2

Fiscal Outlook

Overview

- The Crown's fiscal position is broadly unchanged from the *Budget Update* in the first two years of the forecast but has strengthened in the medium term.
- With stronger economic growth expected, core Crown tax revenue is forecast to grow more rapidly, while expenses remain relatively stable.
- The operating deficit narrows in the current year and a surplus of $86 million is forecast in 2014/15. By 2017/18, the surplus is expected to reach $5.6 billion. These surpluses help fund the Government's capital spending and enable the repayment of debt.
- Net core Crown debt starts to fall in nominal terms as residual cash returns to surplus in 2016/17, a year earlier than previously expected.
- The improved cash position, coupled with a lower starting base in 2012/13, means net core Crown debt falls as a share of GDP to stand at 22.3% by 2017/18.
- The Government Share Offer programme is expected to conclude in the current year with proceeds between $4.6 billion and $5.0 billion now expected to be available for the Future Investment Fund.
- The Crown's balance sheet continues to strengthen as operating surpluses are expected to steadily increase.

Table 2.1 – Fiscal indicators

Year ended 30 June	2013 Actual	2014 Forecast	2015 Forecast	2016 Forecast	2017 Forecast	2018 Forecast
$billions						
Total Crown OBEGAL[1]	(4.4)	(2.3)	0.1	1.7	3.1	5.6
Core Crown residual cash	(5.7)	(4.1)	(3.5)	(1.2)	1.2	3.1
Net core Crown debt[2]	55.8	60.0	63.3	64.5	63.4	60.4
Net worth attributable to the Crown	68.1	69.2	72.2	77.0	83.4	92.4
% of GDP						
Total Crown OBEGAL[1]	(2.1)	(1.0)	0.0	0.7	1.2	2.1
Core Crown residual cash	(2.7)	(1.8)	(1.5)	(0.5)	0.5	1.2
Net core Crown debt[2]	26.2	26.3	26.5	25.8	24.4	22.3
Net worth attributable to the Crown	32.0	30.4	30.2	30.8	32.0	34.2

Notes: 1 Operating balance before gains and losses
2 Net core Crown debt excluding the New Zealand Superannuation Fund (NZS Fund) and advances

Source: The Treasury

Overall, growth in the economy, and continued management of spending levels, is expected to result in the Crown returning to surplus, starting to reduce debt and rebuild the Crown's net worth.

In preparing these fiscal forecasts, key assumptions have been made in relation to the performance of the economy, and managing new spending within Budget allowances. As with all assumptions, there is inherent uncertainty and a change in any one of these could negatively or positively impact the Crown's forecast surpluses and net debt position. The Risks and Scenarios chapter and the Specific Fiscal Risks chapter outline the key risks to the Crown achieving these forecasts.

Core Crown tax revenue increases in each year of the forecasts and by 2017/18 is expected to be $19.2 billion higher compared to 2012/13, reflecting the forecast growth in nominal GDP, as discussed in the Economic Outlook chapter.

While core Crown operating expenses are expected to increase by $8.7 billion over the next five years, they fall to just under 30% of GDP by the end of the forecast period.

These forecasts shows the Government is expected to achieve its fiscal objective of a return to surplus in 2014/15. While a surplus of $86 million is forecast in 2014/15, beyond 2014/15 surpluses are expected to increase by between $1.5 and $2.5 billion each year.

With net debt finishing in a stronger position at 30 June 2013 and a strengthening in the residual cash balance since the *Budget Update*, the net debt track is lower on average by 2.4% of GDP each year. Net debt falls to 22.3% by 2017/18 in line with the Government's medium-term target of net debt brought back to a level no higher than 20% of GDP by 2020. In nominal terms, net debt starts decreasing from 2016/17 as cash surpluses are forecast to return for the first time since 2007/08.

Table 2.2 – Reconciliation between OBEGAL and net debt

Year ending 30 June $billions	**2013 Actual**	**2014 Forecast**	**2015 Forecast**	**2016 Forecast**	**2017 Forecast**	**2018 Forecast**
Core Crown revenue	64.1	68.5	72.3	76.7	80.9	84.9
Core Crown expenses	(70.3)	(72.2)	(73.2)	(75.5)	(77.8)	(79.0)
Net surpluses/(deficits) of SOEs and CEs	1.8	1.4	1.0	0.5	-	(0.3)
Total Crown OBEGAL	**(4.4)**	**(2.3)**	**0.1**	**1.7**	**3.1**	**5.6**
Net retained surpluses of SOEs, CEs and NZS Fund	(1.2)	(1.4)	(1.0)	(0.4)	-	0.2
Non-cash items and working capital movements	1.1	1.4	1.5	2.0	2.3	1.0
Net core Crown cash flow from operations	**(4.5)**	**(2.3)**	**0.6**	**3.3**	**5.4**	**6.8**
Net purchase of physical assets	(1.2)	(2.2)	(1.8)	(1.3)	(1.4)	(1.2)
Advances and capital injections	(1.7)	(1.9)	(2.3)	(2.4)	(1.8)	(1.6)
Forecast for future new capital spending	-	(0.2)	(0.6)	(0.8)	(1.0)	(0.9)
Proceeds from Government share offers	1.7	2.5	0.6	-	-	-
Core Crown residual cash balance	**(5.7)**	**(4.1)**	**(3.5)**	**(1.2)**	**1.2**	**3.1**
Opening net debt	50.7	55.8	60.0	63.3	64.5	63.4
Core Crown residual cash deficit/(surplus)	5.7	4.1	3.5	1.2	(1.2)	(3.1)
Valuation changes in financial instruments	(0.6)	0.1	(0.2)	-	0.1	0.1
Closing net debt	**55.8**	**60.0**	**63.3**	**64.5**	**63.4**	**60.4**
As a percentage of GDP	**26.2%**	**26.3%**	**26.5%**	**25.8%**	**24.4%**	**22.3%**

Source: The Treasury

Core Crown Tax Revenue

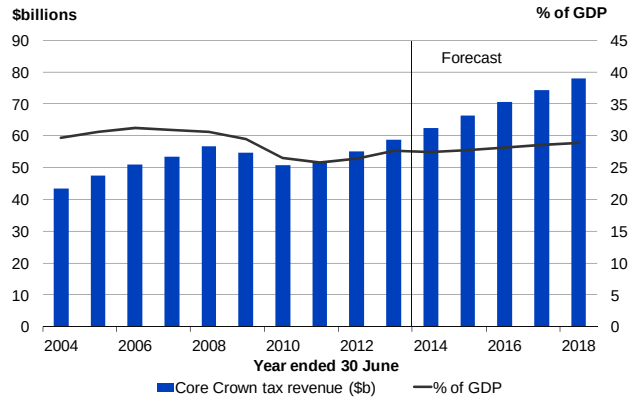
Tax revenue grows by around 5.8% per annum on average over the forecast period...

Core Crown tax revenue is forecast to rise in each year of the forecast period, with the 2017/18 forecast being $77.9 billion, which is $19.2 billion higher than in 2012/13. These annual increases also see forecast tax revenue increasing relative to nominal GDP, reaching 28.8% by the end of the forecast period (Figure 2.1).

Most of the 5.8% average annual growth in tax revenue forecasts comes from growth in the economy with nominal GDP forecast to grow at 4.9% on average over the forecast period. Tax revenue growth slows a little towards the end of the forecast period as nominal GDP growth slows (refer Figure 2.2). The remainder of the forecast tax growth largely relates to increased residential investment, largely owing to the Canterbury rebuild, and the progressive nature of PAYE tax.

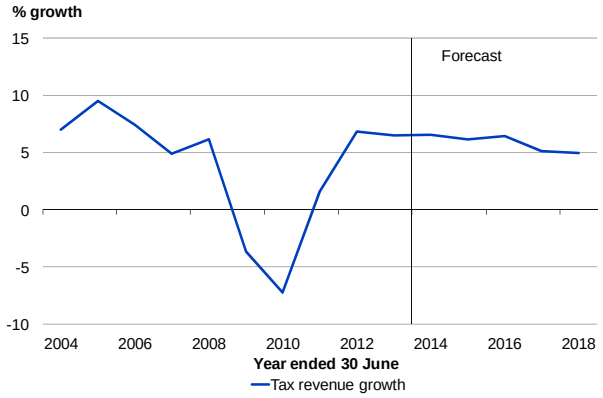
All tax types are expected to increase across the forecast period, with particular strength in tax from employees (PAYE) and goods and services tax (GST), as shown in Table 2.3.

Figure 2.1 – Core Crown tax revenue



Source: The Treasury

Figure 2.2 – Core Crown tax revenue growth



Source: The Treasury

Employment earnings growth (forecast at just below the GDP growth rate) combined with the progressive nature of the personal tax scale add $7.3 billion to source deductions over the forecast period with the average PAYE growth rate of 5.8% per annum.

The level of residential investment is forecast to grow at an average rate of 16% per annum over the forecast period, largely as a result of rebuilding in Canterbury. This increase in investment is expected to boost GST by $1.7 billion by 2017/18.

These forecasts also see an expected rise in 90-day bank bill interest rates from 2.6% on average in 2012/13 to 5.2% by 2017/18, with flow-on increases to tax on interest earned on residents' savings (RWT).

Table 2.3 – Reconciliation of movement in core Crown tax revenue over the forecast period

Year ending 30 June $billions	2014 Forecast	2015 Forecast	2016 Forecast	2017 Forecast	2018 Forecast	Total
Movement in core Crown tax owing to:						
Employees' compensation	1.2	1.1	1.1	1.2	1.3	**5.9**
Entrepreneurial income	0.4	0.2	0.3	0.2	0.2	**1.3**
Corporate profits	0.8	0.7	0.6	0.2	0.2	**2.5**
Private consumption	0.9	0.9	0.9	0.8	0.7	**4.2**
Residential investment	0.4	0.6	0.4	0.2	0.1	**1.7**
Interest rates	(0.1)	0.1	0.3	0.2	0.2	**0.7**
Fiscal drag[1]	0.2	0.3	0.3	0.3	0.3	**1.4**
Timing and other factors	-	(0.1)	0.4	0.5	0.7	**1.5**
Total movement in core Crown tax revenue	**3.8**	**3.8**	**4.3**	**3.6**	**3.7**	**19.2**
Plus: previous year's tax base	58.7	62.5	66.3	70.6	74.2	**58.7**
Core Crown tax revenue	**62.5**	**66.3**	**70.6**	**74.2**	**77.9**	**77.9**
	27.4%	**27.7%**	**28.2%**	**28.5%**	**28.8%**	

Note: 1 Fiscal drag is the additional tax revenue generated from source deductions as an individual's average tax rate increases as their income increases.

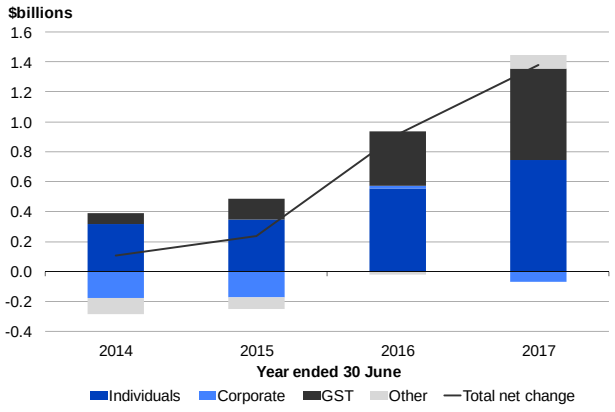
Source: The Treasury

...and is higher than the Budget Update

Compared to the *Budget Update,* tax revenue forecasts have been revised up by $0.1 billion in 2013/14 rising to $1.4 billion by 2016/17.

The bulk of the upwards revision occurs beyond 2014/15 (refer Figure 2.3), with the largest increases from individuals' taxation and GST. A stronger labour market, with higher wages and salaries, is expected to increase PAYE relative to the *Budget Update*, with the change further boosted by fiscal drag. Net other persons' tax also increases as a result of higher forecast profits for unincorporated businesses. Increased employee compensation and profitability lead to higher consumption, boosting GST growth.

Figure 2.3 – Movement in core Crown tax revenue since the *Budget Update*



Source: The Treasury

Although corporate tax is expected to increase over the forecast period in nominal terms as business profitability improves, annual growth is broadly similar to that forecast at the *Budget Update*.

Core Crown Expenses

Growth in core Crown expenses is subdued over the forecast period...

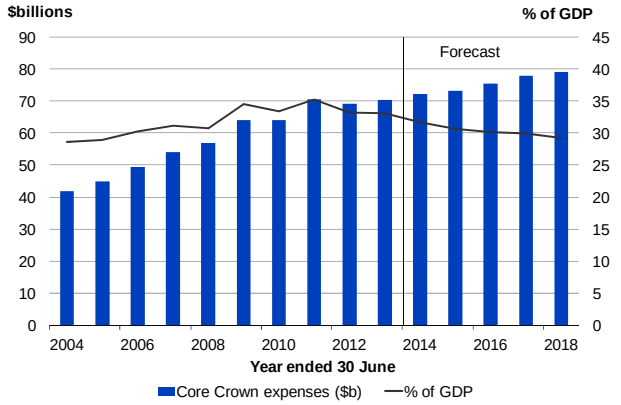
Core Crown expenses are forecast to increase in nominal terms by $8.7 billion in total over the forecast period (Figure 2.4). The growth in core Crown expenses is expected to be at a slower rate than economic growth, so as a result they fall from 33.1% in 2012/13 to 29.2% of GDP by 2017/18, in line with the Government's target of reducing expenses to around 30% of GDP.

Nominal growth in core Crown expenses is largely attributable to new spending for future Budgets, social assistance spending and finance costs as shown in Figure 2.5.

The forecast includes new spending to be allocated in future budgets of around $1.0 billion for the next four budgets. Including the impact of spending decisions from Budget 2013, budget allocations are forecast to increase core Crown expenses by $5.1 billion by the end of the forecast period.

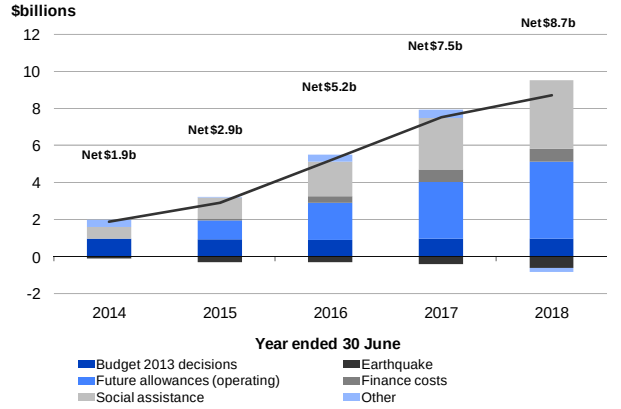
Social assistance spending is expected to increase by $3.7 billion across the forecast period. New Zealand Superannuation payments (the most significant across different social assistance payments) grow by $3.3 billion over the forecast period as payments are indexed to inflation and recipient numbers increase on average by 25,000 over the next five years (Figure 2.6). The rest of the increase in social assistance spending is owing to indexation, with recipient numbers staying relatively stable for other benefit types.

Figure 2.4 – Core Crown expenses



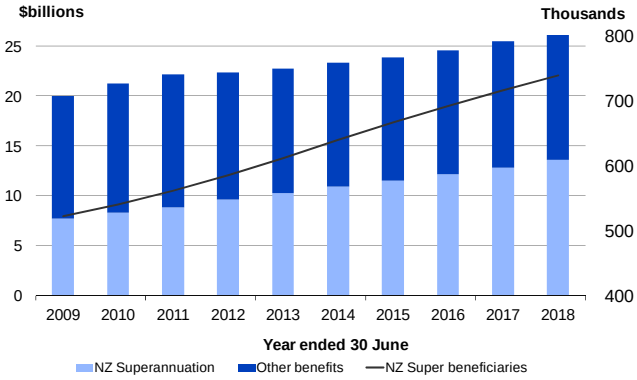
Source: The Treasury

Figure 2.5 – Increase in core Crown expenses



Source: The Treasury

Figure 2.6 – Social assistance spending



Source: The Treasury

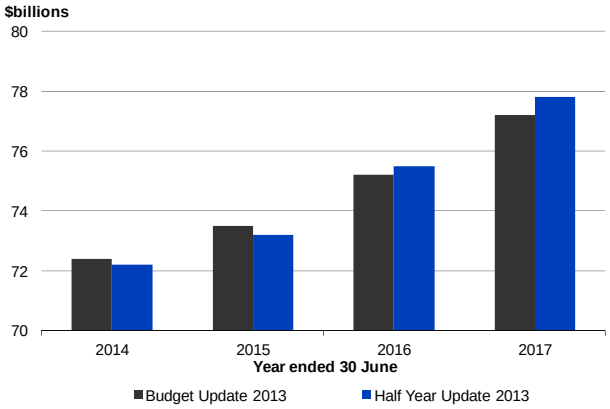
Finance costs increase by $0.7 billion over the forecast period as gross debt continues to increase and interest rates are forecast to rise.

Partially offsetting this higher expenditure, the Crown's earthquake costs reduce over the forecast period as the most significant expenses have already been recognised in previous years (refer to box on page 30 for details of the profile of earthquake expenses).

...but expenses are marginally higher than the Budget Update by the end of the forecast period

Initially expenses are slightly lower than forecast at the *Budget Update*, but by the end of the forecast period expenses are around $0.6 billion higher than previously expected (refer Figure 2.7).

Figure 2.7 – Changes in core Crown expenses since Budget 2013



Source: The Treasury

The strength in economic conditions and impacts from welfare reform have reduced unemployment-related benefit recipient numbers and therefore social assistance expenses compared to the *Budget Update*. However, by the end of the forecast period this trend reverses owing to the impact of a higher inflation track and increases in income-related rents. Refer Table 2.4 in the Operating Balance section below for changes to benefit expenses since the *Budget Update*.

Costs associated with the Government Superannuation Fund (GSF) are also forecast to increase above the level forecast in *Budget Update.* Larger impacts are expected in the last few years of the forecast owing to increases in discount rates causing the interest unwind of the GSF liability to also increase.

In addition to these expenses, some increases (eg, Emissions Trading Scheme expenses) also have a corresponding increase in core Crown revenue and therefore are OBEGAL neutral to the Crown.

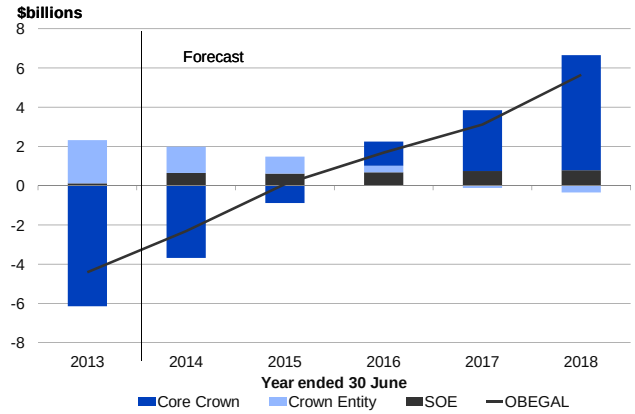
Operating Balance

The Crown is forecast to return to surplus in 2014/15…

Increases in core Crown tax revenue and slowing expenditure growth reflect an improved outlook across the forecast period with the Crown's OBEGAL forecast to return to a surplus of $86 million in 2014/15. This stronger outlook is largely driven by economic factors impacting on tax revenue combined with the continuing programme of fiscal constraint. There are risks to achieving a surplus in 2014/15 and later years should these factors not play out as forecast. Refer to the Risks and Scenarios and Specific Fiscal Risks chapters for further discussion of risks that may impact the Crown's operating balance.

OBEGAL is a total Crown measure, of which the core Crown shows the greatest growth over the forecast period. In 2013/14 the core Crown has an OBEGAL deficit of $3.7 billion which turns around to contribute a $5.9 billion surplus to OBEGAL by 2017/18.

Figure 2.8 – Components of OBEGAL by sector



Source: The Treasury

Both the State-owned Enterprise (SOE) and Crown entity (CE) sectors' contribution to OBEGAL in the future have been significantly changed. Together they contribute $2.0 billion to the OBEGAL surplus in 2013/14 falling to $0.4 billion by the end of the forecasts.

Figure 2.8 shows the composition of OBEGAL from the different sectors of the Government. The CE sector's contribution is expected to fall significantly owing to a reduction in ACC levy rates while the SOE sector's contribution falls owing to the Government's Share Offer programme. Refer to separate section on pages 36 to 41 for further discussion of this programme.

While reductions in ACC levies were included in the *Budget Update*, reductions are higher in these forecasts. Reductions in ACC levies of $300 million in 2014/15 increasing to $1 billion a year from 2015/16 were announced at the time of the *Budget Update*. Since that time specific levy rate reductions for the relevant levy years have now been factored into the forecasts and Cabinet has increased the 2014/15 reduction to $387 million. As a result, the reduction in income has increased in 2014/15 and the timing of the OBEGAL impact for the expected second round of reductions has been revised.

Refer Table 2.4 for a summary of the key changes to the forecasts from the *Budget Update* that impact on OBEGAL.

Table 2.4 – Changes in OBEGAL since Budget 2013

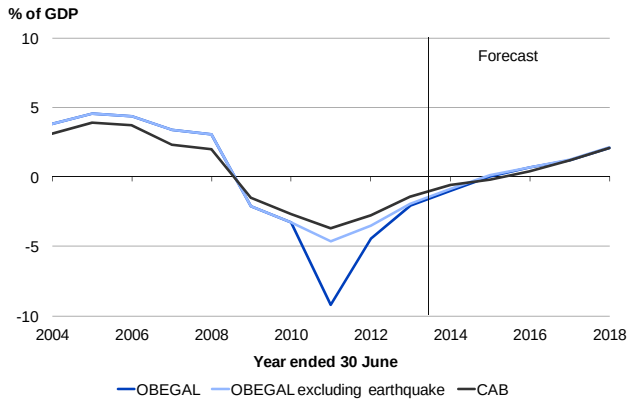
Year ending 30 June $billions	2014 Forecast	2015 Forecast	2016 Forecast	2017 Forecast
OBEGAL – 2013 *Budget Update*	**(2.0)**	**0.1**	**0.8**	**2.6**
Changes in forecasts:				
Tax revenue	0.1	0.2	0.9	1.4
Benefit expense	0.1	0.2	0.1	(0.1)
GSF expenses	-	(0.1)	(0.1)	(0.1)
NZS Fund and ACC interest income	(0.1)	(0.2)	(0.2)	(0.2)
SOE results	(0.1)	(0.3)	(0.2)	(0.1)
ACC levy and insurance expense	(0.1)	-	0.4	(0.3)
Other changes	(0.2)	0.2	-	(0.1)
Total changes since Budget Update	**(0.3)**	**-**	**0.9**	**0.5**
OBEGAL – Half Year Update	**(2.3)**	**0.1**	**1.7**	**3.1**

Source: The Treasury

ACC and NZS Fund's interest income has also decreased since *Budget Update* largely owing to a reduction in the expected level of interest earning assets held by ACC and NZS Fund since Budget 2013.

SOE profits have also declined across the forecast period since *Budget Update* largely owing to foregone profits from the Government's share programme (refer to Government Share Offer Programme section on pages 36 to 41).

Figure 2.9 – OBEGAL and CAB



Source: The Treasury

The underlying nature of OBEGAL can be seen using the cyclically adjusted balance (CAB). This measure adjusts for the state of the economic cycle and significant one-off expenses. Figure 2.9 shows CAB tracking close to OBEGAL in recent years, indicating that the operating deficits between 2009 and 2013 have been largely structural. The projected size of the economy reduced following the recession, implying a smaller tax base while, in contrast, expenses continued to grow. In this forecast, tax revenue is forecast to grow more rapidly than expenses (which remain relatively stable), seeing CAB move to surplus in 2015/16[4] a year later than OBEGAL.

...with OBEGAL surpluses beyond 2014/15 enabling debt to be repaid

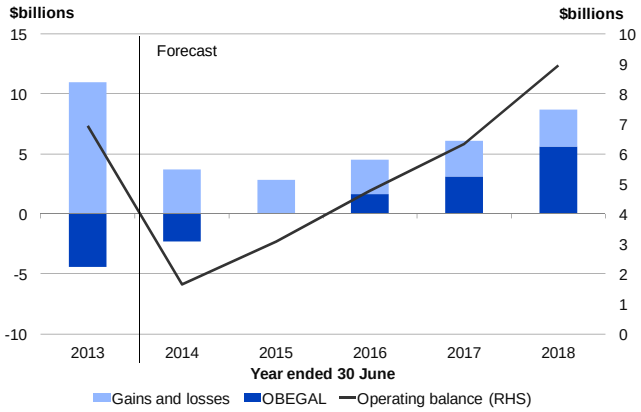
Surpluses are achieved in 2014/15 and continue to increase over the forecast period to a level that translates to being sufficient to fund the Government's capital spending and allows for the reduction of debt.

4 For more details, see the *Additional Information* on the Treasury website www.treasury.govt.nz/budget/forecasts/hyefu2013.

Current strength in equity markets lifts the operating balance…

When gains and losses are included, the total Crown operating balance is forecast to be in surplus across the forecast period with steady growth each year of the forecasts (Figure 2.10). The current year's surplus is a result of gains expected to be made by Crown financial institutions (CFIs), largely ACC and NZS Fund, and reflects strong global equity returns (for example, by 30 September 2013 NZS Fund had made year-to-date gains of $1.0 billion). While the current year reflects strong market growth, the forecast gains in future years assume a long-term rate of return, resulting in more subdued growth in these years. These gains play a part in increasing the Government's financial assets, and the Crown's net worth (discussed on page 33).

Figure 2.10 – Components of operating balance



Source: The Treasury

...and valuations of long-term liabilities contribute to an improved result in 2013/14

In addition, updated long-term liability valuations for ACC (at 30 June 2013 and updated for movements in discount rates to 30 September) and GSF (at 30 September) have also led to significant actuarial gains in the 2013/14 year which also contribute to the Crown's operating balance.

Given the size of the balance sheet, market movements can have a significant impact on the operating balance. Refer to page 35 for further discussion of the impact of these valuations on the Crown's operating balance.

Cost to the Crown of Canterbury Earthquakes

The Government continues to make significant contributions to the rebuild of Canterbury which is one of its four key priorities. Latest estimates for the total cost to the Crown are at $14.9 billion to the end of the forecast period (slightly lower than the $15.2 billion in the *Budget Update*). While some costs have reduced, others have increased.

An updated estimate of costs to the Crown show that core Crown costs have reduced since the *Budget Update* primarily owing to a cost sharing agreement entered into with the Christchurch City Council (CCC) and an updated red zone valuation. However, increases in estimates of Crown entity capital investment in Canterbury (primarily investment in state housing stock) partially offset these reductions.

In June 2013 the Crown negotiated a cost sharing agreement with CCC to contribute up to $1.8 billion for the repair costs of local infrastructure (mainly water and roads). This agreement has increased certainty around the Crown's estimate of local infrastructure costs, reducing them from the $2.4 billion estimate at *Budget Update* to $1.8 billion.

Table 2.5 outlines the latest estimates of the net impact of the earthquake included in these forecasts, the operating/capital split and the expected cash profile of earthquake costs.

Table 2.5 – Net earthquake expenses (operating and capital)

Year ending 30 June	**2011-13**	**2014**	**2015**	**2016**	**2017**	**2018**	**Total**	***Total***
$millions	**Actual**	**Forecast**	**Forecast**	**Forecast**	**Forecast**	**Forecast**	**HYEFU**	***BEFU***
Local infrastructure	1,364	111	110	110	83	50	1,828	*2,395*
Crown assets[1]	40	258	461	353	272	92	1,475	*1,579*
Land zoning	912	122	-	-	-	-	1,034	*1,218*
Christchurch central city rebuild[2]	115	763	135	81	63	(249)	909	*901*
Welfare support	269	19	4	-	-	-	292	*305*
Southern Response support package	458	16	(59)	(27)	(29)	-	360	*301*
Other costs	508	272	71	61	32	32	975	*868*
Core Crown Canterbury earthquake recovery costs	**3,666**	**1,563**	**722**	**577**	**422**	**(75)**	**6,874**	***7,567***
EQC (net of reinsurance proceeds)	8,026	(337)	(47)	(114)	-	-	7,528	*7,532*
Other SOE and CEs	(217)	160	161	242	123	38	507	*66*
Total Crown	**11,475**	**1,385**	**836**	**705**	**545**	**(37)**	**14,908**	***15,165***
Operating and Capital expenses								
Operating expenditure (OBEGAL)	11,253	413	182	45	135	65	12,093	*12,852*
Capital expenditure	222	972	654	660	410	(102)	2,816	*2,313*
Total Crown	**11,475**	**1,385**	**836**	**705**	**545**	**(37)**	**14,908**	***15,165***
Total cash payments[3]	**6,595**	**3,012**	**2,800**	**1,594**	**733**	**(40)**	**14,693**	***15,165***

Notes:

1 Crown assets includes capital expenditure on Canterbury hospitals, schools, Tertiary Education Institutions and the justice and emergency services precinct.

2 Central city rebuild costs are net of expected recoveries.

3 Some expenses are non-cash (eg, asset write-offs and impairments) and therefore do not have a cash element to them.

Source: The Treasury

The Specific Fiscal Risks chapter includes discussion on the risks associated with the Canterbury earthquakes (eg, many of the business cases and project costings for Anchor projects in the central city are yet to be finalised).

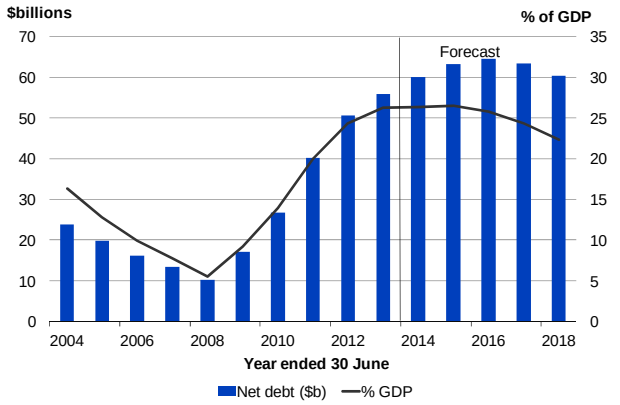
While the expenses are largely recognised up front and indicate the Crown's obligation, the cash profile reflects the expected timing of payments to settle these obligations. As with the expenses, risks also remain regarding the timing of these cash payments.

Net Debt

Net debt peaks as a share of GDP in 2014/15...

When compared to the *Budget Update*, net debt levels have reduced to be on average 2.4 percentage points of GDP lower than previously forecast. This reduction in net debt is owing to a stronger starting position at 30 June 2013 and an improved cash flow over the forecast period.

Figure 2.11 – Net debt



Source: The Treasury

Similar to the operating surplus, core Crown operating cash flows[5] also return to surplus in 2014/15. However, once capital cash flows are included, residual cash remains in deficit two further years, reaching surplus of $1.2 billion in 2016/17, one year earlier than forecast in the *Budget Update*. By 2017/18, core Crown residual cash is expected to increase to a cash surplus of $3.1 billion.

Deficits are funded by an increase in net debt (through additional borrowing or a reduction in financial assets) while surpluses reduce net debt. In nominal terms, net debt is expected to peak on an annual basis in 2015/16 at $64.5 billion, but once residual cash surpluses are forecast, debt is expected to reduce.

Net debt as a share of GDP peaks in 2014/15 at 26.5% (a year earlier than in nominal terms). By 2017/18 net debt is expected to be 22.3% of GDP (Figure 2.11) in line with the Government's medium-term target of net debt brought back to a level no higher than 20% of GDP by 2020.

...with residual cash deficits mostly funded by issuing government bonds

Residual cash surpluses are reached earlier than previously forecast, largely owing to stronger tax receipts and a decline in cash payments. The lower proceeds from the Government Share Offer programme partially offset this increase.

Over the forecast period there is a cash shortfall of $4.4 billion. In order to fund this shortfall along with bond maturities, the bond programme is expected to raise funds of $33.6 billion over the forecast period. Over the forecast period, $26.1 billion of existing debt will be repaid, providing net cash proceeds of $7.5 billion (Table 2.6). The excess cash proceeds raised from the bond programme will be invested in financial assets and used to meet future debt maturities.

As the Crown's fiscal position is stronger at the start of the forecast period than was previously forecast, the bond programme to 2016/17 is $4.0 billion lower than forecast in

5 Net debt and residual cash indicators are measured on a core Crown basis. Residual cash includes both operating and capital activity. This differs from OBEGAL, which is measured at a total Crown level and includes operating activity only.

Budget 2013. The higher-than-forecast starting cash position has allowed for a $2.0 billion reduction in the current year's bond programme as well as the beginning of a buy-back programme to help manage cash flows around the record-large bond maturity in April 2015. A buy-back programme of the April 2015 bond is scheduled to commence in the second half of the 2013/14 fiscal year. Up to $3.0 billion is forecast to be repurchased by 30 June 2014, subject to market conditions.

Table 2.6 – Net increase in government bonds

Year ending 30 June $billions	**2014 Forecast**	**2015 Forecast**	**2016 Forecast**	**2017 Forecast**	**2018 Forecast**	**5-year Total**
Face value of government bonds issued (market)	8.0	7.0	7.0	6.0	6.0	34.0
Cash proceeds from government bond issue						
Cash proceeds from issue of market bonds	8.0	7.1	6.7	5.9	5.9	33.6
Repayment of market bonds	(3.1)	(7.8)	(1.8)	-	(11.9)	(24.6)
Net proceeds from market bonds	4.9	(0.7)	4.9	5.9	(6.0)	9.0
Repayment of non-market bonds	(0.8)	(0.7)	-	-	-	(1.5)
Net repayment of non-market bonds	(0.8)	(0.7)	-	-	-	(1.5)
Net cash proceeds from bond issuance	**4.1**	**(1.4)**	**4.9**	**5.9**	**(6.0)**	**7.5**

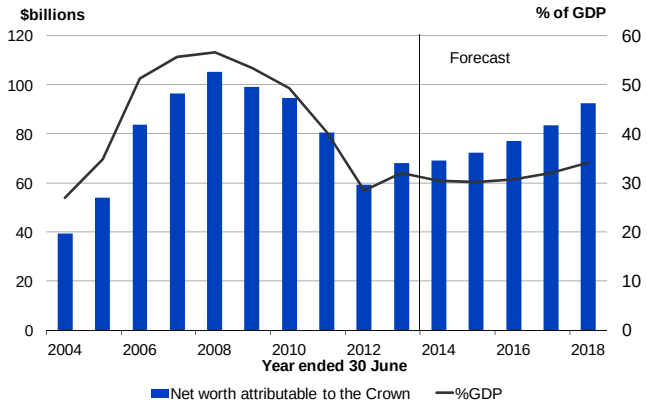
Source: The Treasury

Total Crown Balance Sheet

Operating balance surpluses result in increasing net worth...

Net worth attributable to the Crown increased in 2012/13 for the first time since the global financial crisis and the Canterbury earthquakes. At its height, net worth attributable to the Crown peaked at $105.1 billion in 2007/08.

Figure 2.12 – Net worth attributable to the Crown



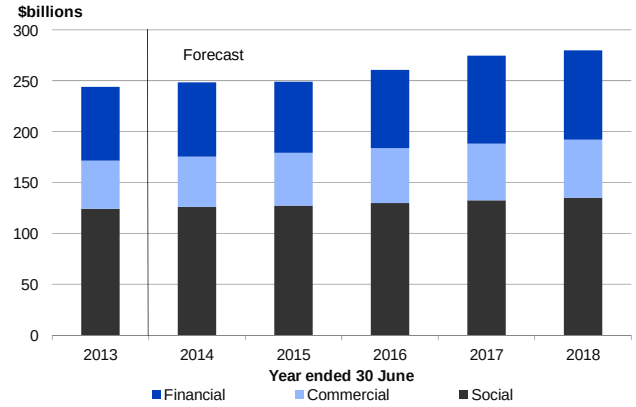
Source: The Treasury

Net worth attributable to the Crown is forecast to continue strengthening in nominal terms, largely owing to forecast operating balance surpluses (of which just under half is attributable to gains on the Crown's investment portfolio), and grow to $69.2 billion by the end of the current year. Net worth is expected to grow another $23.2 billion to stand at $92.4 billion by 2017/18, as shown in Figure 2.12. As a share of GDP this is 34.2%, still well below the peak of 56.6% of GDP in 2007/08.

...with assets increasing $35.5 billion over the forecast period...

Assets are forecast to increase by $35.5 billion, with the growth over the forecast period made up of investments in additional assets of $78.4 billion partially offset by reductions (largely depreciation) of $42.9 billion.

Figure 2.13 – Total Crown assets



Source: The Treasury

The largest asset growth over the forecast period is in the financial assets portfolio (Figure 2.13). This reflects investment growth in CFIs such as NZS Fund and ACC, with much of this growth recognised as gains in the Crown's operating balance with some growth in the asset base from reinvestment.

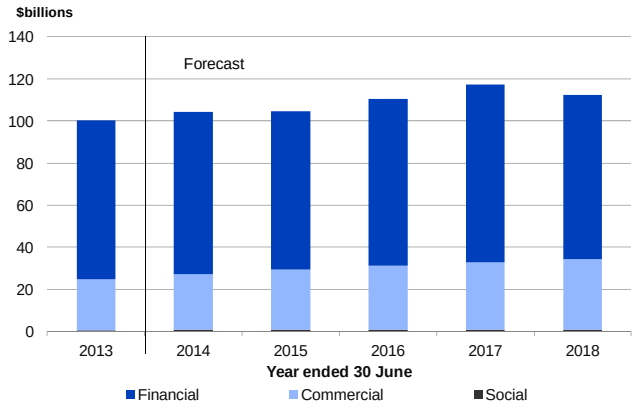
Commercial assets increase $9.5 billion over the forecast period, largely owing to continued growth in the Kiwibank mortgage assets (that grow as their deposits from customers grow) and as SOEs increase their investment in physical assets.

The social asset portfolio (eg, schools, hospitals and social housing) increases by $10.9 billion by the end of the forecast period as a result of new capital spending (funded by the Future Investment Fund, as detailed in the Government Share Offer Programme section on pages 36 to 41), and as existing assets are replaced.

...while liabilities increase at a slower rate

The Crown's liabilities are expected to increase by $7.2 billion over the forecast period, largely driven by increased borrowing. Borrowings are forecast to increase $12.2 billion to $112.3 billion by 2017/18.

Figure 2.14 – Total Crown borrowings

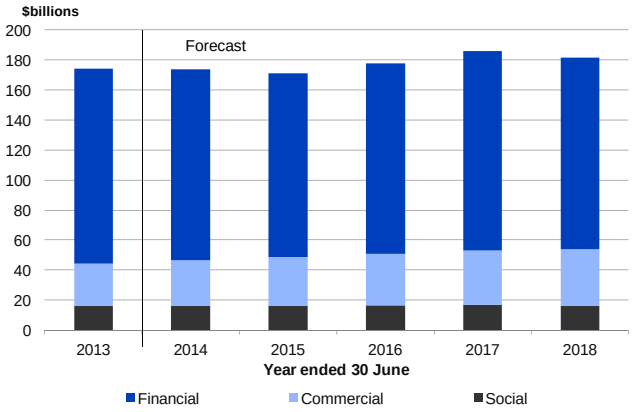


Source: The Treasury

As shown in Figure 2.14, borrowing is mostly held in the financial liability portfolio (by the Treasury's Debt Management Office, and the Reserve Bank). Borrowings in this portfolio increase $2.5 billion over the forecast period to meet the Crown's cash deficits (refer to pages 31 to 32 for discussion of the bond programme). The remainder of borrowing is in the commercial portfolio, and is largely made up of Kiwibank deposits, which grow in line with the bank's mortgage assets.

Partially offsetting the growth in borrowings are reductions in liabilities as a result of settling obligations related to the Canterbury earthquakes. The Crown's earthquake-related insurance liabilities held in the financial portfolio (EQC and Southern Response) are forecast to decrease $8.4 billion over the five-year forecast period as all claims are expected to be settled by 2017/18.

Figure 2.15 – Total Crown liabilities



Source: The Treasury

The Crown's balance sheet is sensitive to market movements...

Many of the assets and liabilities on the Crown's balance sheet are measured at "fair value" in order to disclose current estimates of what the Crown owns and owes. Fair value can be derived in a number of ways, traditionally based on market prices, but where these are not available, values can be best estimates based on certain assumptions. While the measurement at fair value is seen as the most appropriate value of these items, it can be volatile, resulting in fluctuations in the value of the assets and liabilities with changes in the underlying assumptions. Table 2.7 shows an example of some of the key sensitivities to the valuation of the Crown's major assets and liabilities and the impact these can have on the operating balance.

Table 2.7 – Financial instruments sensitivities

Financial assets

Impact on operating balance[1]	**%change**	**$millions**
Interest rates	+1	(532)
	-1	592
Share prices	+10	1,681
	-10	(1,681)
NZD exchange rate	+10	(1,029)
	-10	1,160

1 Using 30 June 2013 sensitivities

Source: The Treasury

Financial assets are the largest asset group on the Crown's balance sheet and have increased significantly in recent years. CFIs (eg, NZS Fund and ACC) hold investments to make financial returns, and those asset values are dependent on market prices, interest rates and exchange rates, which can all be volatile.

The Crown has a number of significant long-term liabilities which are actuarially valued based on estimated future cash flows, over 50 years into the future. As part of the actuarial valuation, inflation rates are used to help estimate future cash flows while discount rates are used to obtain the value of those future cash flows in today's dollars (their present value). Changes in these assumptions can have significant impacts on the valuation because the cash flows are so large and over such long periods. Table 2.8 shows the impact that a 1% change in inflation and discount rates would have on the operating balance.

Table 2.8 – Long-term liability sensitivities

Impact on operating balance[1]	**Discount rate**		**Inflation rate**	
$millions	**+1 %**	**-1 %**	**+1 %**	**-1 %**
ACC outstanding claims	3,628	(4,823)	(4,966)	3,788
GSF retirement liability	1,587	(1,927)	(1,508)	1,831
EQC outstanding claims	33	(33)	(19)	43

1 Using 30 June 2013 sensitivities

Source: The Treasury

...and judgements and estimates also impact on the balance sheet...

Outside of market factors, valuations are subject to a number of judgements and estimates. In general, as time goes on, better information becomes available and initial estimates are updated to reflect current information. Some examples of this include: ACC rehabilitation costs, earthquake-related insurance liabilities and student wage growth.

...while other risks still remain

In addition to those items on the balance sheet there are a number of liabilities (and assets) that may arise in the future but are not yet included; either because they are dependent on an uncertain future event occurring (eg, outcome of litigation) or the liability cannot be measured reliably. If these contingent liabilities crystallise, there will be associated costs with a negative impact on the operating balance. Refer to page 75 for a list of the contingent liabilities that the Crown was exposed to at 31 October 2013. Refer also to the Risks and Scenarios chapter for further discussion on balance sheet risks.

Government Share Offer Programme

At the time of the *Budget Update,* no transactions in the Government Share Offer programme had been completed. Since that time minority shareholdings in Mighty River Power, Meridian Energy and Air New Zealand have been sold and the Government has indicated that the sale of up to 49% of the shares in Genesis Energy will follow in the first half of calendar 2014. At the time the assumptions for this *Half Year Update* were finalised, the proceeds from the Crown reducing its shareholding in Air New Zealand were not known.

Table 2.9 – Progress to date (core Crown)

	Gross proceeds $millions	Net proceeds[1] $millions	% sold	Gain/(loss) on disposal $millions
Mighty River Power	1,685	1,638	48.20	167
Meridian Energy	1,883	1,829	48.98	(422)

Note: 1 Net of direct costs and present value discounting.

Source: The Treasury

As a result of the progress to date (Table 2.9), two key assumptions underpinning the forecast fiscal impact of the programme have been updated in this current *Half Year Update*:

- Total proceeds are now expected to be within an estimated range of $4.6 billion to $5.0 billion, which is based on actual proceeds from the Mighty River Power and Meridian transactions and estimated proceeds from the Genesis Energy and Air New Zealand transactions. The *Half Year Update* forecasts assume the mid-point of this range of $4.8 billion. The previous $6 billion assumption was a mid-point estimate of a range of potential outcomes across the entire Government Share Offer programme. These outcomes have now narrowed considerably since the *Budget Update*. This section includes discussion on the changes in the estimate in proceeds over time.

- Given the Government's announcement regarding the timing of the Genesis Energy share offer, all proceeds from the programme are now expected to be received by 2014/15. The *Budget Update* did not forecast the timing of individual share offers, none of which had been completed by that point, and so assumed proceeds were spread evenly across the four years 2012/13 to 2015/16.

The fiscal impacts of these changes in assumptions are that, while net debt will decrease sooner than previously forecast, that reduction will be smaller as proceeds have been re-estimated. In addition, while the proceeds are received earlier (and so the estimated finance cost savings occur earlier), dividends and profits are also foregone earlier than previously forecast as the Government's share of the companies is reduced.

Table 2.10 – Estimated profile of gross cash proceeds

Year ending 30 June $millions	2013 Actual	2014 Forecast	2015 Forecast
Cash/Debt impact			
Forecast cash proceeds	1,690	2,490	620

Source: The Treasury

This estimated profile is based on the mid-point of the estimated range of $4.6 billion to $5.0 billion, which was set before the proceeds from the Crown reducing its shareholding in Air New Zealand were known.

Table 2.11 – Estimated fiscal impact of the Government Share Offer programme

$billions	Note	Actual to date and forecast
Cash/Debt impact		
Forecast cash proceeds		$4.8 billion
Forecast foregone dividends	1	$321 million p.a.
Estimated finance cost savings	1	$219 million p.a.
Reduction in net debt		$4.2 billion by 2017/18
Accrual impact		
Forecast foregone profits	1	$327 million p.a.
Estimated finance cost savings	1	$219 million p.a.
Net decrease in OBEGAL	1	$108 million p.a.
Loss on disposal recorded in taxpayers' funds	2	$383 million

Notes:

1 Based on an average of the fiscal forecasts subsequent to the programme being completed.

2 Based on the mid-point estimated cash proceeds, the published gain from the Mighty River Power sale and loss from the Meridian Energy sale, and the published net asset position of Air New Zealand and Genesis Energy at 30 June 2013.

Source: The Treasury

The final fiscal impact of the Government Share Offer programme remains uncertain and dependent on a number of factors, including market conditions.

The figures in Table 2.11 are based on the current profit and dividend forecasts supplied by the companies, and forecast interest rates on government debt. This means the figures are a static estimate, at the current time, of the fiscal impact of the Government Share Offer programme.

The figures do not account for uncertainty and risks, and in particular the commercial risks around the estimated profits and dividends from the companies, and risks around future interest rates on government debt. The risks in relation to Mighty River Power and Meridian Energy were explained in the offer documents for these companies. Because of uncertainty and risk, a commercial entity would usually forecast profits that are greater than the Government's cost of borrowing. Whether forecast profits are actually delivered will depend on actual company performance.

Previous *Economic and Fiscal Updates* have disclosed annual estimated fiscal impacts of the Government Share Offer programme, as well as a five-year total. It is no longer possible to give annual figures, as the progress in the programme to date means that providing the latest annual estimates could allow forecast profits and dividends for individual companies in the programme to be calculated. Individual company forecasts are commercially sensitive, and may be "inside information" in relation to the Securities Markets Act 1988. Forecast profits and dividends are supplied to the Treasury by the companies under a confidentiality deed, under which the Treasury has agreed to preserve the confidentiality of this information, and to comply with the provisions of the Securities Markets Act 1988.

Given this, only totals or averages have been disclosed, consistent with section 26V of the Public Finance Act 1989. Future disclosures of the impacts of the Government Share Offer programme will follow the same approach.

Future Investment Fund

In Budget 2012 the Future Investment Fund (FIF) was established to allocate the estimated proceeds from the Government Share Offer programme, rather than issuing debt. So far, $2.1 billion of this fund has been allocated. A large portion of this allocation is expected to be spent on the Canterbury rebuild as well as investments in schools, hospitals, technology and irrigation.

Table 2.12 – Analysis of Future Investment Fund

$billions	**Total Fund**
Forecast cash proceeds	4.8
Allocated in Budget 2012	(0.5)
Allocated in Budget 2013	(1.4)
Commitments against future budgets	(0.2)
To be allocated	**2.7**

Source: The Treasury

With the proceeds from the Government Share Offer programme now expected to be between $4.6 billion and $5.0 billion, the amount remaining to be allocated over the life of the FIF has declined since the *Budget Update*. However, based on current forecasts, the Government does not need to alter the current FIF spending profile as the current profile still ensures the FIF funds all new capital expenditure through to Budget 2016.

Changes to Estimate of Proceeds

Original Estimate

In the *Supplement to the 2010 Investment Statement of the Government of New Zealand* in May 2011[6] the Treasury estimated that the Government Share Offer programme was likely to result in gross sales in the order of $5 billion to $7 billion (Table 2.13). In part, that assessment was based on independent estimates of the commercial values of the companies at that time, along with Air New Zealand's share price.

Table 2.13 – May 2011 estimated gross sales

$billions	Low estimate	High estimate	Estimated commercial value
Mighty River Power	1.35	1.87	3.70
Meridian Energy	2.29	3.18	6.30
Air New Zealand	0.16	0.29	1.20
Genesis Energy	0.58	0.81	1.60
Solid Energy	0.62	0.86	1.70
Total	5.00	7.00	

Source: The Treasury

The estimated commercial values are for 100% of the companies. The figures for Mighty River Power, Meridian Energy, Genesis Energy and Solid Energy were based on the most recent independent commercial valuations of these companies by Macquarie Research, First NZ Capital and Forsyth Barr. The figure for Air New Zealand was based on its share price at the time. These valuation reports are available at: www.comu.govt.nz/publications/information-releases/valuation-reports/2010/

Solid Energy is no longer in a position to be part of the Government Share Offer programme in the near future. Excluding Solid Energy from the May 2011 estimate of proceeds gives a revised range of $4.38 billion to $6.14 billion. The Treasury's estimate of proceeds, $4.6 billion to $5.0 billion, is within this range.

Other factors that have affected the estimated proceeds from the programme include:

- falls in the share prices of comparable New Zealand electricity companies, reflecting a range of influences, and
- the revised contract between Meridian Energy and New Zealand Aluminium Smelters Limited (NZAS) which, according to Meridian Energy, reduced the value of its net assets by $476 million.

6 www.treasury.govt.nz/budget/2011/supp2010is

2013 Budget Update

The exclusion of Solid Energy from the programme was the only new information available at the time the fiscal forecasts for the *Budget Update* were finalised. The $6 billion figure used in previous fiscal forecasts was still within the revised range excluding Solid Energy, although it was towards the top of that revised range.

At that point the share offer for Mighty River Power had not been completed, and so none of the commercial valuations implicit in the $5 billion to $7 billion range had been tested by the market. At the top end of the price range in the offer document, proceeds from Mighty River Power would have been around $1.9 billion, which was above the top end of the estimated range that was part of the $5 billion to $7 billion range.

The Treasury therefore concluded that the *Budget Update* should retain the $6 billion mid-point estimate of proceeds.

Actual proceeds

Table 2.14 – Actual proceeds to date

	May 2011		Actual
	Low	High	gross
$billions	**estimate**	**estimate**	**proceeds**
Mighty River Power	1.35	1.87	1.69
Meridian Energy	2.29	3.18	1.88
Air New Zealand	0.16	0.29	0.36
Total	3.80	5.34	3.93

Source: The Treasury

Total gross proceeds for the three transactions completed to date, at $3.93 billion, are towards the bottom of the May 2011 estimate. For the individual transactions:

- actual proceeds for the Mighty River Power share offer were slightly above the mid-point of the estimated range from May 2011
- actual proceeds for Meridian Energy were below the estimated range from May 2011, but proceeds were affected by the falls in the share prices of comparable New Zealand electricity companies, and the revised contract between Meridian Energy and NZAS, and
- actual proceeds for the Air New Zealand transaction were above the May 2011 estimated range, as a result of the significant increase in Air New Zealand's share price since then.

Accounting for minority interests

The treatment of the programme in the fiscal forecasts reflects that the Government retains the majority ownership and control of the companies. There is therefore no "sale of assets" reported in the consolidated financial statements. The revenue and expenses, assets and liabilities of these companies will continue to be fully consolidated by the Crown.

The key change to the financial statements is the disclosure of the non-controlling interest (often referred to as the "minority interest") of the profits and equity in those companies.

The loss on disposal is calculated as the difference in the book value of the net assets sold and the cash proceeds. This loss is shown as a transfer within the equity section of the balance sheet as it is considered a transaction between owners. There is therefore no loss shown in the statement of financial performance.

Foregone profits represent the portion of profits that would have been recognised by the Government prior to the sale but are now attributable to the minority interests. Forecast foregone profits reduce the Government's OBEGAL. The actual change in the OBEGAL will depend on the actual profits the company generates, which may be different from what is currently forecast.

These profits are different from foregone dividends (although dividends are often a subset of profits), which represent dividend payments by the companies that will now be paid to minority interests. As dividends are a cash receipt, forecast foregone dividends increase the Government's net debt. Again, the actual change in net debt will depend on actual dividends paid by the companies.

Proceeds from the programme decrease net debt. This impact on the Government's debt has flow-on impacts to finance costs. Overall, the programme is expected to decrease net debt by $4.2 billion by the end of the forecast period. This decrease serves to reduce finance costs for the Government.

Fiscal Forecast Assumptions

The fiscal forecasts are based on assumptions and judgements developed from the best information available on 3 December 2013, when the forecasts were finalised. Actual events are likely to differ from these assumptions and judgements. Furthermore, uncertainty around the forecast assumptions and judgements increases over the forecast period. The Canterbury earthquakes add further uncertainty to the economic and fiscal forecasts.

The fiscal forecasts are prepared on the basis of underlying economic forecasts. Such forecasts are critical for determining revenue and expense estimates. For example:

- A nominal GDP forecast is needed in order to forecast tax revenue.
- A forecast of CPI inflation is needed because social assistance benefits are generally indexed to inflation.
- Forecasts of interest rates are needed to forecast finance costs, interest income and discount rates.

A summary of the key economic forecasts that are particularly relevant to the fiscal forecasts is provided in Table 2.15 below (on a June-year-end basis to align with the Government's balance date).

Table 2.15 – Summary of key economic forecasts used in fiscal forecasts

Year ended 30 June	2013 Actual	2014 Forecast	2015 Forecast	2016 Forecast	2017 Forecast	2018 Forecast
Real GDP[1] (ann avg % chg)	2.6	3.0	3.4	2.4	1.9	2.2
Nominal GDP[2] ($m)	212,721	227,793	239,172	250,494	260,334	270,295
CPI (ann avg % chg)	0.8	1.4	2.0	2.5	2.3	2.3
Govt 10-year bonds (ann avg, %)	3.6	4.7	4.9	5.1	5.2	5.2
5-year bonds (ann avg, %)	2.9	4.3	4.6	4.9	5.1	5.2
90-day bill rate (ann avg, %)	2.6	2.7	3.4	4.3	4.8	5.2
Unemployment rate (ann avg, %)	6.6	5.9	5.6	5.4	5.2	4.8
Employment (ann avg % chg)	0.4	2.6	2.2	1.3	1.0	1.4

Notes: 1 Production measure.
2 Expenditure measure.

Source: The Treasury

In addition, there are a number of other key assumptions that are critical in the preparation of the fiscal forecasts.

<table>
<tr><td>Government decisions</td><td>Incorporate government decisions and other circumstances known to the Government up to 3 December 2013.</td></tr>
<tr><td>Tax revenue</td><td>Tax policy changes enacted and announced by the Government will take place as planned and will affect tax revenue and receipts as calculated and agreed between Inland Revenue and the Treasury.</td></tr>
<tr><td>Earthquake costs</td><td>Expenditure (accrual measure) is forecast based on estimates on when key decisions will be taken. The timing of cash payments is based on estimates of when actual spending will take place. Refer to page 30 for further discussion.</td></tr>
<tr><td>Operating allowance</td><td>Net $1.0 billion from Budget 2014 growing at a rate of 2.0% per annum for subsequent Budgets.</td></tr>
<tr><td>Provision for new capital spending</td><td>$1.0 billion in Budget 2014 and $0.9 billion in Budgets 2015 and 2016, then growing at a rate of 2% per annum for subsequent Budgets. For further details, see note 8 of the Forecast Financial Statements.</td></tr>
<tr><td>Government share offers</td><td>Sale programme is forecast to conclude in 2013/14.

Net sale proceeds of $4.8 billion (based on a mid-point estimate of between $4.6 billion and $5.0 billion).</td></tr>
<tr><td>Finance cost on new bond issuances</td><td>Based on the 5-year rate from the main economic forecasts and adjusted for differing maturity.</td></tr>
<tr><td>Top-down adjustment</td><td>A top-down adjustment is made to compensate for departments that tend to forecast upper spending limits (appropriations) rather than best estimates.

Top-down adjustment to operating and capital are as follows:

<table>
<tr><th>Year ending 30 June
$billions</th><th>2014
Forecast</th><th>2015
Forecast</th><th>2016
Forecast</th><th>2017
Forecast</th><th>2018
Forecast</th></tr>
<tr><td>Operating</td><td>1.4</td><td>0.5</td><td>0.3</td><td>0.3</td><td>0.3</td></tr>
<tr><td>Capital</td><td>0.5</td><td>0.1</td><td>0.2</td><td>0.1</td><td>0.1</td></tr>
</table>

The adjustment will be higher at the front end of the forecast period as departments' appropriations (and therefore expenses) tend to be higher in these years, reflecting the flexibility departments have around transferring underspends to later years.</td></tr>
<tr><td>Borrowing requirements</td><td>Forecast cash deficits will be met by reducing financial assets and issuing debt.</td></tr>
<tr><td>Property, plant and equipment</td><td>For the purposes of the forecast financial statements, no revaluations of property, plant and equipment are projected beyond the current year. Valuations as recorded for the 2013 annual financial statements and any additional valuations that have occurred up to 30 September 2013 are included in these forecasts.</td></tr>
</table>

<table>
<tr><td>Student loans</td><td>The carrying value of student loans is based on a valuation model adapted to reflect current student loans policy. As such, the carrying value over the forecast period is sensitive to changes in a number of underlying assumptions, including future income levels, repayment behaviour and macroeconomic factors such as inflation and discount rates used to determine the effective interest rate for new borrowers. Any change in these assumptions would affect the present fiscal forecast.</td></tr>
<tr><td>Investment rate of returns</td><td>Incorporate the actual results to 30 September 2013. Beyond this time, gains on financial instruments are based on long-term benchmark rates of return for each portfolio.</td></tr>
<tr><td>GSF and ACC liabilities</td><td>The GSF and ACC liabilities included in these forecasts have been valued as at 30 September 2013 and 30 June 2013 respectively. The ACC liability has also been adjusted for the 30 September 2013 discount rate. Both liabilities are valued by projecting future cash payments, and discounting them to present value. These valuations rely on historical data to predict future trends and use economic assumptions such as inflation and discount rates. Any change in actual payments or economic assumptions would affect the present fiscal forecast. For example, if the discount rate decreases, the value of the liabilities would increase.

GSF's assets are offset against the gross liability and have been updated to reflect market values. The value of assets over the forecast period reflects long-run rate of return assumptions appropriate to the forecast portfolio mix.</td></tr>
<tr><td>ACC levies</td><td>The forecast includes a $387 million reduction in ACC levies for the 2014/15 levy year rising to $1.0 billion in the following levy year.</td></tr>
<tr><td>NZS Fund contributions</td><td>No contribution is assumed in the forecast period.

<table><tr><th>Year ending 30 June
$billions</th><th>2014
Forecast</th><th>2015
Forecast</th><th>2016
Forecast</th><th>2017
Forecast</th><th>2018
Forecast</th></tr><tr><td>Required contribution</td><td>2.1</td><td>2.2</td><td>2.2</td><td>2.1</td><td>2.0</td></tr><tr><td>Actual contribution</td><td>-</td><td>-</td><td>-</td><td>-</td><td>-</td></tr></table>
The underlying assumptions in calculating the required contribution in each year are the previous year's NZS Fund balance and projected series, over the ensuing 40 years of nominal GDP, net (after-tax) New Zealand superannuation expenses and the Government 5-year bond rate. The latter is used in calculating the Fund's expected long-run after-tax annual return. Over the forecast years all Fund variables, apart from the capital contributions, are provided by the NZS Fund itself.

Refer to the Treasury's website for the NZS Fund model.</td></tr>
</table>