OFFICE OF THE AUDITOR-GENERAL
Te Mana Arotake

Financial Review briefing to the Commerce Committee

2011/12 Financial Year

21 February 2013

Guardians of New Zealand Superannuation and New Zealand Superannuation Fund

Assistance to the Committee

The Commerce Committee is conducting a financial review of the performance in the 2011/12 financial year and the current operations of the Guardians of New Zealand Superannuation (the Guardians) and New Zealand Superannuation Fund (the Fund) in accordance with Standing Order 340.

The Controller and Auditor-General provides Parliament with assurance on the performance and accountability of public entities. The Office of the Auditor-General typically assists select committees with their financial reviews by providing further details on the results of the annual audit in Part A of our written briefings, and by suggesting lines of enquiry and questions relevant to the particular public entity under review in Part B of our written briefings.

Our annual audits provide a high, but not absolute level of assurance about whether a public entity's financial statements comply with generally accepted accounting practice (GAAP) in New Zealand and fairly reflect its financial position and its financial and service performance for the period audited.

Due to the volume of transactions, audit work is planned and performed to obtain evidence on a sample basis. Auditors use professional judgement to assess the evidence and ensure there is reasonable assurance that there are not material misstatements in the financial statements (that is, differences or omissions that would affect someone's overall understanding of the financial statements). We report, in our audit opinion, only material differences or omissions that we find.

To identify lines of enquiry for Part B of this briefing, we:

- analyse the results of the annual audit and the accountability documents;
- refer to any relevant performance audit or inquiry work; and
- use our specific knowledge of the entity gained during the audit process and by on-going contact with the entity.

Where necessary, we checked factual information with the department or other entities to ensure that our advice to the committee is accurate. We did not give the entities any of the contemplated or actual advice that is in this briefing.

Contact for further explanation

If any member of the Committee would like further explanation or elaboration of any aspect of this briefing document, please do not hesitate to contact Henry Broughton, Sector Manager, Parliamentary Group on 04-917-1500 or e-mail henry.broughton@oag.govt.nz at the Office of the Auditor-General.

Summary of key issues

Part A: Results of the 2011/12 audit

- We issued an unmodified audit opinion on the financial statements of the Guardians of New Zealand Superannuation (the Guardians) and the New Zealand Superannuation Fund (the Fund).
- We assessed and graded the entities' management control environment as very good. We assessed and graded their financial information systems and controls as very good, and the service performance information and associated systems and controls for the Guardians as good.

Part B: Advice to the Committee

The key points we cover for the Committee, and suggest questions on, are:

- The Fund made a modest gain of 1.21% for the 2011/12 year and the Committee may want to know how the Fund is performing for the current year.
- The Retirement Policy and Research Centre based at Auckland University reports that the Fund only beat the cost of Government debt by $346 million since its inception compared with the $1.5 billion reported in the Fund's 2011/12 Annual Report. The Committee may want to get the Guardians' views on the different figures.
- The Guardians' value-add activities are determined by reference to a Reference Portfolio. The Committee may want to know more about the portfolio and confirm it is an appropriate benchmark to measure performance.
- The Guardians have set themselves a 20-year performance target of returning the Treasury Bill rate plus 2.5%. The Committee may want to know what the risks are to achieving this target.
- The Guardians consider that responsible investors should have concern for environmental, social and governance matters. The Committee may want to know how the Guardians integrate responsible investment matters into its investment practices.
- In 2009 the Minister of Finance issued the Guardians with a directive encouraging more investments in New Zealand assets and the Committee may want to know how the Guardians determine when to invest in New Zealand assets.

Overview of the Guardians of New Zealand Superannuation and New Zealand Superannuation Fund

The New Zealand Superannuation Fund (the Fund) and the Guardians of New Zealand Superannuation (the Guardians) were established by the New Zealand Superannuation and Retirement Act 2001 to reduce the tax burden on future New Zealand taxpayers of the cost of New Zealand Superannuation.

The Fund is a special-purpose savings vehicle giving certainty that some of the future cost of New Zealand Superannuation is covered. The Fund is also expected to add to Crown wealth over the long term by earning more for the Government in investment returns than the Government would save in debt servicing.[1]

The Guardians, as a Crown agency, are charged with managing the Fund according to a legislated mandate.

That mandate requires the Guardians to manage the Fund in a commercial and prudent fashion comprising:

- Best-practice portfolio management;
- Maximising return without undue risk; and
- Avoiding prejudice to New Zealand's reputation as a responsible member of the world community.[2]

As a result of the Global Financial Crisis, in the 2009 Budget the Government decided to reduce contributions to the Fund until the Crown operating balance returned to a level of surplus that was sufficient to resume contributions. At present the Treasury estimates this will be in the 2017/18 year.

In 2009 the Guardians received a direction from the Minister of Finance requiring them to, while always investing in a prudent and commercial manner, identify and consider opportunities to increase the allocation to New Zealand assets in the Fund.

As at 30 June 2012 the value of the Fund was $18.70 billion. This increased to $20.92 billion as at 30 December 2012.

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[1] Guardians of New Zealand Superannuation Statement of Intent 1 July 2012 to 30 June 2017, page 1.
[2] Guardians of New Zealand Superannuation Statement of Intent 1 July 2012 to 30 June 2017, page 1.

Part A: Results of the 2011/12 audit

1 Audit opinion

1.1 We issued an unmodified audit opinion on the financial statements and non-financial performance reporting of the Guardians and the Fund.

2 Environment, systems and controls for measuring financial and service performance

2.1 Our conclusions on the entities' management control environment, systems, and controls for measuring financial performance, for the year ended 30 June 2012, are set out in the table below.

2.2 We made our conclusions in the context of our work in forming an opinion on the financial statements. The purpose of commenting on the underlying environment, systems, and controls is to highlight areas for improvement identified during the audit. The grades assigned for 2011/12 reflect our recommendations for improvement as at 30 June 2012. They are not an assessment of overall management performance or of the Guardians' effectiveness in achieving their financial objectives. (See the Appendix for an explanation of the grading scale and underlying assumptions.)

Management control environment	
2011/12 – Very good	No improvements are necessary.
2010/11 – Very good	
Comment	
No deficiencies were noted in the areas we reviewed during 2011/12.	
Financial information systems and controls	
2011/12 – Very good	No improvements are necessary.
2010/11 – Very good	
Comment	
No deficiencies were noted in the areas we reviewed during 2011/12.	
Service performance information and associated systems and controls	
2011/12 – Good	Improvements would be beneficial and we recommend that the Guardians address these.
2010/11 – Good	Deficiencies we identified in 2010/11 have been largely resolved.
Comment	
Forecast of non-financial performance Our review of the Guardians' 2012-17 Statement of Intent (SOI) and the related performance management framework found that the Guardians have good systems and controls supporting the setting of organisational direction, outcomes, priorities, and targets, and for assessing performance against these.	

Based on our review of the SOI and discussions with management, we are satisfied that the SOI complies with relevant legislative requirements and appears reasonable.

Statement of Service Performance

We have audited the 2011/12 SSP and reviewed the contents in the light of our knowledge of the Guardians, the Fund, and their outputs. We are satisfied that the performance measures have been appropriately reported against.

Based on the areas we reviewed during 2011/12, we found that appropriate policies, systems, and controls were in place and appeared to be operating effectively.

3 Significant matters of audit interest

3.1 We noted the following significant matters of interest from our audit of the Fund and the Guardians.

Investments

3.2 During the year, the Fund entered into a number of new investment products. We did not encounter any significant issues during our audit of these investments. However, we draw the Committee's attention to some of the key audit considerations in relation to the Fund's investment portfolio.

Valuation of Z Energy Limited

3.3 The Fund owns 50% of the shares in Z Energy Limited, which was recorded at fair value at 30 June 2012. The valuation was independently performed by PricewaterhouseCoopers (PwC). We have read the report prepared by PwC as of 31 March 2012 and the update of the valuation as of 30 June 2012. We note that the final assessed valuation range for the complete enterprise ($1,410 million to $1,510 million) is at the lower end of the discounted cash flow valuation range ($1,367 million to $1,622 million) after taking into consideration the results from the earnings multiple valuation approach.

3.4 As at 30 June 2012, the total value of the Fund's total investment in Z Energy was $518.5 million, a decrease from $560.6 million at 30 June 2011. This is a consequence of the decrease in the New Zealand Refinery Company Limited (NZRC) share price during the last 12 months and an increase in the level of debt and bonds of Z Energy. We are satisfied that the valuation of the Fund's investment in Z Energy is within a reasonable range.

Private equity investments

3.5 The total fair value of private equity investments has increased from $887 million at 30 June 2011 to $1,332 million at 30 June 2012. The increase is attributable to the increase in the level of current private equity investments due to capital calls paid, investments in new private equity funds, and the privatisation and resulting reclassification from global equity to private equity of the Horizon Group.

3.6 The private equity investments are valued using the most recent quarterly management accounts provided by the investment managers of these investments. Given the Fund's year end close timetable, the March management accounts are used in assessing the value. After year end, management receives the June management accounts and track the differences in the valuation from March to June. These differences are not material in the current year.

Employee incentive accrual

3.7 The Guardians' financial statements include an accrual for employee incentive of $4.3 million. The Employee Policy and Remuneration Committee of the Board of the Guardians is required to approve the employee incentive calculation each year. We noted that the calculation methodology had a number of components that required management judgement (for example, future returns of the Fund, forecasted remuneration levels and individual KPI achievement).

3.8 There are currently two versions of the incentive scheme. The newer version was introduced during 2011, and the former scheme will be phased out by 2013. We have examined the calculation and the key inputs of the employee incentives.

3.9 We are satisfied that the employee incentive accrual is reasonable.

4 Legislative compliance

4.1 We reviewed the systems and procedures that the Guardians use to identify and comply with legislative requirements. No issues arose that need to be drawn to the Committee's attention.

Part B: Advice to the Committee

5 Fund performance

2011/12 performance

5.1 For the year ended 30 June 2012 the Fund's before tax, after expense result was a modest gain of 1.21%. Overall the Fund size remained flat at $18.70 billion on an after-tax basis. This compares to a Fund size of $18.65 billion in 2010/11.

5.2 The Committee may wish to ask:

> The Committee notes the Fund returned 1.21% for the year ended 30 June 2012.
>
> - How satisfied were the Guardians with the performance of the Fund in 2011/12? How is the Fund performing for the 2012/13 year?

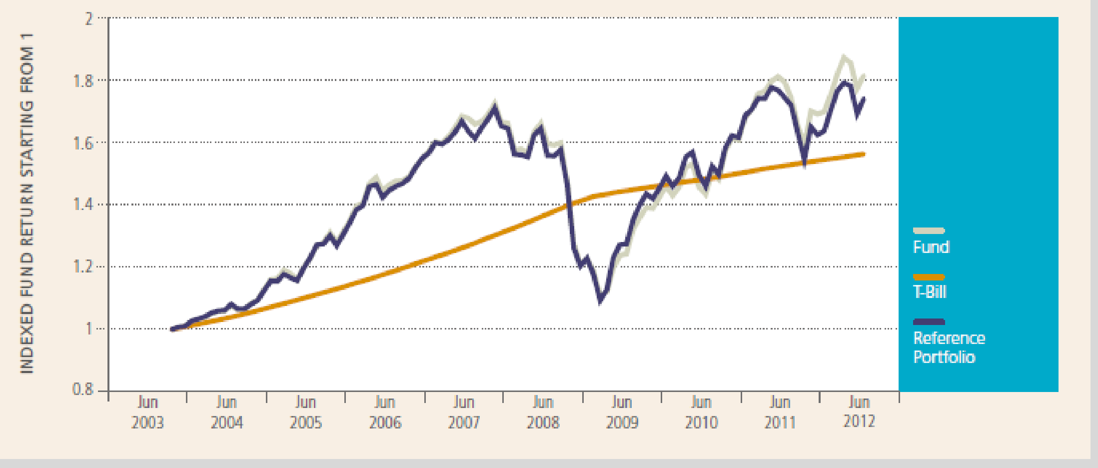
Performance since inception

5.3 The Fund was established to reduce the tax burden on future New Zealand taxpayers arising from the cost of New Zealand superannuation. This is a long-term outcome.

5.4 The Guardians use two benchmarks to measure the long-term performance of the Fund which are:

- A comparison with the 90-day Treasury Bill rate. The Guardians use this comparison as a proxy for the opportunity cost to the Government of contributing capital to the Fund, instead of using the money to retire debt; and
- A comparison with a Reference Portfolio which is a shadow or notional portfolio of passive, low-cost, listed investments suited to the Fund's long- term investment horizon and risk profile. This portfolio is used to measure how much value the Guardians' active investment strategies add to the Fund's value.

5.5 The graph below from the Fund's 2011/12 Annual Report (page 18) shows the Fund's cumulative returns since its inception when compared to the 90-day Treasury Bill rate and the Reference Portfolio cumulative returns.



5.6 We observe that:

- The gap between the Fund's return (7.05%) and the Treasury Bill return (5.23%) since the Fund's inception means the Fund has earned $1.512 billion over the 90-day Treasury Bill rate since the Fund's inception[3]; and
- The gap between the Fund's return (7.05%) and the Reference Portfolio's return (6.54%) represents the added-value that the Guardians' active investment activities have contributed to the Fund since inception of the Fund. This amounts to $827 million.[4]

5.7 That said, a report from the Retirement Policy and Research Centre based at Auckland University says that as at 30 June 2012 the Fund only beat the cost of Government debt by $346 million compared with the $1.512 billion referred to in the Fund's 2011/12 Annual Report.[5] We understand the Retirement Policy and Research Centre use the yield on 10 year Government stock to estimate the Fund's performance.

5.8 The Committee may wish to ask:

> The Committee notes that a report from the Retirement Policy and Research Centre based at Auckland University says that the Fund only beat the cost of Government debt by $346 million since its inception compared with the $1.5 billion referred to in the Fund's 2011/12 Annual Report.
>
> - What are the Guardians' views on the Retirement Policy and Research Centre's findings?

5.9 The Committee may also wish to

> The Committee notes the Guardians measure its value-add activities by reference to a Reference Portfolio.
>
> - Why is the Reference Portfolio an appropriate benchmark to compare performance?
> - Do other sovereign wealth funds adopt a similar approach to measuring performance?

20-year performance target

5.10 The Guardians have set themselves a 20-year performance target of returning the Treasury Bill rate plus 2.5%.[6]

5.11 The Committee may wish to ask:

> The Committee notes the Guardians have set themselves a 20-year performance target of returning the Treasury Bill rate plus 2.5%.
>
> - Do the Guardians consider that they are likely to meet the 20-year performance target?

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3 New Zealand Superannuation Fund Annual Report 2011/12, page 2.
4 New Zealand Superannuation Fund Annual Report 2011/12, page 2.
5 *RPRC Pension briefing 2013-1*, 4 February 2013, The University of Auckland Business School.
6 New Zealand Superannuation Fund Statement of Intent 1 July 2012 to 30 June 2017, page 6.

6 Responsible investment

6.1 The Guardians consider that responsible investors who exercise best-practice portfolio management should have concern for environmental, social and governance (ESG) issues.[7]

6.2 The Guardians are a signatory to the United Nations' Principles for Responsible Investment (UNPRI) which is the internationally accepted benchmark for how institutional investors should manage environmental, social and governance issues.

6.3 UNPRI has established six principles for responsible investment by signatories which are that a signatory should:

- Incorporate ESG issues into the investment analysis and decision-making process;
- Be active owners and incorporate ESG into ownership policies and practices;
- Seek appropriate disclosure on ESG issues by the entities invested in;
- Promote acceptance and implementation of the Principles within the investment industry;
- Work together to enhance the effectiveness in implementing the Principles; and
- Report on activities and progress towards implementing the Principles.

6.4 The UNPRI conducts a survey of a member's progress against these six principles and the following chart shows the Guardians' performance relative to all asset-owner signatories of the UNPRI since 2008.[8]

Quartile summary

	2008	2009	2010	2011
GPS	n/a	1	1	1
Principle 1	3	3	1	1
Principle 2	1	1	1	1
Principle 3	2	3	1	1
Principle 4	1	1	1	1
Principle 5	2	1	1	1
Principle 6	2	1	1	1
Number of peers	74	128	168	198

Top quartile 1 (green), quartile 2 (yellow), quartile 3 (orange), bottom quartile 4 (red)

6.5 We note that care must be taken with the results as scores are calculated based on self-assessment and, we understand, have not been independently audited by the UNPRI Secretariat or PRI Assessment Group.

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7 New Zealand Superannuation Fund Annual Report 2011/12, page 38.
8 No assessment was undertaken in 2012 as the UNPRI is reviewing its methodology.

6.6 The Committee may wish to ask:

The Committee notes the Guardians consider that responsible asset owners who exercise best-practice portfolio management should have concern for environmental, social and governance issues.

- How do the Guardians integrate responsible investment practices into its investment practices?
- How do the Guardians know that its passive investments comply with its responsible investment criteria?

7 Target operating model and tilting

Target operating model review

7.1 One of the priorities for the 2011/12 year was for the Guardians to develop a "target operating model" to assess where to focus its investment search and selection and to have the highest possible confidence of maximising returns without undue risk.

7.2 We understand that in developing the model the Guardians looked closely at international best practice, studying the operating models used by a number of similar funds overseas.

7.3 The Committee may wish to ask:

The Committee notes the Guardians developed a "target operating model" which established an ideal view of its activities and the resources required to support the Guardians' investment activities.

- What changes did the Guardians make as a result of the review?

Tilting

7.4 Over the last four years the Guardians have introduced an investment strategy referred to as "tilting". Broadly, this involves "tilts" towards or away from asset classes and currencies when the Guardians consider that the market has substantially overreacted (either up or down) compared with the Guardians' long-term assessment of relevant value. The Guardians have said that to date the results have been promising.[9]

7.5 The Committee may wish to ask:

The Committee notes the Guardians adopt an investment approach called "tilting" which means the Guardians will tilt towards or away from investing in asset classes and currencies when they think the market has over or under-valued them.

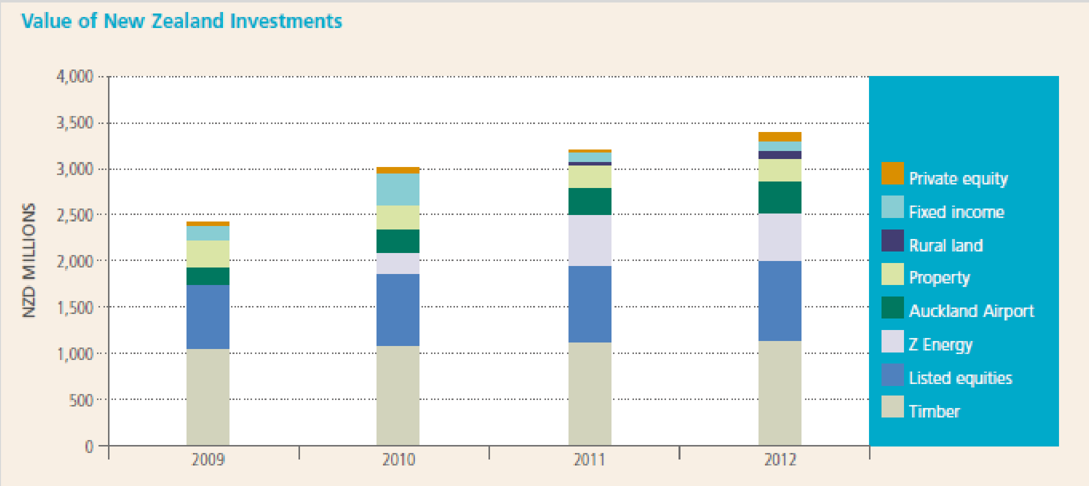
- How do the Guardians decide when to adopt a tilting position?
- What are the risks associated with tilting?
- In which asset classes has tilting worked well? Where has it been less successful?

[9] New Zealand Superannuation Fund Annual Report 2011/12, pages 8-9.

8 New Zealand investments

8.1 In 2009 the Minister of Finance issued the Guardians with a New Zealand Investment directive encouraging more investments in New Zealand assets. Specifically, the Minster directed the Guardians to note that it was the Government's expectation that opportunities that would increase the allocation of New Zealand assets in the Fund should be appropriately identified and considered by the Guardians.

8.2 In the three years since 30 June 2009, the proportion of the overall Fund invested in New Zealand has increased from 21.3% to 22.9%.[10] Over the same period, the value of the Guardians' investments increased from $2.4 billion to $3.4 billion.[11] This is illustrated in the chart below.[12]



8.3 The Committee may wish to ask:

> The Committee notes that in 2009 the Minister of Finance issued the Guardians with a directive encouraging more investments in New Zealand assets.
>
> - What challenges and practical difficulties do the Guardians face increasing its proportion of New Zealand investments?
> - How do the Guardians ensure that New Zealand investments are not undertaken at the expense of better overseas investments?

10 This excludes cash and foreign exchange hedging instruments such as foreign exchange contracts and cross currency swaps.

11 If foreign exchange hedging instruments were included the value would have increased from $3.2 billion to $4.6 billion.

12 Refer New Zealand Superannuation Fund Annual Report 2011/12, page 25.

9 Employment

9.1 The Guardians carried out a restructuring during the year which mainly affected the investment and asset allocation team. This resulted in the disestablishment of nine roles and the establishment of 15 new roles.

9.2 The Committee may wish to ask:

> The Committee notes the Guardians carried out a restructuring during the year which mainly affected the investment and asset allocation team.
>
> - What were the aims of the restructure and have these been achieved?
> - Do the Guardians have any difficulty employing suitably qualified investment managers? If so, how are these overcome?

APPENDIX

Explanation of scope and grades

Indicative Areas	
Management Control Environment	This is the foundation of the control environment and may include consideration of the following: • clarity of strategic planning/the way the entity manages and reports performance; • communication and enforcement of integrity and ethical values; • commitment to competence; • participation by those charged with governance – for example, the involvement and influence of Audit Committee and Board (or equivalent); • management philosophy and operating style; • organisational structure; • assignment of authority and responsibility; • human resources policies and practices; • risk assessment and risk management; • key entity-level control policies and procedures; • information systems and communication (including information technology planning and decision-making); • monitoring; and • legislative compliance arrangements.
Financial Information Systems and Controls	These are the systems and controls (including application-level computer controls) over financial performance and financial reporting and include the following: • appropriateness of information provided; • presentation of financial information; • reliability of systems; • control activity (including process-level policies and procedures); and • monitoring.
Service Performance Information and Associated Systems and Controls	This concerns the quality of the service performance measures selected for reporting against, as well as the systems and controls (including application-level computer controls) over service performance reporting, and includes the following: • appropriateness of information provided and reported; • presentation of SSP information; • reliability of systems; • control activity (including process-level policies and procedures); and • monitoring. Comments and grades are based on conclusions drawn from the 2012-2015 SOI and the 2011/12 SSP.

Grade	Explanation of grade
Very good	No improvements are necessary.
Good	Improvements would be beneficial and we recommend that the Guardians address these.
Needs improvement	Improvements are necessary and we recommend that the Guardians address these at the earliest reasonable opportunity.
Poor	Major improvements are required, and we recommend the Guardians urgently address these.

1. The reporting under Part A of this briefing, *Environment, Systems, and Controls for Measuring Financial and Service Performance,* is a by-product of the underlying audit work carried out to form an opinion on the financial and service performance statements. Its scope is limited to those areas of the management control environment, information systems and controls the auditor has given attention to during the course of the audit.

2. Recommendations for improvement are generally limited to those findings that the auditor considers are the more notable weaknesses in the design or operation of the management control environment, information systems, or controls. The recommended improvements determine the grade assigned. A single, serious deficiency drawing a recommendation for improvement may, of itself, determine the grade. Similarly, the most serious deficiency among several will draw a stronger recommendation and affect the grade accordingly.

3. Deficiencies in the management control environment, information systems, or controls are the gaps between what auditors observe and what auditors consider, in their professional judgement, constitutes best practice (see below). Auditors' professional judgement is informed by many factors, including national and international standards, knowledge of best practice, and standards and expectations for the public sector in New Zealand.

4. To help ensure the relevance to all entities of the auditor's recommendations and grading, the auditor's recommendations are made with reference to what is considered best practice given the size, nature, and complexity of the entity. Thus, notions of best practice will vary among entities because what is considered necessary, sufficient, or beneficial for some entities may not be so for others. There is therefore not a "one size fits all" standard across the public sector. Rather, recommendations for improvement are based on the auditor's assessment of how far short the entity is from a standard that is appropriate for the entity's size, nature, and complexity of its business.

5. Further, notions of best practice may vary over time in response to change – for example, changes in the operating environment, changes to standards, and changes in general expectations. Grades assigned to entities may therefore fluctuate from year to year according to how entities respond to changes in the environment and in best-practice expectations. Grades may also be affected from year to year because of changes in emphases, in accordance with the auditor's risk-based approach to testing systems and controls.

6. Improvements are recommended only when it is considered, in the auditor's judgement, that the benefits of the improvements would justify the costs.

7. Recommendations for improvement are based on the auditor's conclusions about the state of the entity's management control environment, information systems, and controls as at the end of the financial year.