 2011 report includes fiscal trends covering at least the next 10 years and the Government's long-term fiscal objectives.

The Government must explain changes in, and/or inconsistencies between, the *Fiscal Strategy Report*, the *Budget Policy Statement* and the previous year's *Fiscal Strategy Report*.

Supplement to the 2010 Investment Statement of the Government of New Zealand

The *Supplemen*t updates the *2010 Investment Statement of the Government of New Zealand* which provides an overview of the significant assets and liabilities on the Crown's balance sheet, how they have changed over time and how what the Crown owns and owes is forecast to change over the next five years. The *Supplement* explains ways in which new Crown investment can be funded, gives greater clarity around medium-term investment priorities and signposts how the Government is working to improve asset management.

Budget Economic and Fiscal Update

The *Update* includes the Treasury's overall economic forecasts and the forecast financial statements of the Government, along with the implications of government financial decisions and other information relevant to the fiscal and economic position.

The Estimates of Appropriations

The *Estimates* outline expenses and capital expenditure the Government plans to incur on specified areas within each Vote for the financial year about to start (the Budget year).

Information Supporting the Estimates of Appropriations

Information Supporting the Estimates is organised on the basis of sectors, with each Vote and its administering department allocated to one sector (a small number of departments are in more than one sector). The *Information Supporting the Estimates* comprises sector overview information, together with statements of responsibility; performance information for appropriations in Votes covered by the sector; and statements of forecast service performance and forecast financial statements of departments included in the sector. *Statements of Intent* of departments included in the sector form part of the supporting information.

The Supplementary Estimates of Appropriations and Supporting Information

The *Supplementary Estimates* outlines the additional expenses and capital expenditure required for the financial year about to end. The *Supporting Information* provides reasons for the changes to appropriations during the year, related changes in performance information and certain additional performance information for new appropriations.

Internet

These documents will be made available on the New Zealand Treasury's Internet site at http://www.treasury.govt.nz

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Foreword

I am pleased to present this *Supplement* to the inaugural *2010 Investment Statement of the Government of New Zealand* (*Investment Statement*).

The main objective of the *Investment Statement* was to facilitate better understanding of what the Crown owns and owes on behalf of the public. It sought to promote a Crown-wide investment perspective and provided an overview of the significant assets and liabilities on the Crown's balance sheet and how they are forecast to grow over time. The *Supplement* reinforces those objectives. It:

- provides greater transparency, with a focus on areas of relative weakness in the *Investment Statement* such as sources of funding, and social asset performance information, and
- indicates the Government's investment intentions, updated for decisions in Budget 2011, especially around using existing capital more efficiently and the Mixed Ownership Model.

The *Supplement* will facilitate efforts to ensure that the management of the Crown's balance sheet is properly aligned with the Government's broader fiscal strategy and policy objectives. In particular, the overall allocation of capital can be better managed. The Government therefore intends to make changes to future Budget processes to increase the transparency of capital investment decisions, especially over how existing capital is reinvested, and to improve our approach to major investment decisions.

It is the Government's intention that the balance sheet should be actively shaped over time consistent with our overall social service, infrastructure and other priorities. We will be faced with choices on how best to invest our capital – making those choices in a more transparent and informed environment will assist us to deliver better outcomes for New Zealanders and assist our efforts to raise New Zealand's potential growth rate in the years ahead.

Hon Bill English
Minister of Finance

19 May 2011

Executive Summary

Managing the Crown's balance sheet well is part of prudent fiscal management

The Crown's assets and liabilities are held on behalf of all New Zealanders. Last year's *Investment Statement* emphasised the importance of better managing the balance sheet as part of overall prudent fiscal management. At 30 June 2010, assets totalled $223 billion, liabilities $128 billion and net worth was $95 billion.

Over the next four years the balance sheet will expand, but Crown net worth will fall slightly. Net assets are projected to increase by $34 billion, but liabilities rise by $45 billion, mostly through debt issuance. Managing asset and liability exposures matters because any loss of value, on either side of the balance sheet, is ultimately borne by taxpayers and compounds the deterioration in Crown finances. The Government's fiscal strategy is to achieve surplus and start to reduce debt by 2014/15.

Substantial Crown investment over the next five years is underway...

Between 2010 to 2015 the Crown will accumulate an additional $78 billion of gross assets. This includes substantial infrastructure investment already underway, including roads, rail, ultra-fast broadband, schools, hospitals and electricity transmission and generation. The projected increase in physical assets is $38 billion by 2015. The majority of the balance includes growth in Crown financial institutions' (CFIs) investments ($24 billion), and new student loans ($8 billion).

...and is funded by a variety of sources

A large portion of total new investment, $57 billion, is funded from sources outside the core Crown. For example, this includes investments by State-owned enterprises (SOEs) funded from debt and retained earnings, investment gains by CFIs and levies that fund transport, the Accident Compensation Corporation (ACC) and the Earthquake Commission (EQC).

The remaining $21 billion represents the funding requirement for the core Crown, financed from general revenue. Currently, the Crown is borrowing to fund capital investment. This emphasises the need for careful consideration of capital spending. The Crown balance sheet has more than doubled in size over the past decade. Yet only a minority of this investment is funded via new capital allowances; the balance receives much less scrutiny. In addition, the Crown's ability to redeploy capital as needs and priorities change, as any business would do, has been limited. The Government believes that there is considerable scope to reprioritise and use existing capital better, rather than simply increasing borrowing.

There is scope to redeploy capital invested in the Crown's commercial assets. The Government has decided to extend the Mixed Ownership Model to four SOEs and further reduce the shareholding in Air New Zealand Limited (Air NZ), while retaining majority stakes. This brings a number of additional benefits; sharper commercial disciplines on the companies, easier access to capital, wider investment opportunities for New Zealand savers and deeper capital markets.

Proceeds are expected to be in the order of $5 billion to $7 billion, starting in 2012. This reallocation of capital will therefore fund up to one-third of the Crown's investment in core social infrastructure over the next five years, and significantly reduce the need to borrow to fund this investment.

1

Investment Intentions

Acting on the Government's Intentions for the Balance Sheet

This *Supplement* is a companion to the inaugural *Investment Statement*, which provided an overview of the significant assets and liabilities on the Crown's balance sheet and how they are forecast to grow over time.

The Crown's balance sheet is large and has expanded steadily over the past 15 years, more than doubling in value between 2000 and 2010. As at 30 June 2010, the Government owned $223.4 billion of assets and net worth (total assets less total liabilities) measured $95 billion.

The Government is taking an active role in shaping the Crown's balance sheet

A strong balance sheet is instrumental in helping to lower the Government's overall cost of capital raising and in providing a buffer to help withstand economic shocks. The Government is continuing to explore ways to better use its large balance sheet. This includes looking at options to use existing capital more efficiently and applying a higher level of scrutiny to all spending (not just the marginal new investment), to ensure it is directed to the areas of highest value.

The Government's balance sheet will grow substantially over the period from 2011 to 2015 with total new investment of $78 billion (once depreciation and other reductions in assets are taken into account, net assets are expected to increase by $34.3 billion). There is substantial planned infrastructure investment in roads, rail, broadband and electricity transmission and generation. The Government will also continue to invest in financial assets via its various investment arms.

A large portion of this total new investment will be funded commercially by SOEs, reinvested returns and investment gains within the CFIs, and the dedicated revenue stream for transport. The remaining portion, $21.4 billion, must be funded centrally from general revenue.

The *Investment Statement* signalled how the balance sheet will be shaped over time and how the performance of its individual components will be improved, The Government's balance sheet intentions are unchanged from those set out in the *Investment Statement:*

- rebuilding the Crown's balance sheet buffer against future adverse events
- systematically working to reduce the Crown's risk exposures, including through strengthening the economy

- sharpening incentives on State agencies to use existing Crown capital well
- continuing to look at introducing private sector capital and disciplines where appropriate to help drive up the performance of State assets, and
- more actively reprioritising Crown capital to its highest value use.

Rebuilding the Crown's balance sheet buffer against future adverse events

Working the Crown's balance sheet harder through a more efficient use of capital is an integral component of the Government's fiscal strategy, which includes an earlier return to surplus in 2014/15 and a lower Crown debt burden.

Having a low level of net debt provided the Government with a good buffer going into the domestic recession and global financial crisis, followed by the Canterbury earthquakes. The Government is committed to rebuilding that buffer as fast as practicable. Overall, borrowing will lead to an increase in gross and net debt, with net worth declining to $83.9 billion by 2015. Current forecasts show net debt peaking at just under 30% of gross domestic product (GDP) by 2015, with the Government committed to ensuring that it is then brought back to a level of no higher than 20% of GDP by the early 2020s.

Reducing debt levels will lower future borrowing and financing costs which in turn will help to reduce our vulnerability to future adverse events. It will also enable lower interest rates and a lower exchange rate than would otherwise be the case.

Restoring the Crown's balance sheet buffer requires not only low levels of net debt, but also careful investment in high-quality assets.

The value of the Crown's financial portfolio assets is forecast to grow over the next five years, from $60 billion to $67.9 billion in 2015. Increases will occur in:

- ACC's financial assets, arising from higher ACC levies and the continued reinvestment of the returns on these assets, and
- the New Zealand Superannuation (NZS) Fund's assets arising from investment returns.

However, there will be a reduction in the Reserve Bank of New Zealand (RBNZ) and New Zealand Debt Management Office (NZDMO) assets attributable to the continued unwinding of assets accumulated during the global financial crisis.

Whilst growth in the Government's financial assets is necessary to strengthen the buffer, we will also focus on raising the quality of the Crown's investments across all asset classes.

Prioritising capital to its highest value use

The amount that we spend each year on new and replacement capital is substantial. The annual capital allocation is an important source of funding but it contributes only a small portion of the total capital spending each year. The Government is committed to improving the quality of all capital spending, not just the marginal new amount, and will continue to explore mechanisms to prioritise where capital is used.

As indicated in the *Investment Statement*, the Government places highest priority on ensuring social services and infrastructure can be delivered to an appropriate quality level. The key change will be how this new investment is funded in future. In particular, we will look to free up and recycle capital from other areas of the balance sheet. This will enable

us to continue to invest in priority areas such as schools and better transport while limiting additional borrowing.

Budget 2011 aims to make savings, identify greater efficiencies in the public sector and to target funding to priority areas. Consistent with this, the Government's investment decisions reflect the following priorities:

- Key social infrastructure investment, with a focus on those investments which will transform the efficiency, effectiveness and sustainability of public services, and specific aspects of economic infrastructure, namely, ultra-fast broadband and KiwiRail Group Limited (KRG)'s turnaround plan.
- The Government is setting a high hurdle for business cases that seek new capital. Most areas are expected to manage within their existing capital base, and all State agencies will need to deliver better value from their existing capital.
- Agencies are being asked to consider where disposal of surplus assets (eg, closed schools, surplus New Zealand Defence Force [NZDF] properties) can be made without significant impact on service delivery, and how the process of disposals can be accelerated. Any capital released will be recycled to higher-priority parts of the Crown's balance sheet.
- For the financial portfolio, the priorities are to set an appropriate level of risk and to receive full risk-adjusted returns on our investments.
- For the commercial portfolio, entities are required to operate dividend policies that (amongst other things) are commensurate with listed peers and achieve an appropriate balance between dividend levels versus reinvestment in the business.

The Government will continue to look for opportunities to get better value from its existing assets. For example, the Government owns (or leases) around 69,000 houses, providing housing for 200,000 people. As part of its response to the Housing Shareholders' Advisory Group report and recommendations on how to meet the challenges facing the sector, the Government has announced that it will look for more cost-effective ways of managing the demand for housing. A recent example is the sale of 24 old, but high-value, properties which earned Housing New Zealand Corporation (HNZC) more than $19 million. This can be reinvested in State housing in the areas that need it most.

Our intention is for new investments to be funded as far as possible from the existing balance sheet. One way of freeing up capital to reduce debt accumulation is to extend the Mixed Ownership Model – of the type adopted for Air NZ – to more of the Government's commercial assets. This is considered in Section 2.

Sharpening incentives on State agencies to use existing Crown capital well

The Government is further enhancing incentives for the efficient use of capital. We are applying the same restraint on capital spending as on operating spending. The gross new capital spending allocation will be $900 million per Budget from Budget 2012 to 2016 inclusive, down from the previous allocation of $1.39 billion for these years. The lower level of $900 million had previously been planned to apply from 2015/16. This allocation, which excludes spending on reconstruction following the Canterbury earthquakes, will strongly encourage efforts to ensure that capital is allocated to high-priority areas.

As indicated in the *Investment Statement*, the Government will continue to use three broad levers to sharpen incentives: greater transparency around performance information

and regarding future capital investment intentions; higher performance and efficiency expectations; and more consistent exposure to the cost of capital. Since publishing the *Investment Statement* we have:

- developed a framework for performance reporting for social assets as a step towards identifying key performance areas and indicators that are central to understanding how well assets are meeting their intended purpose (see Section 3), and
- started to make better use of the 10-year capital intentions information provided by capital-intensive agencies to give early notice of the capital requirements under current government policies.

Introducing private sector capital and disciplines to help drive up the performance of State assets

We are taking steps to introduce sharper commercial disciplines and greater external oversight to improve the performance of State assets.

We are developing enhanced procurement approaches. For example, public-private partnerships (PPPs) introduce innovations in whole-of-life asset management under a pay-for-performance, risk-sharing model. Current PPP projects in procurement phase include the men's prison at Wiri, South Auckland, and the two new schools at Hobsonville Point, West Auckland.

The Government has also signalled that it is looking at how it can work with third-party providers to grow their capability to meet demand for social housing.

The Mixed Ownership Model will help to raise the productivity of the companies involved through introducing sharper commercial disciplines and enhanced scrutiny of business proposals.

The Government will continue to consider other commercial arrangements that have the potential to lift performance across the portfolio.

Systematically working to reduce the Crown's risk exposures, including through strengthening the economy

In five years' time, both assets and liabilities on the Crown's balance sheet will increase. Assets are forecast at $257.7 billion and liabilities at $173.8 billion (from $223.4 billion and $128.4 billion in 2010 respectively). This growth underscores the critical importance of reducing our risk exposures and of more transparently outlining our future investment intentions.

There are two broad risks associated with the balance sheet:

- the specific risks associated with particular assets and liabilities recognised on the balance sheet which we seek to manage, and
- implicit risks, contingent on unforeseeable events, that crystallise rarely with the result that the Government takes on additional liabilities (and risk).

This risk profile underscores the need for careful monitoring and management of existing assets and liabilities as well as clear objectives to mitigate the risks to taxpayers who ultimately have to fund the balance sheet and bear the costs of any reduction to net worth and of sub-optimal returns from existing assets.

The Canterbury Earthquake Recovery Fund

The Canterbury earthquakes are a tragic example of an unforeseeable, contingent risk. The Government is establishing a Canterbury Earthquake Recovery Fund as part of Budget 2011 to pay for its share of the estimated recovery costs. Its size will initially be set at $5.5 billion, excluding the Crown's EQC obligations and ACC costs, as these are funded by levies.

As regards capital, it will cover the Government's share of repairing essential local infrastructure – mainly water and roading infrastructure – as well as repairing State-owned assets such as state highways, schools and hospitals. It will also cover the financial support package for AMI Insurance Limited (AMI), welfare support and emergency response.

Approximately $1.2 billion has been allocated from the Canterbury Earthquake Recovery Fund to cover essential local infrastructure. From the Crown's viewpoint, this is treated as a grant, since the assets will be owned by the local authority and will not appear on the Government's balance sheet.

Estimates of the impact of the earthquakes on government-owned assets are still preliminary and will be subject to revision over the next year. Damage to schools, which will be covered largely by insurance, appears to be the single biggest issue. Other costs of repairing other government-owned infrastructure, such as state highways, housing and health facility assets, are also largely covered by insurance and/or will be factored into future government investment decisions. Approximately $85 million has been allocated from the Canterbury Earthquake Recovery Fund to meet these costs.

Other balance sheet risks that have materialised

The Government intends to reduce specific risk exposures as conditions permit. Particular examples are:

- The original voluntary opt-in Retail Deposit Guarantee Scheme was introduced in late 2008, expired in October 2010 and was replaced with a more limited extended scheme until 31 December 2011, substantially reducing taxpayers' exposure to the deposit-taking sector.
- South Canterbury Finance Limited assets will be realised as quickly as practicable, consistent with getting the most value for taxpayers.
- We will ensure that the backup support package for AMI will only be used as a last resort, while providing a platform for the company to seek alternative commercial arrangements to replace the Government's support package as soon as possible.

More generally, the Government's focus on rebalancing the economy and increasing national savings will also reduce wider risks to the Crown's tax base and fiscal position. It will support sustainable economic growth.

Structure of Supplement

The *Supplement* is structured as follows:

- Section 2 projects how changes to the balance sheet over the next five years will be funded and explains the Government's decisions around the Mixed Ownership Model.
- Section 3 highlights ways in which we are seeking to take a more active approach to balance sheet management:
  - improving the information held on the performance of our social assets, with case studies on school property, the Department of Corrections' (Corrections) asset management and the proposed state highway asset management system, and
  - ensuring that the level of the Crown's liquid assets is under regular review.
- Section 4 provides a focus on the compositional changes between the Crown's social, commercial and financial portfolios over the period from 1995 to 2010, together with a commentary on those changes.

2

How the Balance Sheet is Forecast to Change over the Next Five Years

The Forecast Statement of Financial Position

The *Investment Statement* classified each of the assets and liabilities of the Crown into three categories – social, financial and commercial. This *Supplement* follows the same portfolio categorisations:

Social assets and liabilities	Assets and liabilities held by the Crown primarily to provide public services or to protect assets for future generations. These include, for instance, roads, schools and the national parks. For the purposes of this document, social assets also include tax receivables and student loans managed by Inland Revenue, and Crown companies that do not have purely commercial objectives (such as the Crown Research Institutes [CRIs] and TVNZ).
Financial assets and liabilities	Assets and liabilities held by the Crown to finance or pre-fund government expenditure and to recognise the obligation for future expenditure. This category is comprised of the CFIs (NZS Fund, ACC, EQC and GSF), the central bank (RBNZ) and government borrowing (NZDMO).
Commercial assets and liabilities	A portfolio of companies held by the Crown with purely commercial objectives. The companies are largely self-sustaining entities operating in openly competitive environments. This category is comprised of all the SOEs and Air NZ.

Table 2.1 shows the forecast movements in the balance sheet over the next five years. The forecast asset values in the table below do not include revaluations of physical assets. The information they contain is consistent with that in the Forecast Financial Statements in the *Budget Economic and Fiscal Update* (BEFU), which have been based on the Treasury's best professional judgement.

Table 2.1 – Forecast Statement of Financial Position as at 30 June

	2010	2011	2012	2013	2014	2015	Change between 2010 and 2015	
	Actual $m	Forecast $m	Forecast $m	Forecast $m	Forecast $m	Forecast $m	$m	%
Assets								
Cash and cash equivalents	7,774	9,103	8,886	8,929	9,032	9,332	1,558	20.04
Receivables	13,884	17,514	16,709	15,269	15,108	15,705	1,821	13.12
Marketable securities, deposits	43,687	49,006	43,034	36,404	41,989	37,607	(6,080)	-13.92
Share investments	12,179	14,206	16,095	18,540	21,506	24,042	11,863	97.41
Advances	18,447	19,851	22,433	24,635	25,140	25,634	7,187	38.96
Inventory	1,160	1,309	1,380	1,426	1,434	1,461	301	25.95
Other assets	1,661	1,668	1,662	1,655	1,648	1,645	(16)	-0.96
Property, plant and equipment								
Land	16,688	16,803	16,892	16,990	17,090	17,193	505	3.03
Buildings	24,019	24,822	25,232	25,436	25,718	25,609	1,590	6.62
Electricity distribution network	2,251	2,812	3,553	4,104	4,327	4,607	2,356	104.66
Electricity generation assets	13,642	13,953	14,915	15,468	15,642	16,121	2,479	13.17
Aircraft	1,731	2,083	2,587	2,864	3,280	3,409	1,678	96.94
State highways	24,838	25,838	26,504	27,273	28,171	29,236	4,398	17.71
Rail network	12,437	12,554	12,755	12,803	12,790	12,755	318	2.56
Specialist military equipment	3,413	3,382	3,377	3,210	3,383	3,579	166	4.86
Specified cultural and heritage	8,505	8,522	8,559	8,590	8,616	8,645	140	1.65
Other plant and equipment	5,806	6,164	6,812	7,567	8,097	8,317	2,511	43.25
Equity accounted investments	9,049	9,398	9,613	9,815	10,010	10,295	1,246	13.77
Intangible assets and goodwill	2,184	2,524	2,714	2,703	2,679	2,629	445	20.38
Forecast for new capital	-	-	142	146	147	147	147	
Top-down capital adjustment	-	(100)	(270)	(270)	(270)	(270)	(270)	
Total assets	**223,355**	**241,412**	**243,584**	**243,557**	**255,537**	**257,698**	**34,343**	**15.38**
Liabilities								
Issued currency	4,020	4,380	4,598	4,828	5,070	5,323	1,303	32.41
Payables	9,931	9,169	9,603	9,608	9,887	10,221	289	2.91
Deferred revenue	1,628	1,433	1,371	1,343	1,323	1,324	(304)	-18.67
Borrowings	69,733	91,003	101,383	104,652	113,994	111,023	41,290	59.21
Insurance liabilities	27,131	31,802	30,533	29,680	30,543	32,271	5,140	18.95
Retirement plan liabilities	9,940	9,271	8,895	8,580	8,316	8,085	(1,855)	-18.66
Provisions	5,984	8,835	8,929	7,927	7,153	5,598	(385)	-6.43
Total liabilities	**128,367**	**155,893**	**165,312**	**166,618**	**176,286**	**173,845**	**45,478**	**35.43**
Asset breakdown by:								
Social	110,938	113,300	115,882	117,809	120,019	122,360	11,422	10.30
Commerical	52,410	55,722	60,289	64,126	65,912	67,414	15,004	28.63
Financial	60,007	72,390	67,414	61,622	69,606	67,923	7,916	13.19
Liability breakdown by:								
Social	13,938	16,349	17,186	16,089	15,543	14,146	(42)	-0.30
Commerical	21,975	25,133	28,815	31,790	32,693	33,494	11,769	53.56
Financial	92,455	114,411	119,311	118,740	128,059	126,205	33,751	36.51
Total net worth	**94,988**	**85,519**	**78,272**	**76,939**	**79,251**	**83,853**	**(11,135)**	**-11.72**

Source: The Treasury

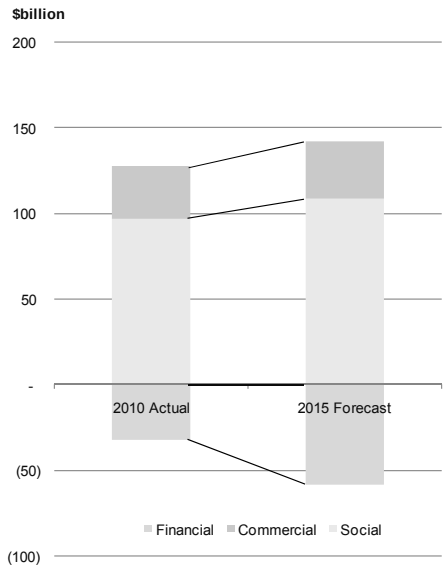
Table 2.1 shows that, as reported in the inaugural *Investment Statement*, liabilities are forecast to grow faster than assets over the next five years. These projections would result in net worth falling by $11.1 billion by 2015, from $95 billion to $83.9 billion.

There are a number of key drivers of this change:

- Share investments represent the largest area of asset growth, contributing over a third of total asset growth. This is driven primarily by expected gains in the value of current investments and the reinvestment of returns.

- The forecast changes will see the social portfolio experience growth in net worth of $11.4 billion, in accordance with the Government's intentions to reprioritise capital to its highest value use.
- The Government's focus on investment in infrastructure is evident over the next five years, including $4.4 billion of investment in the value of state highways and a combined $4.8 billion of investment in electricity generation and the distribution network.
- The jump in insurance liabilities in 2010/11 reflects the EQC's obligations arising from the Canterbury earthquakes. While these obligations will be paid out fully over the forecast period, this will be offset by the continued growth in the gross ACC liability, resulting in the Crown's insurance liabilities remaining around this elevated level throughout the forecasts.

Figure 2.1 – Net values of portfolios in 2010 and forecasts for 2015



Source: The Treasury

- Around 90% of the increase in the Crown's liabilities is from the forecast increase in borrowings. This is forecast to peak at $114 billion in 2014, before falling to $111 billion in 2015. The $41.3 billion increase over the forecast period is the single largest movement on the balance sheet.
- The overall fall in the Crown's net worth is driven primarily by forecast deterioration in the net value of the financial portfolio, from -$32.4 billion to -$58.3 billion, as a result of this borrowing.

Forecast changes in asset values

The above forecasts show changes in a number of asset areas. Table 2.2 summarises the main sources of growth and reductions in asset values.

Table 2.2 – Forecast changes in asset values

$million	2010 Actual	2011 Forecast	2012 Forecast	2013 Forecast	2014 Forecast	2015 Forecast	5-Year Total
Addition of property, plant and equipment	6,555	7,964	8,628	7,433	7,444	7,055	38,524
Other large asset investments:							
- Student loans issued	1,525	1,579	1,590	1,615	1,644	1,648	8,076
- CFI investment growth	5,733	5,792	2,931	4,370	5,375	5,680	24,148
- Forecast for new capital spending	-	-	242	454	651	800	2,147
- Kiwibank mortgages	1,927	836	2,238	1,870	87	86	5,117
Total other large asset investments	9,185	8,207	7,001	8,309	7,757	8,214	39,488
Approximate gross investment in assets	**15,740**	**16,171**	**15,629**	**15,742**	**15,201**	**15,269**	**78,012**
Reduction in assets:							
- Depreciation on PPE	(3,582)	(3,767)	(4,032)	(4,192)	(4,328)	(4,440)	(20,759)
- Reduction in NZDMO/RBNZ financial assets	(2,981)	3,885	(8,066)	(8,079)	4,303	(7,010)	(14,967)
- Balance sheet funding for new capital	-	-	(100)	(450)	(650)	(800)	(2,000)
Other changes in assets	(2,973)	1,768	(1,259)	(3,048)	(2,546)	(858)	(5,943)
Net change in assets	**6,204**	**18,057**	**2,172**	**(27)**	**11,980**	**2,161**	**34,343**
Total assets	**223,355**	**241,412**	**243,584**	**243,557**	**255,537**	**257,698**	

Source: The Treasury

The table shows that:

- The gross investment over the next five years is forecast to be $78 billion.
- Half of this investment is due to property, plant and equipment (PPE) additions of $38.5 billion.
- CFIs' investment growth – driven by projected increases in the value of the existing portfolio of assets, together with the reinvestment of returns – is the next largest driver, contributing roughly 30% (or $24.1 billion) to gross investment.
- Student loan advances are expected to grow steadily each year, representing over 10% (or $8.1 billion) of gross investment, before initial write-downs.
- Forecast new capital spending will be covered by incorporating sufficient capital released by the Mixed Ownership Model to cover new initiatives.[1] [2]
- This gross increase will be offset by a reduction in assets of $37.9 billion. This is mostly attributable to depreciation and to the continued unwinding of RBNZ's and NZDMO's assets accumulated during the global financial crisis. After other changes, the net increase in assets over the next five years is therefore forecast to be $34.3 billion, as above.

Impact of the Canterbury earthquakes on EQC and government-owned assets

The economic and fiscal impacts of the Canterbury earthquakes and the Government's response to these are discussed in the *Fiscal Strategy Report* (FSR) and the BEFU.

The following box highlights the impact on the National Disaster Fund (NDF) and EQC.

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1 Note that allocations will not sum to the gross capital allowance of $900 million per Budget for any given year, owing to timing differences between the decision to allocate funds and their eventual use. For example, construction of a major asset such as a prison will be spread over several years.

2 For the purposes of preparing the Forecast Statement of Financial Position for the period from 2011 to 2015, we have estimated that new capital spending of $2 billion will be funded from the existing balance sheet; for example, by a portion of the capital released under the Mixed Ownership Model. The residual amount forecasted for new capital spending over the forecast period ($147 million) is covered by the Budget 2011 contingency.

The impact of the Canterbury earthquakes on EQC

- **287,000** claims received to date in relation to the Canterbury earthquakes
- **$3 billion** likely reduction in the $6 billion fund as a result of the earthquakes

- Holds assets to help meet the costs of a natural catastrophe
- Canterbury earthquake claims are the current focus, while the appropriate size and composition of the NDF will need to be reassessed in the medium term

EQC is funded by a levy on domestic insurance policies and manages the NDF, which is intended to help meet the costs to EQC of a major earthquake, or other natural catastrophes covered, within New Zealand. The NDF has grown from those levies and from investment income. EQC has a Crown guarantee; if the NDF and reinsurance cover was ever to be fully used up as the result of a natural disaster, the Crown would provide whatever further funding was required to settle claims against EQC.

Size and composition of NDF

Prior to the 4 September Canterbury earthquake, the NDF had investments totalling around $6 billion, invested in cash ($300 million), global equities ($1.7 billion) and New Zealand government bonds ($4 billion). EQC had also purchased $2.5 billion of reinsurance cover, with a further $500 million purchased after the September 2010 Canterbury earthquake. The two major Canterbury earthquakes and associated aftershocks are likely to reduce the size of the NDF by $3 billion (with EQC's reinsurance covering any costs above this), and increase the cost to EQC of purchasing reinsurance cover for future natural disasters.

Risks and challenges

For the Crown, the main balance sheet risks associated with EQC include having to make payments under the Crown guarantee, or having to borrow to redeem the NDF's investments in New Zealand government bonds in the event that the Crown exercises its option to redeem these. The appropriate size of the NDF is an important issue. Given the Crown guarantee, the NDF and EQC reinsurance programme are effectively a form of pre-funding a contingent liability – the cost of natural disaster claims against EQC; the larger the fund and level of reinsurance, the smaller the chance that the Crown guarantee will be called on.

Once all claims from the Canterbury earthquakes have been met, the NDF is expected to consist of around $3 billion of assets. The NDF will grow over time from premium income and investment returns. The Treasury has estimated that it would take the NDF approximately 15 years to grow back to its previous size of $6 billion, under current policy settings. This estimate is based on a number of important assumptions, including that there are no further major natural disasters during that period. The appropriate size and mix of investments of the NDF will need to be reassessed as a result of the Canterbury earthquakes.

Government priorities

The short- to medium-term priorities include managing the response to the Canterbury earthquakes.

How the Crown's Investment will be Funded

Sources of funds

An analysis of the sources and uses of funds provides an insight into overall balance sheet trends and the likely focus of the Government's investment decisions.

The Government's annual capital allowance ($900 million from Budgets 2012 to 2016) is only a small proportion of the Crown's total investment in any given year. Total investment is funded from a variety of sources. These include borrowing, core Crown revenues (taxation and dividends from SOEs) and the Government's existing asset base. Other funding sources available for specific investments include returns from investments held by CFIs, hypothecated levies such as the Road User Charge, third-party revenues such as state house rentals and cash generated and retained by SOEs.

Year-by-year analysis 2011 to 2015

This section analyses the forecast sources of funds and their application on a year-by-year basis for the period from 2011 to 2015.

Table 2.3 breaks investments into broad PPE and non-PPE and other categories, in keeping with the approach generally adopted in the Government's financial statements. It then seeks to examine how those additions will be funded.

Total Crown investment over the next five years is substantial, at $78 billion. Most of this investment, $56.6 billion, is funded by dedicated sources outside the core Crown, such as reinvestment and valuation increases in CFIs, cash retained in SOEs after dividends paid to the Crown in SOEs, commercial borrowing by SOEs and student loan repayments; or from sources available only for particular purposes, primarily transport levies. The remaining $21.4 billion is funded by core Crown activity, effectively from a mixture of additional borrowing, direct and indirect taxation, dividends from SOEs and other sovereign revenue. These general revenue sources are available to fund priority investments across the Government's balance sheet.

Any analysis of source and application of funds requires a number of assumptions. Each dollar spent is interchangeable in the absence of legal constraints, so it is difficult to specify funding sources with precision. In particular, it is impossible to disaggregate funding sourced from core Crown activity. In some cases (eg, the provision of social housing by HNZC), the Crown also charges for goods and services – third-party revenue of that kind is included within general revenue.

Table 2.3 – Summary of forecast investments and sources of funding, 2011 to 2015

$million	2011	2012	2013	2014	2015	Total
Investments:						
PPE additions	7,964	8,628	7,433	7,444	7,055	38,524
Non-PPE investments						
Student loans additions	1,579	1,590	1,615	1,644	1,648	8,076
CFI asset investment growth	5,792	2,931	4,370	5,375	5,680	24,148
Kiwibank mortgages	836	2,238	1,870	87	86	5,117
Forecast new capital spending	-	242	454	651	800	2,147
Total investments	**16,171**	**15,629**	**15,742**	**15,201**	**15,269**	**78,012**
Funding sources for investments						
Funding sourced from core Crown activity:						
Used to purchase PPE	2,597	2,362	2,351	2,870	2,488	12,668
Used for budget capital allowances (incl. forecast new capital spending)	1,052	1,404	888	1,013	923	5,280
Used for issuing student loans	793	756	688	644	572	3,453
	4,442	4,522	3,927	4,527	3,983	21,401
Other funding sources:						
Student loan repayments	786	834	927	1,000	1,076	4,623
Proceeds from asset disposals	170	194	163	319	229	1,075
Hypothecated revenue for roading	1,400	1,072	1,161	1,214	1,470	6,317
Financial and operating returns from CFIs	1,155	1,110	2,245	2,920	2,912	10,342
Valuation gains/(losses) on CFI investments	4,637	1,821	2,125	2,455	2,768	13,806
Borrowing by SOEs	1,089	2,116	1,009	825	518	5,557
Operating surpluses generated by SOEs	1,656	1,722	2,315	1,854	2,227	9,774
Kiwibank deposits	836	2,238	1,870	87	86	5,117
	11,729	11,107	11,815	10,674	11,286	56,611
Total funding	**16,171**	**15,629**	**15,742**	**15,201**	**15,269**	**78,012**

Source: The Treasury

Investment in PPE: forecast 2011 to 2015

Departments, Crown entities and SOEs all acquire PPE, which in total represents around half of projected investment over the period from 2011 to 2015.

Table 2.4 – Forecast PPE additions, 2011 to 2015

$million	2011	2012	2013	2014	2015	Total
PPE additions:						
Departments	1,984	1,946	1,425	1,874	1,481	8,710
Crown entities	2,862	2,460	2,461	2,576	2,768	13,127
SOEs	3,118	4,222	3,547	2,994	2,806	16,687
Total PPE additions	**7,964**	**8,628**	**7,433**	**7,444**	**7,055**	**38,524**
Funding sources by portfolio:						
Departments						
Proceeds from asset disposals	24	61	22	23	23	153
Core Crown activity used to fund past budget capital allowances	542	459	119	38	44	1,202
Core Crown activity	1,418	1,426	1,284	1,813	1,414	7,355
Total dept PPE funding	**1,984**	**1,946**	**1,425**	**1,874**	**1,481**	**8,710**
Crown entities						
Proceeds from asset disposals	78	93	107	169	174	621
Hypothecated revenue for roading	1,400	1,072	1,161	1,214	1,470	6,317
Revenue from core Crown activity used to fund past budget capital allowances	205	359	126	136	50	876
Revenue from core Crown activity	1,179	936	1,067	1,057	1,074	5,313
Total CE PPE funding	**2,862**	**2,460**	**2,461**	**2,576**	**2,768**	**13,127**
State-owned enterprises						
Proceeds from asset disposals	68	40	34	127	32	301
Borrowing by SOEs	1,089	2,116	1,009	825	518	5,557
Core Crown activity used to fund past budget capital allowances	305	344	189	188	29	1,055
Operating surpluses generated by SOEs	1,656	1,722	2,315	1,854	2,227	9,774
Total SOE PPE funding	**3,118**	**4,222**	**3,547**	**2,994**	**2,806**	**16,687**
Total PPE funding	**7,964**	**8,628**	**7,433**	**7,444**	**7,055**	**38,524**

Source: The Treasury

This table shows us that:

- total investment in PPE over the forecast period is large ($38.5 billion in total), with SOEs and Crown entities (predominantly the New Zealand Transport Agency [NZTA]) in particular forecast to invest substantial amounts
- capital commitments have long-lasting effects, with $3.1 billion worth of allocations from past years being rolled out over the period ($1.2 billion in departments, $0.9 billion in Crown entities and $1 billion in SOEs – predominantly KRG), and
- excluding SOEs, other government investment plans are largely funded through borrowing and taxation and hypothecated revenues.

Gross capital allowances for Budget 2012 and beyond have not been included in Table 2.4 above. Future new capital initiatives will be funded from the existing balance sheet, primarily using some of the proceeds from the Mixed Ownership Model.

Forecast investment in PPE by SOEs is an aggregate of the data provided to the Government by individual SOE boards. The practical operation of the SOE model means that each SOE board is responsible for its investment plans. The Government is regularly engaged with individual SOEs and keeps their forecasts under constant review. Some general trends are apparent:

- Seventy-eight percent of forecast SOE investment in PPE is attributable to Meridian Energy Limited (Meridian), Mighty River Power Limited (MRP), Genesis Power Limited (Genesis), Solid Energy New Zealand Limited (Solid Energy), Transpower New Zealand Limited (Transpower) and KRG.
- Most SOEs forecast that they will continue to be cash flow positive and to fund their own capital investment from operating cash flows and debt.
- The main exception is KRG, which has received a $250 million allocation from the capital allowance in Budget 2011 and is likely to seek further capital injections.[3]
- There is some uncertainty over the timing of capital expenditure in Meridian, MRP and Genesis owing to suppressed market conditions, with Solid Energy's capital expenditure plans also under review.

Investment in non-PPE assets: forecast 2011 to 2015

Non-PPE assets include financial assets, student loans and Kiwibank Limited (Kiwibank) mortgages. Forecast new capital spending has also been included, as the exact nature of the investment has yet to be determined.

Investment in the Crown's financial assets takes place mostly owing to reinvesting returns. For ACC in particular, its full-funding requirement means that the levies collected in any one year cover the life-time costs of the claims incurred in that year, even though claims may be paid out over many years. The amount that is not paid out in that year is invested to cover future costs. Financial assets held continuously by the CFIs are also forecast to increase in value (by $13.8 billion up to 2015).

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[3] The Government's investment in ultra-fast broadband through Crown Fibre Holdings Limited has also required capital. It is accounted for as a share investment rather than as PPE.

Table 2.5 summarises major movements in non-PPE assets in the period up to 2015, while Table 2.6 highlights the forecast sources of capital for those investments.

Table 2.5 – Forecast movements in non-PPE assets, 2011 to 2015

$million	2011	2012	2013	2014	2015	Total
Opening balance	**95,971**	**109,680**	**107,157**	**103,777**	**112,775**	
CFI investment growth	5,792	2,931	4,370	5,375	5,680	24,148
Student loans additions	1,579	1,590	1,615	1,644	1,648	8,076
Student loans other changes	(1,044)	(1,093)	(1,158)	(1,201)	(1,245)	(5,741)
Kiwibank mortgages	836	2,238	1,870	87	86	5,117
RBNZ and NZDMO activity	3,885	(8,066)	(8,079)	4,303	(7,010)	(14,967)
EQC reinsurance receivable	3,339	(1,139)	(1,600)	(600)	-	-
Other movements	(678)	1,016	(398)	(610)	386	(284)
Total movement	13,709	(2,523)	(3,380)	8,998	(455)	16,349
Closing balance	**109,680**	**107,157**	**103,777**	**112,775**	**112,320**	

Source: The Treasury

Table 2.6 – Summary of funding sources for non-PPE investments, 2011 to 2015

$million	2011	2012	2013	2014	2015	Total
Funding sources for investments						
Core Crown activity used to fund student loans	793	756	688	644	572	3,453
Reissuance of student loan repayments	786	834	927	1,000	1,076	4,623
Financial and operating returns from CFIs	1,155	1,110	2,245	2,920	2,912	10,342
Valuation gains/(losses) on CFI investments	4,637	1,821	2,125	2,455	2,768	13,806
RBNZ and NZDMO activity	3,885	(8,066)	(8,079)	4,303	(7,010)	(14,967)
Kiwibank deposits	836	2,238	1,870	87	86	5,117
Other	1,617	(1,216)	(3,156)	(2,411)	(859)	(6,025)
Total movement in non-PPE investments	**13,709**	**(2,523)**	**(3,380)**	**8,998**	**(455)**	**16,349**

Source: The Treasury

Growth in Kiwibank mortgages is matched by an increase in deposits.

Investment in student loans: forecast 2011 to 2015

Gross investment in student loans is projected to be $8.1 billion in the period from 2011 to 2015. This investment is immediately written down to fair value, resulting in a write-off (effectively a subsidy) rate of 45 cents in every $1 for the 2010/11 year, largely owing to the interest free loans and income contingent repayment policies. No account is taken of the Crown's cost of capital in calculating this write-off rate. Projected loan repayments of $4.6 billion reduce the Crown's net investment in student loans to $3.5 billion over the period.

The Government is looking to ensure that this complex and growing asset is governed appropriately and to improve repayment compliance, particularly by overseas borrowers. Measures introduced in Budget 2011 will help to ensure better value for the taxpayer.

How large are the Crown's commercial assets?

The *Investment Statement* reported the value of the commercial portfolio on a book value basis, meaning that both assets and liabilities were included separately. This is in accordance with Generally Accepted Accounting Practice (GAAP), and reflects the requirement that a consolidated report on the financial position of the Government needs to include the assets and liabilities that are controlled, whether through commercial entities or other means. This means that the *Investment Statement* is consistent with the *Financial Statements of the Government of New Zealand.*

However, from a balance-sheet management perspective, the size of the portfolio is best thought of in terms of its net (equity) value – that is, the *net value* of assets less liabilities. The rationale for this is that, as the Government owns the *entities*, the SOEs' assets and liabilities come as a package.

These differing perspectives lead to contrasting conclusions regarding the relative importance of the commercial portfolio to the Government's financial position. Using the gross reporting methodology, the *Investment Statement* reported the commercial portfolio as representing 23% of the Government's total assets as at 30 June 2010. However, under the net reporting approach, the portfolio represents 8% of total assets at this date. The equity valuation of 8% of the Crown's assets is more accurate from an internal decision-making perspective.

As explained in the Crown Ownership Monitoring Unit (COMU)'s *2010 Annual Portfolio Report*, the Government is moving to the use of total shareholder value as a key measure of company and portfolio performance. As we develop a history of reliable valuations these will become more valuable measures of performance. Independent valuations of some SOEs are available on the COMU website www.comu.govt.nz

Extending the Mixed Ownership Model

Could enable up to **$5 to $7 billion** of new assets to be funded without further borrowing

Significant undertaking that could increase New Zealand Exchange (NZX) capitalisation by up to **10%**

At least **51%** of each company will be retained by the Crown

- Implementation to take place over three to five years, beginning 2012, subject to a mandate being secured from the electorate, the results of scoping studies and market conditions
- Expected to create investment opportunities, sharpen commercial disciplines and help companies to grow as well as offering an alternative to continued borrowing to fund growth in priority assets

What is mixed ownership?

The Mixed Ownership Model applies to companies partly owned by the Crown and partly owned by private investors. Air NZ has operated along these lines since 2002, under Crown holdings that have ranged between 82% and 74%. In contrast, the SOE model involves companies being 100% Crown-owned.

Why extend mixed ownership?

As outlined in Section 1, the Government's investment intentions include:

- introducing private sector capital and disciplines, where appropriate, to help drive the performance of State assets, and
- prioritising capital to its highest value uses.

Mixed ownership will support both of these intentions, and presents an alternative to continued borrowing to fund priority investment. It also offers three further advantages:

- it broadens the pool of investment opportunities for New Zealand savers and supports deeper capital markets
- it introduces sharper commercial disciplines, more transparency and greater external oversight for the companies involved, and
- it provides the opportunity for the companies involved to obtain more capital to grow further, without depending entirely on a cash-strapped government.

The Government's assessment is that it is doubtful that Air NZ would have performed as well as it has since 2002 under full government ownership.

Can relevant government tests be met?

The Government has set five tests that must be satisfied before it would proceed with extending the Mixed Ownership Model. We are confident these tests can be met for reasons outlined below.

Meeting relevant tests

Test 1: The Government would maintain a majority controlling stake by owning at least 51% of the company.	Maintaining majority government ownership is readily achievable by ensuring that at least 51% of each of the companies under consideration is retained in Crown ownership. The exact percentage offered in each company will be subject to detailed examination and will reflect consideration of planned capital expenditure and dividend reinvestment plans.
Test 2: New Zealand investors would be at the front of the queue for shareholdings, and the Government would need to be confident of widespread and substantial New Zealand share ownership.	There is substantial capacity between KiwiSaver, other managed funds, iwi, retail investors, and the Government's own investment arms – including the NZS Fund – to support strong domestic demand. Initial Public Offerings (IPOs) are the preferred method of extending the Mixed Ownership Model given the Government's desire to achieve widespread and substantial New Zealand ownership. As set out in the box on the following page, this test could be achieved in a number of ways. Final decisions on the precise arrangements that will be adopted to ensure this test is met will not be taken until detailed scoping studies have been completed.
Test 3: The companies involved would have to present good opportunities for investors.	Engagements with market participants to date confirm that all companies under consideration have the potential to provide good investment opportunities. Some flexibility will be maintained in the exact timing of any extension of the Mixed Ownership Model to enable potential complexities and volatility in global equity markets to be managed.
Test 4: The capital freed up would have to be used on behalf of taxpayers to fund new public assets and thereby reduce the pressure on the Government to borrow.	The extension of the Mixed Ownership Model has the potential to fund significant new public assets and substantially reduce the pressure on the Government to borrow. The Treasury has estimated that proceeds are likely to be in the order of $5 billion to $7 billion, based on the latest commercial valuations available and assuming no measures with potential value impacts, such as price discounts, are in place.
Test 5: The Government would need to be satisfied that industry-specific regulations adequately protected New Zealand consumers.	We are confident that regulatory settings, including changes in train through the Electricity Authority and the Government's water management workstream, are adequate to protect consumers. Although recent regulatory changes are expected to exert downward pressure on future prices, electricity prices will continue to reflect the cost of new generation and are likely to rise over time, regardless of whether any changes in Crown ownership occur.

Together with advantages offered by a Mixed Ownership Model, these five tests will guide the design of a mixed ownership programme of offerings. The programme will also be designed to meet objectives to minimise programme execution risks and to ensure the programme is well advanced by 2014 so as to allow capital to be released to finance near-term priorities.

Giving New Zealanders first priority and ensuring widespread and substantial New Zealand participation

The Government is committed to giving New Zealand investors first priority in extending the Mixed Ownership Model and ensuring widespread and substantial New Zealand participation.

We are confident there is likely to be strong domestic demand and that it would be feasible for New Zealand investors to fill the majority of a carefully designed programme of offerings. Potential investors include:

- the Government's investment arms, such as NZS Fund and ACC, that have total combined assets of $39.5 billion as at 30 June 2010[4]
- domestic institutional investors – around $7.6 billion worth of investments in domestic equities and $27 billion worth of total equity investments are currently held by New Zealand households in superannuation and other managed funds, such as KiwiSaver accounts,[5] and there is also substantial capacity among iwi investors, with assets held by Iwi/Runanga and other Māori entities estimated to total $10.6 billion in 2010[6], and
- domestic retail investors – as at December 2009 around $100 billion was held by domestic retail investors in term deposits and other short-term accounts.[7]

A number of specific measures could be adopted to ensure this test is met, such as:

- a priority allocation, pre-registration and instalment receipts
- financial incentives, such as price discounts and loyalty shares, and
- hard ownership restrictions, such as individual or total ownership caps, or separate domestic shares.

No final decisions will be taken on the precise arrangements that will apply until the results of detailed scoping studies have been considered.

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4 Calculated using information from the *2010 Annual Portfolio Report*, Table 5 (page 29), available online at http://www.comu.govt.nz/publications/annual-portfolio-report/2010/

5 Sourced from December 2010 RBNZ statistics, published 25 February 2011 on the RBNZ website: http://www.rbnz.govt.nz/statistics/monfin/c15/download.html

6 Based on Māori Economic Taskforce Report estimates, available online at http://www.tpk.govt.nz/_documents/taskforce/met-rep-assetbaseincexpend-2011.pdf

7 Based on RBNZ statistics, published 12 May 2010 and available online at http://www.rbnz.govt.nz/statistics/monfin/HHAandL.xls

How do we intend to proceed?

The Government is committed to seeking a mandate from the electorate to proceed with extending mixed ownership to MRP, Genesis, Meridian and Solid Energy. These companies have been selected because they are sizeable, well established and represent good investment opportunities. The Government is also committed to seeking a mandate to reduce its shareholding in Air NZ.

Implementation of this policy will occur over a three- to five-year period beginning 2012, subject to market conditions and detailed company scoping study findings.

In recognition of the variety of interests iwi may have in mixed ownership offerings, including as potential long-term and stable investors, iwi will be consulted through the Iwi Leaders Forum and other forums as appropriate prior to the programme being finalised.

How much capital will be released?

It is not possible at this stage to determine the exact amount of capital that will be released from extending the Mixed Ownership Model to the four SOEs in question, and by further reducing the Crown's shareholding in Air NZ.

The Treasury has estimated that proceeds are likely to be in the order of $5 billion to $7 billion for a programme that does not involve measures with potential value impacts on the companies under consideration (such as price discounts). These estimates are based on calculations set out below that draw from independent 2010 commercial company valuations commissioned by COMU and reflective of the circumstances prevailing at the time. Actual proceeds will depend on investor valuations at the time of listing, equity market conditions and company performance, along with the exact percentage of the company offered to the public and whether any measures are adopted that have potential value impacts. It is possible that these factors may lead to different outcomes from those set out below, even if the Government were to retain the same level of holdings as those outlined in Table 2.7.

Table 2.7 – Indicative proceeds based on COMU-commissioned valuations dating from 2010

Company	Current shareholding	Commercial value	Potential proceeds from Crown retaining:	
			51%	60%
Air NZ	74.32%	$1.2b[8]	$0.28b	$0.17b
Genesis	100%	$1.6b[9]	$0.78b	$0.64b
Meridian	100%	$6.3b[9]	$3.09b	$2.52b
MRP	100%	$3.7b[9]	$1.81b	$1.48b
Solid Energy	100%	$1.7b[9]	$0.83b	$0.68b
		$14.5b	**$6.80b**	**$5.49b**

Source: The Treasury

[8] Based on NZX share price of $1.11 on 24 March 2011.

[9] Based on 2010 independent commercial valuations commissioned by COMU published on the COMU website (refer: http://www.comu.govt.nz/publications/information-releases/valuation-reports/2010/).

What are the likely impacts on domestic capital markets?

Any offerings arising from extending the Mixed Ownership Model are likely to have a significant positive impact on the depth and liquidity of New Zealand capital markets. We estimate they could lead to an increase in NZX market capitalisation of up to 10%.

What are the likely impacts on the Crown's fiscal position?

Extending a Mixed Ownership Model will have a number of impacts on the Crown operating balance and Crown balance sheet. These will include the impact of profits foregone by the Crown (made up of dividends and retained profits). They will also include one-off impacts from the receipt of proceeds, transaction costs and any gains from sale (against current accounting valuations).

Table 2.8 sets out estimated impacts on the Crown operating balance following the completion of a programme of Mixed Ownership Model offerings.

Table 2.8 – Estimated impacts on the operating balance

Estimated annual operating balance impacts post programme completion Annual impact (excl. one-off impacts)	(NZ$b)
Foregone dividends[10]	(0.2)
Foregone Crown share in retained profits[11]	(0.1)
Reduced interest costs[12]	0.4

Source: The Treasury

It shows no significant ongoing impacts are expected on the operating balance from extending mixed ownership, with the impact of foregone dividends and retained profits being offset by lower interest expenses from reduced Crown borrowing.

The main impact is expected to be on core Crown debt, driven by the large positive impact from proceeds received by the Crown. We estimate the net positive impact on core Crown debt could be in the order of $5.5 billion to $7.5 billion.

Crown net worth is expected to remain broadly the same because the capital freed up would be used to fund new public assets, the resulting effect being a change in the mix of Crown assets owned and a reduction in the level of borrowing that would have otherwise occurred.

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[10] This figure is based on Treasury estimates, which use historical returns and assume no significant changes in company dividend policies.

[11] This figure is based on Treasury estimates and analysis of historical returns.

[12] Calculated based on an assumption of Crown borrowing costs of 6%.

Measuring the overall fiscal impact of extending a Mixed Ownership Model

Some have sought to estimate the overall fiscal impact of a Mixed Ownership Model by comparing equity returns offered by relevant companies, calculated on the basis of the book (or accounting) value of equity, to the Crown cost of borrowing.

The overall fiscal impact of extending a Mixed Ownership Model should not be estimated solely on this type of comparison for the following reasons:

1. **The overall fiscal impact will reflect a combination of factors.** As per the discussion on likely impacts on the Crown fiscal position above, overall fiscal impacts will, along with foregone dividends, reflect a combination of proceeds received, lower debt servicing costs and foregone profits. The prices paid to the Crown will include a premium that reflects expected future earnings. This premium would effectively compensate the Crown for dividends and profits foregone.

2. **Measurement issues.** The Crown would expect any proceeds from extending a Mixed Ownership Model to reflect the commercial value of its equity. Returns calculated on the basis of book (or accounting) value of equity are unlikely to offer an accurate estimate of commercial value. Measures of total shareholder return should be treated cautiously given difficulties in valuations.

3. **Expectation of compensation for commercial risk.** Comparisons of this nature ignore the commercial risk associated with the Crown's investments. The Crown's cost of borrowing – measured on the basis of bond rates – solely reflects the direct cost the Crown faces when it raises debt. Because the Crown expects to obtain a return commensurate with the level of commercial risk it bears, it would expect its average returns from owning SOEs to incorporate some risk premium above the Crown's cost of borrowing. Dividend yields for the companies under consideration for mixed ownership have in some years been lower than the cost of Crown debt as some of these commercial risks have materialised.

Broader benefits of sharper commercial disciplines, greater transparency, improved investment opportunities and deeper capital markets will not be captured by this type of comparison.

An often cited concern is that mixed ownership will result in significant negative impacts on the current account balance. The Government's assessment is that extending a Mixed Ownership Model will encourage a stronger domestic savings culture in New Zealand while facilitating greater productive investment in the economy, developments which will reassure investor confidence in the country's ongoing ability to fund its large external debt liabilities with the world.[13]

[13] This assessment is informed by Treasury analysis available online at http://www.treasury.govt.nz/publications/informationreleases/overseasinvestment/pdfs/oi-t2010-1266.pdf

3

Improving Asset Management

The transparency provided in the inaugural *Investment Statement* was a necessary precursor, but no guarantee, to achieving ongoing improvements in the management of the Crown's balance sheet. This section signposts several ways in which the Government is working to deliver ongoing improvements in asset management practices.

Enhancing the Visibility of Asset Performance in the Social Portfolio

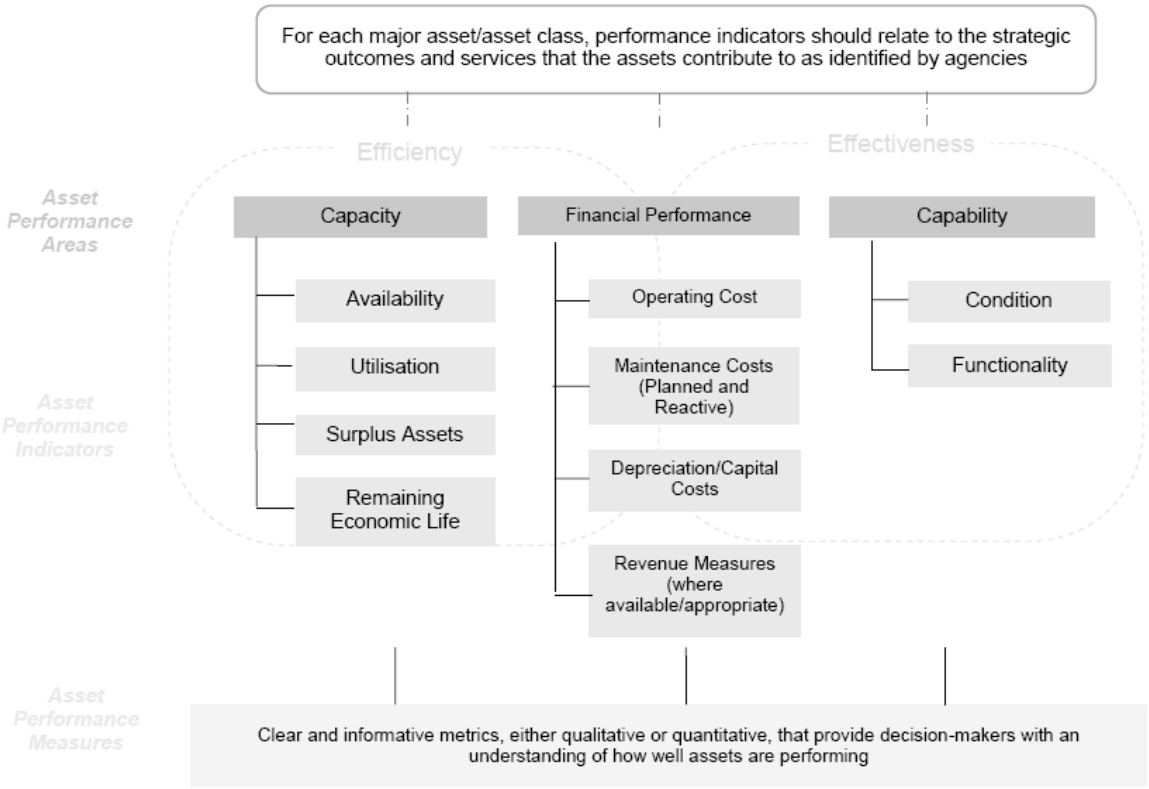
The social asset portfolio contains assets with significant acquisition and whole-of-life costs. Social assets comprise around 50% ($110.9 billion at 30 June 2010) of the Crown balance sheet and they underpin the delivery of a range of core public services.

It is critical that the Crown maintains robust information about how these assets are performing. Agencies also need reliable information about whether their assets are being used in a cost-effective way to deliver services, and to inform investment and procurement decisions.

A framework for social asset performance reporting

While many social assets serve outcome-specific purposes, the things that matter for performance, such as the capacity and condition of the assets, are broadly consistent across different types of assets. This makes it possible to develop a framework that, at a high level, can be applied across a broad range of assets. We will refine this framework over time.

Figure 3.1 – The social asset reporting framework



Source: The Treasury

The asset reporting framework does not replicate information about strategic outcomes and output reporting in other accountability documents such as *Statements of Intent.* Rather, the framework aims to fill a gap in the current suite of information. As a key purpose of this information is to enable decision-makers to understand how the assets they control are contributing to the strategic outcomes, the metrics reported should link back to and inform wider reporting on the Government's strategic outcomes and output delivery.

The framework focuses on three key areas of performance, Capacity, Capability and Financial Performance:[14]

Capacity: the productive potential of the assets.

Capacity is informed by indicators of asset availability and utilisation, providing a picture of the productive potential of the assets. This information can be supplemented by information on surplus assets (assets that are unused because they are obsolete or surplus to requirements), and remaining economic life (how much longer the asset can provide the required level of services before a significant upgrade or renewal is required).

[14] Elements of the framework have been informed by the International Infrastructure Management Manual (Version 3.0, 2006) which has been developed with public and private sector industry input from Australia, New Zealand, the United States, South Africa and the United Kingdom.

Capability: the ability of the assets to meet expected service standards.

Capability is informed by indicators of functionality (how suitable or fit for purpose the asset is for its intended use) and condition (the physical state of the asset).

Financial Performance: the financial flows associated with the asset, using total life costs where possible.

This approach supplements commonly reported financial asset information with physical asset information. It can provide further insights into performance by enabling a more complete picture of asset quality and use.

Applying the framework

The framework can help agencies to monitor and assess the performance of their assets, and to better understand the linkages between different dimensions of performance (eg, condition and utilisation). It needs to be supported by good-quality metrics and careful analysis informed by the operational and policy context.

The framework also provides a basis for reporting at more aggregate levels. This enables meaningful benchmarking of performance where there are reasonably like-for-like comparators (eg, land and buildings) and a ready market for similar types of assets. Standardised reporting on asset performance will help decision-makers to plan the best configuration and utilisation of the assets from the perspective of the entire portfolio.

The next *Investment Statement* will extend the scope for asset performance reporting based on a standard template and, where possible, consistent performance indicators across the social asset portfolio.

This *Supplement* draws on the experiences of three capital-intensive agencies to illustrate how asset performance information enables better asset management and delivers improved outcomes.

Ministry of Education (MOE): Building the school property portfolio asset performance information

The school property portfolio comprises 2,034 primary schools and 336 secondary schools, located on 18,000 hectares, and valued at $10.1 billion as at 1 July 2010. MOE is responsible for:

- ensuring school property is effectively maintained and upgraded
- purchasing land and constructing new property to meet demand, and
- identifying and effectively disposing of surplus property.

MOE is currently reviewing its performance measures for school property as the existing measures are too low level and process focused. MOE wants a set of indicators that are more useful in assessing the quality of its management of the portfolio, its ability to react to changes in demand and how well it is able to future-proof the portfolio. The measures are a work in progress and reflect current data collection abilities and systems development. As more robust data become available, MOE will refine its key performance indicators and set more aspirational performance targets. Three main information areas are to be focused on:

Capacity – managing demand growth

Student numbers are expected to increase by 44,000 to around 800,000 school students across New Zealand by 2020. Additional capacity needs to be constructed in the right place, while preserving appropriate flexibility to accommodate future demographic shifts. MOE needs information to manage capacity at a regional level. It will also work more closely with schools to identify and rationalise surplus property.

Managing the portfolio better

Currently, MOE has limited information at an individual school level across the property portfolio, including, for example, which buildings most need updating or replacing. This is important for MOE to be able to ensure that funding is better targeted and to improve the value for money from the school property spend. MOE will address this by establishing financial benchmarks and reviewing its procurement models. The implementation of two new PPP schools in Hobsonville is expected to identify opportunities for improving existing procurement methods and asset management.

Ensuring schools are fit for purpose

The Modern Learning Environment (MLE) standard introduced in 2010 helps schools upgrade their teaching spaces to support modern educational requirements, including being broadband ready. Over the next two years, MOE will also develop clearer standards for the condition of school property so that the classroom environment is safe for all learners. This will enable better planning of life-cycle asset replacement and reduce the need for more reactive expenditure on health and safety.

	Initiative	Indicator/Target
Capacity	**The presence of regional property plans to identify and address issues around capacity**	Evidence of plans in each region by 30 September 2012
	Reduce the proportion of maintenance funding spent on maintaining surplus buildings (in open schools)	Evidence that the funding spent on maintaining surplus buildings is reducing
	Surplus property in open schools is rationalised in a timely manner	Surplus property is reduced to 15% by 30 June 2012
Portfolio Management	**Improve ability to demonstrate good value for money in property management**	A portfolio benchmark for value for money will be developed by 30 December 2012
	Schools use MOE's procurement models and processes for new builds	90% of schools use MOE's procurement model and processes for new build projects
	Regularly review MOE's procurement approach for effectiveness by a qualified independent expert	Procurement models assessed by an independent expert
Fitness for Purpose	**Ensure all new school builds will meet the "advanced" MLE standard**	100% by 30 June 2012
	Ensure school buildings remain in a safe condition by continuing scheduled maintenance	Percentage of maintenance costs spent on priority 1 or 2 (health and safety/high operational risk) reduces over time
	Maintain or improve the condition of the state school property portfolio over time	A sampling methodology to measure the school property portfolio is developed by 30 September 2012

Corrections: Developing innovative approaches to asset management

Corrections manages over $2 billion worth of assets, including prisons, probation centres and supporting infrastructure such as information technology (IT).[15] In support of its core frontline goals of "*improving public safety and reducing re-offending*", Corrections must deliver world class assets that are fit for purpose. It aims to achieve this through the use of smart procurement choices.

Corrections has augmented its traditional approach to building, leasing and maintaining assets with a full suite of service delivery approaches. It aims to deliver continuous improvement across the entire Department by leveraging the innovation that comes from targeted private sector partnering.

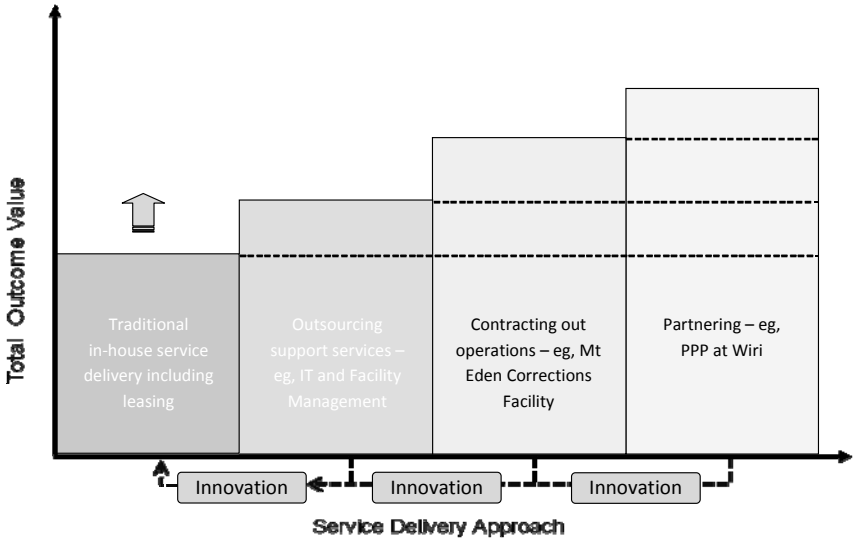
Corrections is doing things differently…

Corrections' role is changing from administering services to managing outcomes. The private sector service provider is motivated by the normal commercial drivers, leaving Corrections to concentrate on getting better outcomes for the community.

In this new role, Corrections sets the level and standard of service, required to meet its strategic objectives, and then monitors the service provider's performance against the contracted benchmarks.

The service provider is responsible for determining how best to deliver the services to the specification and standards of the contract. As expectations rise, over time, the service provider and Corrections will need to consistently find new and improved ways of working.

Delivering greater value through new approaches to asset management...



[15] Corrections also leases a significant number of commercial properties across New Zealand.

Improved asset monitoring and reporting are central…

The contractual agreements enable Corrections to place greater focus on evaluating performance against a set of defined standards. Payment is aligned with the actual quality of the service Corrections receives, with penalties for poor performance and incentives for good results.

Corrections is using the performance information generated from these contracts to improve its performance across the breadth of the organisational assets. For example, the outsourced facilities management contract enables Corrections to monitor performance in the following areas:

Key outcome	KPI	Measuring performance
The condition of building fabric, plant and equipment is maintained or improved over the term of the contract	Effective service life	The effective service life is the current residual economic life of the asset based on the agreed portfolio maintenance deterioration curve at the start of the planning period
A Department-approved annual maintenance plan is completed in a timely manner	Lifecycle cost maintenance plan	The lifecycle cost maintenance plan is a forecast of proactive maintenance expenditure over the planning period
The condition of building fabric, plant and equipment is maintained or improved over the term of the contract	Condition rating	The condition rating is an accurate assessment of the asset's current asset condition using the accepted methodology at the start of the planning period

Positive feedback loops back into Corrections…

The key is finding the right balance of public/private involvement to drive the necessary changes needed for Corrections to continually improve its performance efficiency and/or reduce cost.

Establishing long-term, strategic relationships with world-class service providers with clear incentives to remain competitive, allows Corrections to reduce its overall management burden while retaining responsibility for strategic decision-making. Corrections achieves improved levels and standards of service for the same or lower cost. Staff are exposed to private sector disciplines and gain access to innovative ways of working.

The performance management regime ensures greater transparency and, when combined with the competitive tension of being measured against a private provider, drives improvements in the efficiency, effectiveness and economy of Corrections' own operations.

Transport: Development of state highway classification system

Availability of asset performance information about state highways

NZTA and its predecessor organisations have for many years collected and published data for many performance metrics in relation to the state highway network. Much of the data are publicly available online through the Transport Monitoring Indicator Framework, at http://www.transport.govt.nz/ ourwork/TMIF/Pages/default.aspx

The published indicators include utilisation statistics (broken down by road type, vehicle type, urban/rural and region); network reliability in terms of congestion; and quality of the road surface. At the aggregate level, such indicators have informed decision-makers about maintenance, congestion and safety pressures on the network. At the detailed level, they have informed network management decisions by the NZTA such as where to put passing lanes and how to optimise timing of maintenance.

Why develop a state highway classification system?

Resources available for state highways will always be limited. Classifying state highways means we can group roads with similar functions together. This is a necessary first step to ensuring over time that roads with similar functions have similar service levels, and provides a useful framework for targeting resources to areas of greatest long-term needs.

In February 2011, NZTA published a draft state highway classification system, available at http://www.nzta.govt.nz/consultation/classification-system/

A classification system for the state highway network can contribute to the Government's priority of increased economic productivity and growth by:

- helping NZTA align planning, investment and operational activities for the network to address capacity constraints, and
- signalling to road users the levels of service they can expect (over time) on highways in each category of the classification system.

The draft classification system uses available data, especially on the extent and type of utilisation, to categorise highways in the state highway network based on their national, regional or local roles, and their functions within the network. Criteria that determine the classification of a highway include its functions in moving freight (to and from ports), people (to and from places of work, tourist attractions and airports) and securing links between major population centres.

Once consultation is completed, the classification system will inform the process for determining appropriate levels of service for each category of the network. Aligning service levels according to each road's function means we can signal long-term performance expectations to highway users and the wider community.

Indicative service levels will be included in the draft State Highway Network Strategy which will then go out for public engagement.

The indicative service levels will inform future State Highway Asset Management Plans. These describe the appropriate technical service levels applicable for each road according to its use; for example, whether median barriers or other safety improvements features are suitable for the given road.

Congestion and safety measures are collected for much of the network. Congestion and safety are not among the criteria for the classification, but show where there are deviations from the expected service level on parts of the network and are therefore taken into account when assessing the need for investment.

Maps of specific attributes of state highway usage are available online using the link above.

The Liquidity of the Crown's Balance Sheet

Sovereign liquidity management has received strong attention in recent years…

Despite the recent global financial crisis, the creditworthiness of the Crown remains strong and as such the need for liquidity is relatively small. However, the Crown is mindful of the importance of sovereign liquidity management, an importance which has been highlighted by recent events. Internationally, a strong reliance on credit markets has seen many governments face significant funding pressures when heightened solvency concerns, both perceived and real, resulted in a reluctance of these markets to lend. Domestically, the recent Canterbury earthquakes have also illustrated the possibility of funding requirements arising from extreme and unexpected natural events.

Strong liquidity buffers are unlikely to have entirely eased the funding pressures on governments, nor would their use necessarily be preferred to borrowing to meet the costs of natural disasters. However, asset liquidity provides the Crown with flexibility to reallocate resources if required and as such having an understanding of this ability can help reduce its market reliance when such events occur.

…but Crown liquidity should have a broader focus than financial marketability alone

Understanding liquidity is also an important component of the New Zealand Crown's risk management. Broadly speaking, liquidity is an organisation's ability to meet obligations as they fall due without incurring unacceptable costs. Typically, the main factors which influence this ability are the access to debt markets and the financial marketability of assets – that is, the ability of different assets to be sold within a specified period without requiring a heavy discount.

When assessing the Crown's liquidity, two other factors should also supplement this:

- *Legal accessibility* – many assets on the Crown's balance sheet, such as the assets held by the CFIs, have their use restricted by legislation. Legislative changes are complex, will take time and thus reduce the ability of the Crown to use these assets for meeting short-term obligations.
- *Social costs* – for the Crown, "unacceptable costs" should include both financial *and* social costs; for example, the possible detrimental effects to social services. Some judgements regarding which assets can be sold with fewer practical implications than others are possible.

Governments also have unusual capabilities to meet liquidity requirements from sources off the balance sheet. A government's power to tax, the potential existence of strong international credit lines and its control of the money supply provide, at least in principle, an extensive ability to meet obligations without drawing on assets. Although these are valid options for the Government, they do not lend themselves to balance sheet-based liquidity analysis and so their consideration is not included in this *Supplement*.

The Crown's assets can be roughly divided into three liquidity classifications...

The Crown's balance sheet assets can be loosely grouped into three liquidity classifications:

- *Liquid assets*: assets which are realisable within three months at full market value, face no legal restrictions and where liquidation would have limited short-term social costs. These consist of NZDMO's marketable assets which are held primarily for day-to-day fiscal purposes, along with tax and student loan receivables due within a three-month period.
- *Fairly liquid assets*: assets which can be realised at or near market value, but where disposal could require legislative changes and/or involve moderate social costs. For example, assets held by the CFIs are legally ring-fenced for specific uses, and drawing on them would expose the Crown to significant future fiscal obligations.
- *Illiquid assets*: assets which are unmarketable within a three-month period,[16] or where disposal would involve significant social costs. This includes: all social assets, owing to the undesirability of affecting social services and the difficulty in identifying saleable assets in the short term; and SOEs, owing to their largely publicly-untraded nature and the subsequent difficulty in selling any entity within the timeframe.

A summary of each classification and a portfolio breakdown is shown below.

Table 3.1 – Liquidity classification as determined by financial marketability, legal accessibility and practical costs

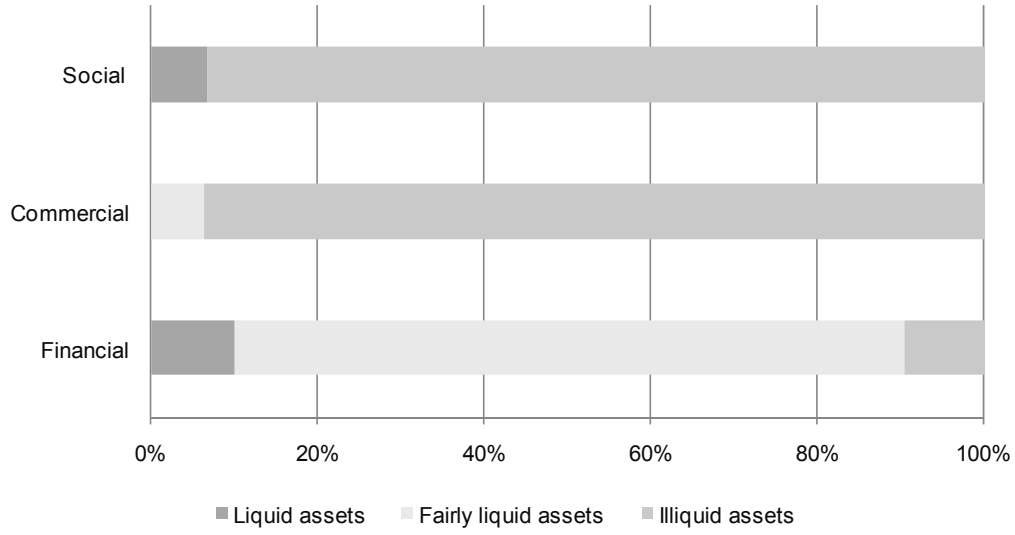
Liquidity classification	Assets included In liquidity classification	$million[17]
Liquid assets	• NZDMO marketable assets • Tax receivables (incl. repayments currently due on student loans and social benefits)	13,531
Fairly liquid assets	• CFIs' marketable assets • RBNZ's marketable assets • Shares in listed companies (eg, Air NZ)	59,305[18]
Illiquid assets	• Social assets (all assets held by agencies and CEs, incl. student loans where repayments not yet due but excl. tax receivables) • SOEs' assets • All financially unmarketable assets	150,327

[16] A conservative approach has been taken to financial marketability in this analysis. All assets excluding cash and equivalents, receivables, marketable securities and deposits due within 12 months are deemed "unmarketable" for the three-month timeframe considered here.

[17] All figures are based on February 2011 data, which are the most recent available at the time of publication.

[18] Based on the book value of Air NZ.

Figure 3.2 – Asset portfolio breakdown by liquidity classification



Source: The Treasury

...to provide an indication of the liquidity of the Crown's balance sheet

The above figures show that a third of the Crown's balance sheet is held in either "Liquid" or "Fairly liquid" form. The large proportion of illiquid assets is appropriate given the dominance of social assets and PPE on the Crown's balance sheet. Of the approximately $73 billion of assets potentially suitable for short-term liquidity purposes, the majority ($63 billion) is held in the financial portfolio.

4

How the Crown's Balance Sheet has Changed over Time

$103 billion growth in net worth over past 15 years

66% of growth in net worth from social portfolio, **22%** from commercial

67% of growth in social and commercial portfolios from revaluations

- Revaluations are the largest driver of the increase in net value, reflecting both growth in underlying asset values and accounting policy changes
- Capital investment was the next largest driver. The social and financial portfolios were the main recipients of this investment

The *Investment Statement* provided a discussion of recent balance sheet trends, focusing on changes in the strength of the balance sheet, and highlighted the movements of three fiscal indicators over the past 15 years – net debt, net worth and net worth excluding social assets. This *Supplement* complements this by providing a stronger focus on the compositional changes of the balance sheet between portfolios – social, financial and commercial – over the same period, and on the main causes of these changes.

A copy of the actual balance sheet (Statement of Financial Position) as presented in the *Financial Statements of the Government of New Zealand* is included for reference. The supporting notes in this document are an integral part of the Crown balance sheet and can be found at http://www.treasury.govt.nz/government/financialstatements/yearend/jun10

Statement of Financial Position (as at 30 June 2010)

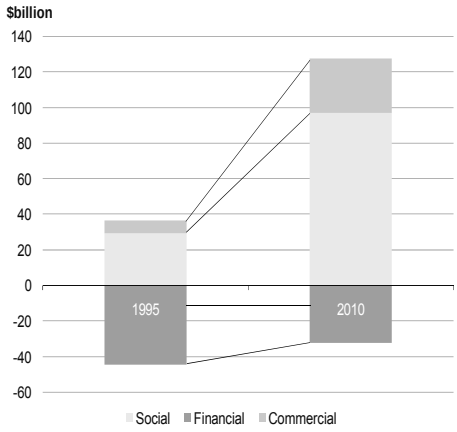
Forecast Original Budget $m	Forecast Estimated Actuals $m		Actual 30 June 2010 $m	Actual 30 June 2009 $m
		Assets		
5,042	6,143	Cash and cash equivalents	7,774	6,268
14,093	13,813	Receivables	13,884	14,619
49,683	45,465	Marketable securities, deposits and derivatives in gain	43,687	45,708
11,867	15,675	Share investments	12,179	11,160
17,268	17,967	Advances	18,447	15,604
1,165	1,177	Inventory	1,160	1,082
1,836	1,518	Other assets	1,661	1,630
110,251	113,634	Property, plant and equipment	113,330	110,135
9,197	8,925	Equity accounted investments	9,049	8,777
2,133	2,320	Intangible assets and goodwill	2,184	2,168
72	-	Forecast for new capital spending	-	-
(375)	(125)	Top-down capital adjustment	-	-
222,232	**226,512**	**Total assets**	**223,355**	**217,151**
		Liabilities		
4,220	4,147	Issued currency	4,020	4,005
10,296	8,950	Payables	9,931	9,139
1,213	1,331	Deferred revenue	1,628	1,426
76,423	73,643	Borrowings	69,733	61,953
25,345	27,305	Insurance liabilities	27,131	26,567
10,307	9,158	Retirement plan liabilities	9,940	8,993
4,479	5,499	Provisions	5,984	5,553
132,283	**130,033**	**Total liabilities**	**128,367**	**117,636**
89,949	**96,479**	**Total assets less total liabilities**	**94,988**	**99,515**
		Net worth		
31,803	34,027	Taxpayer funds	31,087	36,382
57,723	62,110	Property, plant and equipment revaluation reserve	63,593	62,612
41	(105)	Other reserves	(94)	74
89,567	**96,032**	**Total net worth attributable to the Crown**	**94,586**	**99,068**
382	447	Net worth attributable to minority interest in Air New Zealand	402	447
89,949	**96,479**	**Total net worth**	**94,988**	**99,515**

Source: The Treasury

The balance sheet has experienced significant growth over the past 15 years and is now much stronger than it was.

As can be seen in Figures 4.1 and 4.2, expansion in assets has outstripped that of liabilities across all three portfolios. The social portfolio has experienced the single largest increase in net value, driven by a $66.9 billion increase in assets and a minor reduction in liabilities. This expansion in the social portfolio is expected to persist in the future as the Government continues to prioritise capital to its highest value use, particularly in the areas of social services and infrastructure investment. The past 15 years have also seen strong growth in the commercial portfolio. The net value of the Crown's commercial holdings grew four-fold over the period, representing proportionately the largest growth of the three portfolios. Despite significant growth in its assets, growth in the financial portfolio was comparatively modest as the large asset growth was offset to a significant degree by a substantial increase in liabilities to fund spending elsewhere.

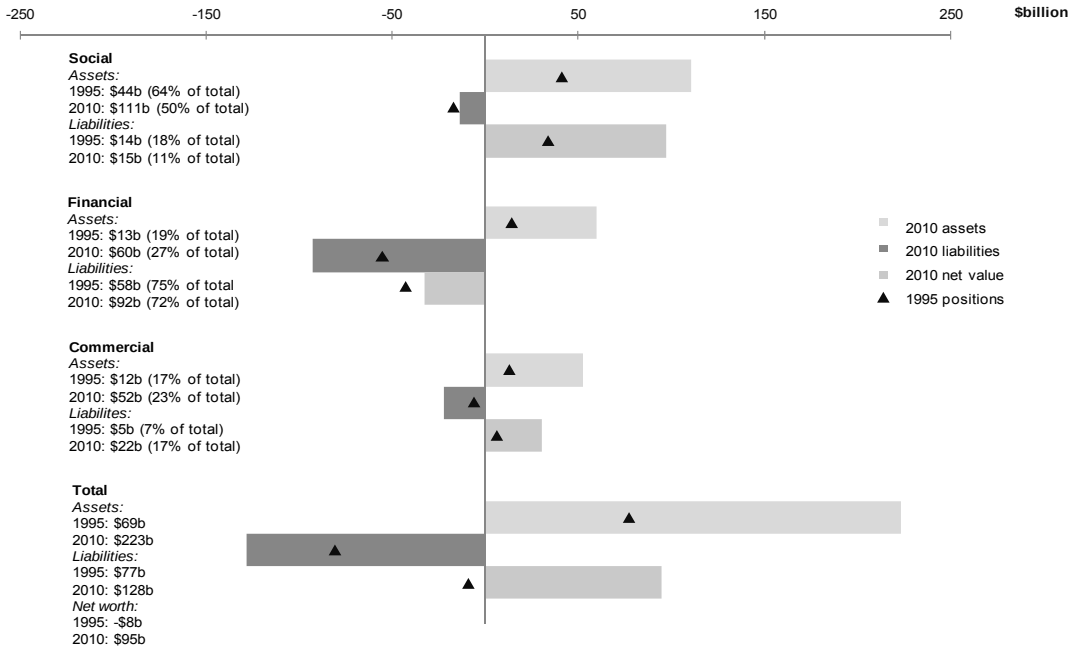
Figure 4.1 – Net values of portfolios in 1995 and 2010



Source: The Treasury

Overall, this expansion across all three portfolios resulted in a significant improvement in the Crown's net worth, from a negative position in 1995 to a positive $95 billion in 2010. The global financial crisis has, however, led to a decline in net worth since 2008.

Figure 4.2 – Financial positions of portfolios in 1995 and 2010

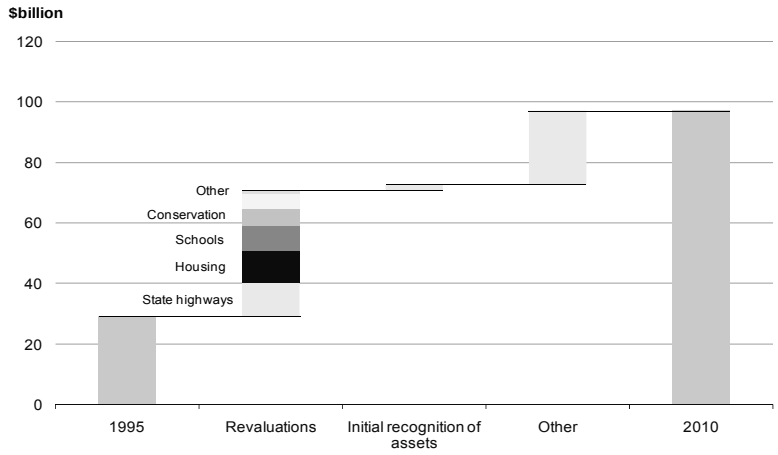


Source: The Treasury

Figures 4.3, 4.4 and 4.5 breakdown the movements within each portfolio into the main factors contributing to them.

Figure 4.3 shows that three main factors have been behind the substantial growth in the social portfolio over the past 15 years:

Figure 4.3 – Breakdown of social portfolio changes



Source: The Treasury

- *Revaluations* have accounted for approximately 60% of the overall increase in social value. These revaluations are primarily driven by increases in land values and as such are concentrated in the areas with the largest property portfolios – state highways, housing, schools and conservation make up 85% of the social revaluations. Increases in market prices for areas such as housing and schools, and inflation in the costs of construction for state highways, have also caused higher replacement values for the buildings and capital formations on the land.

- The *initial recognition of assets* has contributed $1.9 billion to the social portfolio since 1995. This primarily consists of previously unrecognised areas of the state highway network and the recognition of roughly $300 million of Department of Conservation fences.

- Approximately a third of the social portfolio's expansion comes from *other* changes, which largely represents capital allocations for new investment in social assets from each year's Budget.

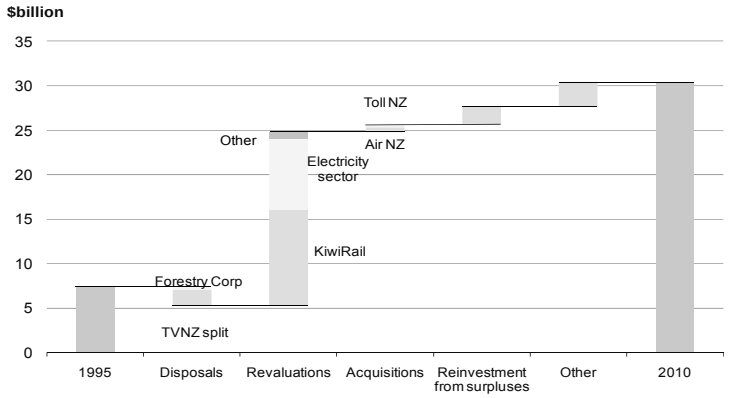
As mentioned, the Crown's commercial holdings experienced the greatest relative growth of the three portfolios. As Figure 4.4 shows, this significant expansion was caused by a number of elements:

- *Revaluations* account for the majority of the change over the past 15 years, representing almost 85% of the overall increase. While this includes increases in the value of underlying assets, especially the growth in property values, the majority of the revaluations reflect changes in accounting policies. The largest of these was the change in the accounting recognition of KRG's track assets in 2006, from a commercial to a replacement cost basis. This saw their reported value increase from a nominal sum to around $13 billion. For the energy SOEs, as well as growth in underlying commercial values, the shift from cost valuation to an independent fair value approach[19] has led to their large representation in the revaluation figures.

[19] The exact valuation methodology differs for each company.

- *Reinvestment from surpluses* formed a relatively small proportion of the growth in commercial assets, at $2 billion, while *other* changes account for just over 10% of the growth in value.

Figure 4.4 – Breakdown of commercial portfolio changes

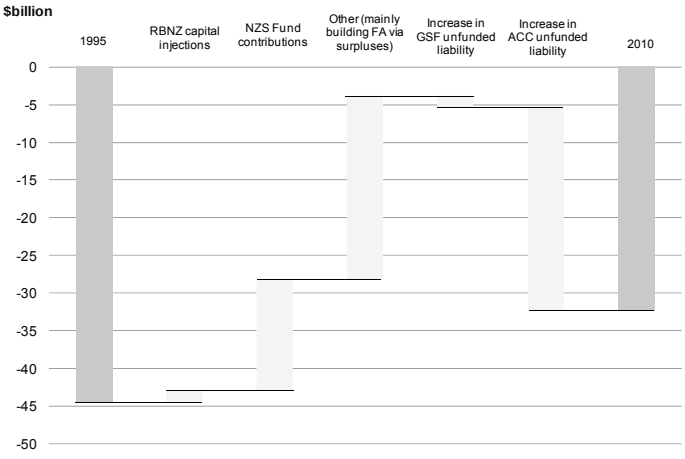


Source: The Treasury

The financial portfolio has also experienced significant changes over the past 15 years. However, unlike the social and commercial portfolios where movements were primarily favourable, the substantial increase in financial assets has been offset to a significant extent by increases to, and the recognition of new, liabilities.

- *NZS Fund contributions* were introduced in 2001 in order to partially pre-fund the expected future costs of New Zealand Superannuation. These amounted to $14.8 billion between 2001 and 2010, when the Government temporarily suspended contributions pending the Crown's return to a sufficient budget surplus. Contributions are forecast to resume in 2016/17.
- Other sources of growth within the financial portfolio contributed $24.4 billion over the past 15 years. This is made up primarily of Crown budget surpluses during the 2000s, which boosted NZDMO's assets, and the returns on investments held within the financial portfolio.
- The *increase in the ACC unfunded liability* is the single largest movement within the financial portfolio, offsetting two-thirds of the gross increase in financial assets. The predominant factor in this movement is the change from pay-as-you-go to full funding – in 1999 for the levied accounts and 2001 for the Crown-funded non-earners' account. As a consequence of the change to full funding, the accounting policy was changed to recognise the unfunded liability of the earlier claims. ACC was then able to better report its progress in collecting additional revenue to cover the cost of that liability. ACC was initially required to be fully funded by 2014, but this was extended to 2019 in 2010 following a significant increase in the liability between 2004 and 2009.

Figure 4.5 – Breakdown of financial portfolio changes



Source: The Treasury

- Other factors contributing to the increase in the ACC liability during that period include a decline in rehabilitation performance, an increasing number of claims and a change in accounting standards as well as the impact of the global financial crisis bringing lower returns on investment.
- Over the past two years, ACC has had a significant turnaround in performance, recording a $2.5 billion reduction in the net liability in the 2009/10 year and is projecting a surplus of in excess of $3.5 billion in the 2010/11 year. The turnaround in performance is on the back of a focus on the fundamentals of the ACC scheme: cost control, improved investment returns and innovations in service delivery.

How the Crown's Investment has been Funded

This section complements the commentary in Section 2 for the period from 2007 to 2010.[20]

Sources of funds 2007 to 2010

Over the period, total assets increased by $43.1 billion from $180.3 billion to $223.4 billion, including revaluations of existing assets.

As explained in Section 2, these investments were funded by a variety of sources – including borrowing, taxation, the existing asset base, cash generated by SOEs and third-party revenues.

Year-by-year analysis 2007 to 2010

This section analyses the sources of funds and their application on a year-by-year basis beginning in 2007.

As in Section 2, it breaks total investments into broad PPE and non-PPE and other categories. It then seeks to examine how those investments have been funded.

Table 4.1 shows investments over time, and gives an indication of how these have been funded.[21] Tables 4.2 to 4.4 then provide more details for different asset classes.

[20] New Zealand International Financial Reporting Standards (NZ IFRS) figures are available from the 2007 year, meaning that data are comparable across years.

[21] Additions differ from net movements in PPE as, for any given year, net movements will also include disposals, revaluations and depreciation.

Table 4.1 – Summary of investments and sources of funding, 2007 to 2010

$million	2007	2008	2009	2010	Total
Investments:					
PPE additions	5,266	5,284	7,258	6,555	24,363
Non-PPE investments					
Student loans additions	1,176	1,201	1,350	1,525	5,252
CFI asset investment growth	6,189	2,137	433	5,733	14,492
Kiwibank mortgages	1,028	1,944	2,911	1,927	7,810
Total investments	**13,659**	**10,566**	**11,952**	**15,740**	**51,917**
Funding sources for investments					
Funding sourced from core Crown activity:					
Used to purchase PPE	1,308	1,414	2,019	1,559	6,300
Used for past budget capital allowances	1,236	864	1,504	1,234	4,838
Used for contributions to the NZS Fund	2,048	2,104	2,243	250	6,645
Used for issuing student loans	621	572	640	771	2,604
	5,213	4,954	6,406	3,814	20,387
Other funding sources:					
Student loan repayments	555	629	710	754	2,648
Proceeds from asset disposals	292	244	405	252	1,193
Hypothecated revenue for roading	888	1,034	1,232	1,267	4,421
Financial and operating returns from CFIs	2,497	1,737	2,215	2,951	9,400
Valuation gains/(losses) on CFI investments	1,644	(1,704)	(4,025)	2,532	(1,553)
Borrowing by SOEs	389	529	321	814	2,053
Operating surpluses generated by SOEs	1,153	1,199	1,777	1,429	5,558
Kiwibank deposits	1,028	1,944	2,911	1,927	7,810
	8,446	5,612	5,546	11,926	31,530
Total funding	**13,659**	**10,566**	**11,952**	**15,740**	**51,917**

Source: The Treasury

Investment in PPE

Departments, Crown entities and SOEs all acquire PPE. Table 4.2 breaks total PPE additions and funding sources down across the three entity types.

Table 4.2 – PPE additions, 2007 to 2010

$million	2007	2008	2009	2010	Total
PPE additions:					
Departments	1,569	1,137	1,625	1,755	6,086
Crown entities	2,002	2,205	2,588	2,410	9,205
SOEs	1,695	1,942	3,045	2,390	9,072
Total PPE additions	**5,266**	**5,284**	**7,258**	**6,555**	**24,363**
Funding sources by portfolio:					
Departments					
Proceeds from asset disposals	74	46	67	56	243
Core Crown activity used to fund past budget capital allowances	1,003	511	513	844	2,871
Core Crown activity	492	580	1,045	855	2,972
Total dept PPE funding	**1,569**	**1,137**	**1,625**	**1,755**	**6,086**
Crown entities					
Proceeds from asset disposals	65	54	81	87	287
Hypothecated revenue for roading	888	1,034	1,232	1,267	4,421
Revenue from core Crown activity used to fund past budget capital allowances	233	283	301	352	1,169
Revenue from core Crown activity	816	834	974	704	3,328
Total CE PPE funding	**2,002**	**2,205**	**2,588**	**2,410**	**9,205**
State-owned enterprises					
Proceeds from asset disposals	153	144	257	109	663
Borrowing by SOEs	389	529	321	814	2,053
Core Crown activity used to fund past budget capital allowances	-	70	690	38	798
Operating surpluses generated by SOEs	1,153	1,199	1,777	1,429	5,558
Total SOE PPE funding	**1,695**	**1,942**	**3,045**	**2,390**	**9,072**
Total PPE funding	**5,266**	**5,284**	**7,258**	**6,555**	**24,363**

Source: The Treasury

As explained in Section 2, this analysis requires a number of assumptions.

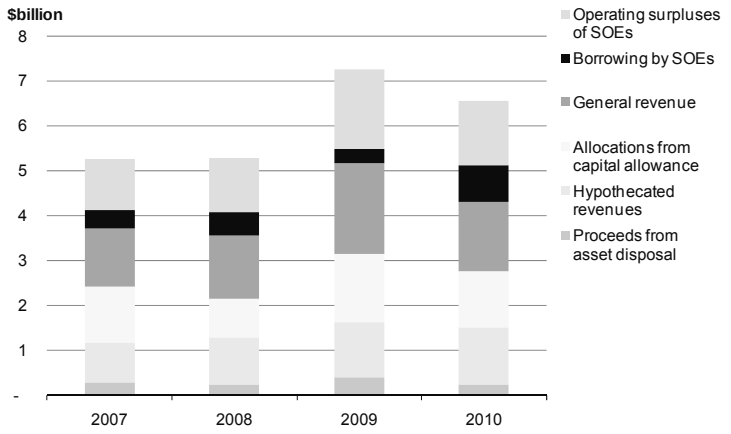
However, in general terms:

- total investment in PPE has been large, with roughly 63% of this in social assets held by departments and Crown entities
- asset disposals have played only a small part in funding recent acquisitions, providing just 5% of total PPE funding
- new capital invested by successive governments through the annual capital allowance is most significant for departments but overall represents only 20% of total investment ($4.8 billion of $24.4 billion).[22] It is reasonable to assume that the capital allowance will be sourced from overseas borrowings in years when the Government is running a deficit, as at present
- dedicated (hypothecated) revenue streams are significant for funding the state highway network but not for other government-owned assets

[22] Allocations will not sum to the capital allowance for any given year, owing to timing differences between the decision to allocate funds and their eventual use.

- the vast bulk of spending funded by general revenues (primarily new borrowing and current taxation) occurs in the housing, District Health Board and education sectors
- within the investment funded by core Crown activities, there is no direct link between depreciation funding[23] and individual asset purchases, and

Figure 4.6 – Sources of PPE funding, 2007 to 2010



Source: The Treasury

- over the past four years, SOEs – with the exception of KRG – have generally been able to fund capital investment from their operating cash flows. However, there has also been an increase in SOE debt raised on commercial terms in recent years. Other sources of funds have made relatively modest contributions.

Investment in non-PPE assets

Table 4.3 summarises major movements in non-PPE assets since 2007, while Table 4.4 highlights the sources of capital for those investments.

Table 4.3 – Movement in non-PPE assets, 2007 to 2010

$million	2007	2008	2009	2010	Total
Opening balance	**66,396**	**73,718**	**85,063**	**93,359**	
CFI investment growth	6,189	2,137	433	5,733	14,492
Student loans additions	1,176	1,201	1,350	1,525	5,252
Student loans other changes	(734)	(471)	(1,538)	(1,288)	(4,031)
Kiwibank mortgages	1,028	1,944	2,911	1,927	7,810
RBNZ and NZDMO activity	1,555	7,949	6,508	(2,846)	13,166
Other movements	(1,892)	(1,415)	(1,368)	(2,439)	(7,114)
Total movement	7,322	11,345	8,296	2,612	29,575
Closing balance	**73,718**	**85,063**	**93,359**	**95,971**	

Source: The Treasury

[23] Depreciation funding is a shorthand expression that recognises that when an agency is funded for all of its costs, including the costs of assets being consumed over time, cash reserves will become available to provide a source of funds for replacement capital expenditure. Depreciation funding is within departmental baselines and so sourced from revenue from core Crown activities.

Table 4.4 – Summary of investments into non-PPE assets, 2007 to 2010

$million	2007	2008	2009	2010	Total
Funding sources for investments					
Core Crown activity used for contributions to the NZS Fund	2,048	2,104	2,243	250	6,645
Core Crown activity used to fund student loans	621	572	640	771	2,604
Reissuance of student loan repayments	555	629	710	754	2,648
Financial and operating returns from CFIs	2,497	1,737	2,215	2,951	9,400
Valuation gains/(losses) on CFI investments	1,644	(1,704)	(4,025)	2,532	(1,553)
RBNZ and NZDMO activity	1,555	7,949	6,508	(2,846)	13,166
Kiwibank deposits	1,028	1,944	2,911	1,927	7,810
Other	(2,626)	(1,886)	(2,906)	(3,727)	(11,145)
Total movement in non-PPE investments	**7,322**	**11,345**	**8,296**	**2,612**	**29,575**

Source: The Treasury

This shows:

- CFI additions are driven by a combination of Crown contributions (to NZS Fund), ACC levies in excess of current year ACC costs and investment returns. The performance of funds under management in the CFIs has a significant impact on the Crown's total investment plans.
- Issuing new student loans is a major investment by the Crown. We assume that new loans are first funded by repayments of existing loans, with the balance being Crown contributions from general sources.
- While gross student loan advances amounted to $5.3 billion, the net cash impact after repayments is only half of this amount. As discussed in Section 2, the balance sheet asset is further reduced by the write-down of loan balances to fair value.

Glossary of Terms

ACC	Accident Compensation Corporation
Air NZ	Air New Zealand Limited
AMI	AMI Insurance Limited
BEFU	Budget Economic and Fiscal Update
CFIs	Crown financial institutions, which are ACC, EQC, GSF, NPF and NZS Fund
COMU	Crown Ownership Monitoring Unit, the Treasury
Corrections	Department of Corrections
CRIs	Crown research institutes
EQC	Earthquake Commission
FSR	Fiscal Strategy Report
GAAP	Generally Accepted Accounting Practice
Genesis	Genesis Power Limited
GDP	Gross domestic product
GSF	Government Superannuation Fund
HNZC	Housing New Zealand Corporation
IPO	Initial Public Offering
IT	Information technology
Kiwibank	Kiwibank Limited
KPI	Key Performance Indicator
KRG	KiwiRail Group Limited
Meridian	Meridian Energy Limited
MLE	Modern Learning Environment
MOE	Ministry of Education
MRP	Mighty River Power Limited
NDF	Natural Disaster Fund
NPF	National Provident Fund
NZDF	New Zealand Defence Force
NZDMO	New Zealand Debt Management Office, the Treasury
NZ IFRS	New Zealand International Financial Reporting Standards
NZS Fund	New Zealand Superannuation Fund
NZTA	New Zealand Transport Agency
NZX	New Zealand Exchange
PPE	Property, plant and equipment
PPP	Public-Private Partnership
RBNZ	Reserve Bank of New Zealand
SOEs	State-owned enterprises
Solid Energy	Solid Energy New Zealand Limited
Transpower	Transpower New Zealand Limited