DISCUSSION PAPER

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

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This brief discussion paper provides a very basic analysis but plausible solution to allow Government to capitulate to our collective demands for fairer indexation. This analysis is by no means complete but I hope my thoughts act as a foundation and catalyst for more robust discussions and collective positioning by ALL organisations in moving forward in our campaign.

INTRODUCTION

This brief discussion paper provides additional information that I have been piecing together since my response to the Matthew's Report. It is offered to all Representative Organisations as background research to help with the collective "water boarding" strategy that I wrote about a few weeks ago.

Whilst I don't profess that this analysis is anywhere near complete, I believe it is well enough advanced to enable others with greater minds than mine to consider, validate and formulate robust positions in which we can collectively engage Government.

With the foregoing in mind, the paper is broken down into two sections. The first section gives an overview of the analysis with a graphical representation of the parameters involved in producing a "net cost" for improved indexation. The second section (Annex A) provides the analytical details and assumptions made. In addition to this document, I have included an accompanying Microsoft Excel spreadsheet (Office 2007), which provides the basis of the calculations and assumptions used.

GENERAL

As I stated in my response to the Matthew's Review, Mr Matthews failed to provide the Government with a set of "net cost" figures for the Government to consider. He instead only gave a cursioury overview of issues concerning "clawback" and remained relatively mute with regards to the assets contained in the Future Fund.

Additionally, Finance is quoted by Matthews as saying that there are no assets to offset an increase to the CRF for improved indexation. Whilst this statement is perhaps techincally correct, it nevertheless illustrates just how superficial the Matthew's Report really is because he makes no effort to produce a forward growth projection for the Future Fund together with "clawbacks" in order to derive a "net cost" figure.

Whilst "clawback" is an important ingredient in our argument (and I am of the firm belief we need to ensure that it is accurate and current) I don't believe we have paid much attention to or exploited the likely projections of the Future Fund to any great degree.

As a consequence, Figure 1., is a graphical representation of the data and assumptions contained in Annex A. The graph ties together a number of projections in order to paint a better picture of the true interraltionships between the projection of:

- current unfunded liabilities[1];
- future liabilities if improved indexation is applied[2];

[1] Initial figures derive from Future Fund Actuary Letter., *Target Asset Level Declaration,* dated 8 May 2008.

- "clawback" as calculated in 2005 by the Australian Government Actuary; and
- a number of forward projections of the likely growth of the Future Fund.

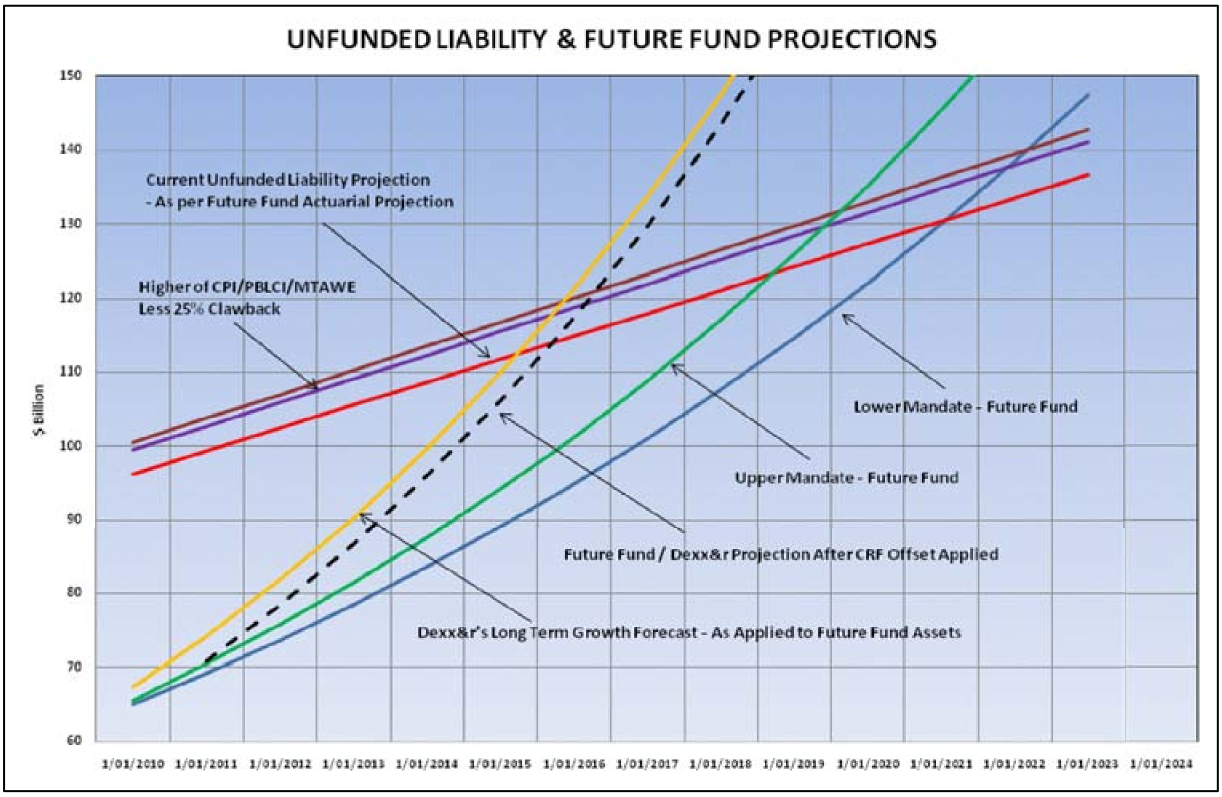

Figure 1

As can be seen above, the red line shows the current unfunded liability projected over time[3].

The brown line shows the adjusted projection of the unfunded liability if indexation was to be increased to CPI or MTAWE, whichever is the higher[4].

The all important purple line shows the improved indexation less a "clawback" of 25%. If "clawback" was to be increased to the 2002 NATSEM figures of 37-58% then the purple line would move closer to the red line and would therefore reduce the annual "unfunded" cost out of the CRF. Matthews quotes Finance as saying that the cost of improved indexation would in

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

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

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

the order of $40B over the period considered and my calculations would suggest that this figure is reasonably accurate[5].

Therefore, it is imperative that we try to obtain an up to date and valid "clawback" figure that approaches the current unfunded liability in order to demonstrate a reduced cost[6].

The upward projections show a number of scenarios pertaining to the earnings projections of the Future Fund over time. The Green and Blue lines are the upper and lower investment mandates required of the Future Fund as per the enabling legislation.

The Yellow line is Dexx&r's Long Term Growth Forecast for Superannuation up to 2017[7]. Whilst this growth rate has a number of implications and is used for illustration purposes only, the current annualised return of the Future Fund as demonstrated over the last quarter is approximately 9.5%. Therefore, whilst being a little less conservative, the Yellow line may indeed be representative of the growth of the Future Fund over time.

The Black dotted line is the most important projection on this graph. What it tries to illustrate is a situation where the Government takes profit above the "upper mandate" of the Future Fund to offset[8] and neutralise any cost increase in the CRF due to improved indexation.

Based upon the Yellow line projection and the "clawback" figure used, I believe the Government would only need to find $1.5B in the first year (i.e. 2010/11) because all outer years show a profit above the 100% offset required. Clearly a higher "clawback" figure would reduce the first year and outer year liabilities.

Whilst using excess profit above the Upper Mandate would require a legislative amendment, I believe we would be in a strong position to argue that a change is defensible because the original constructs of the Future Fund remain intact to reduce the unfunded liability by 2020.

[5] This is a gross figure of outlays only and does not account for CRF injection of contributions.
[6] Clawback figures ranging from 15-58% are unacceptable when we are talking about cost in the Billions of dollars. Is it any wonder Politicians go weak at the knees when confronted by these issues.
[7] Please be aware that this growth rate also includes employer contributions and therefore does not reflect a true earnings growth rate per se. However, the in the last quarter the Future Fund did produce an annualised return of approximately 9.5% so a profit projection above the Upper Mandate is not unreasonable.
[8] The CRF should only be supplemented with an amount of profit required to provide a 100% offset for the improved indexation.

CONCLUSION

This analysis is provided to Representative Organisations for their respective consideration, validation and collective positioning with each other in engaging and "waterboarding" the Government to provide improved indexation.

Representative Organisations should band together and fund an independent authority to update and validate an irrefutable "clawback" figure.

The formulation and presentation of an accurate "clawback" figure together with a mature funding strategy (i.e. offsets from the Future Fund) would reinforce our collective credibility in the eyes of Government/Opposition.

Finally, I believe that the confluence between "clawback" and the utilisation of excess Future Fund earnings should be one of our new and principle mantras in moving forward.

ANNEX A

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

Table 1

Notes:

1. Future Fund Balance as at 30 June 2009 = $61.04B[9].
2. The figures presented for 2009-11 in red were derived from the Future Fund Actuary Letter., *Target Asset Level Declaration*, dated 8 May 2008. The projections highlighted in this column are incremented by $3.1B p.a. as per original projections performed by Dr. Knox. A linear projection is provided because it is assumed that entrants and exits into and out of Commonwealth and Military Superannuation will remain relatively constant over the projection period.
3. CPI is assumed to be 2% p.a. over the long run. However, irrespective of the CPI, given that the Future Fund Mandates are percentages above CPI then the growth projections will be directly proportional in percentage terms over time.
4. The „Unfunded Liability to higher of CPI/MTAWE' figures have been projected at 4.6% p.a above the "Current Unfunded Liability Projection". This figure (derived from Matthews / Finance) is used to bridge the gap between the Matthew's Report and this analysis.
5. As can be seen in green, if the Future Fund's earning rate is at the upper end of its mandate then unfunded liabilities will be extinguished by 2019.
6. As can be seen in yellow, if the Future Fund's earning rate is consistent with Dexx&r's Long Term Growth Forecast for superannuation assets, then unfunded liabilities will be extinguished in 2015-16.
7. As can be seen in blue, in the unlikely event that the Future Fund earning rate only achieves the lower end of the mandate then unfunded liabilities will not be extinguished until 2021.
8. The red hashed area represents a $1.5B shortfall in the CRF for the first year of improved indexation. A small price to pay for the improved retirement outcomes of 600,000 former and current employees!

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