2017/18 Annual review of the Guardians of New Zealand Superannuation

Report of the Finance and Expenditure Committee

April 2019

Contents

Michael Wood
Chairperson

Guardians of New Zealand Superannuation

Recommendation

The Finance and Expenditure Committee has conducted the annual review of the Guardians of New Zealand Superannuation for 2017/18, and recommends that the House take note of its report.

Introduction

The Guardians of New Zealand Superannuation is an autonomous Crown entity responsible for managing the New Zealand Superannuation Fund. The Fund comprises a pool of assets on the Government's balance sheet.

The purpose of the Fund is to reduce the tax burden of superannuation for future taxpayers. It was created as a way to partially pre-fund (pay-as-you-go) future retirement benefits to help smooth the cost of New Zealand Superannuation between today's taxpayers and future generations.

The New Zealand Superannuation and Retirement Income Act 2001 requires the Guardians to manage the Fund on a prudent, commercial basis, consistent with:

- best-practice portfolio management
- maximising return without undue risk to the Fund as a whole
- avoiding prejudice to New Zealand's reputation as a responsible member of the world community.

The board of the Guardians has seven members and is chaired by Catherine Savage. Matt Whineray was appointed chief executive in July 2018, replacing Adrian Orr. The entity employed 127 full-time-equivalent staff as at 30 June 2018.

Financial overview

The Fund returned a profit before income tax of $4,382 million in 2017/18. This was significantly lower than the profit of $6,201 million in 2016/17. As at 30 June 2018, the Fund's net assets were $39.3 billion, roughly $4 billion more than the previous year. The 2018 annual report (page 36) notes that "the Fund again out-performed global markets" and that "the Fund is well ahead of its performance benchmarks since inception".

Financial markets have experienced some volatility recently, which saw the Fund experience negative returns in the last quarter of the 2018 calendar year before rebounding in January. Market volatility is an expected outcome for long-term, growth-oriented funds. With no substantial withdrawals forecast until the 2050s, the Guardians can remain focused on their long-term investment strategies and take advantage of the ups and downs along the way.

Between 2003 and 2009, the Government contributed $14.8 billion to the Fund. Contributions were suspended in 2009, during the global financial crisis, and restarted in

2017/18. The Government contributed $500 million to the Fund in 2017/18 and is projected to contribute a further $7.2 billion over the next four years. When the Fund reaches its expected peak, in 2071, the Government's capital withdrawals from the Fund, combined with the Fund's tax payments, are expected to cover 21 percent of the total net cost of New Zealand Superannuation.

The Fund is one of the largest institutional investors in New Zealand. Its New Zealand investments are valued at $6 billion, which is an increase from $2.4 billion in 2009. However, the Guardians note that although the amount invested in value terms has been increasing, the proportion of the overall Fund invested in New Zealand has been reducing. For example, it reduced from 21.3 percent in 2009 to 15.4 percent in 2018.

Audit results

We were pleased to note that the Auditor-General assessed and graded the Guardians' management control environment, financial information systems and controls, and performance information and associated systems and controls as "very good".

The main issue arising from the audit related to valuation of investments in the Kaingaroa Timberlands Partnership, Kiwi Group Holdings Limited, Horizon Group Pty Ltd, and View Inc. However, the auditors found no significant uncertainties during their audit procedures that would cause them to believe the investment valuations were not reasonable.

Investment in Auckland light rail

The Guardians are talking to the Ministry of Transport, the New Zealand Transport Agency, and the Treasury about a proposed investment in light rail in Auckland. This is an urban development project aiming to provide fast, reliable, safe, and frequent public transport around the city and between the airport and the city. We asked how much of the attractiveness of the model to the Guardians is linked to the airport connection as opposed to the urban development aspect, but the Guardians said the project has not yet reached this level of detail. The project planners have looked at potential options and are still deciding which procurement path to go down. We were told that the project still has options in terms of the technologies, the routes, and, in particular, the integration with urban development outcomes.

The Guardians' mandate is to make commercial investments. They therefore need to find an intersection between this mandate and the outcomes that the Government and Auckland Council want. Any investment must meet their investment hurdle. They start with a benchmark portfolio and need to expect better returns on new investments than they would receive on the investments that they sell. If they invest in a riskier asset, they would need to sell more existing investments.

The overall investment proposition the Guardians are considering includes building the light rail, but also participating in development along the way, such as buying up land around potential stations and developing that land as an investment. We heard that the revenue model to fund the light rail project is still open for debate with the Ministry of Transport and the Treasury. Various different models have been used around the world. One potential option is for the city to guarantee the investor a return based on a certain fare per passenger, and the investor would take the risk of passenger numbers falling short of estimates. This model has been used in Montreal. The Guardians use precedents to calculate the risk factors for projects like light rail, including projects that have been undertaken by their investment partners.

Taxation of the Fund

The New Zealand Superannuation Fund pays New Zealand tax. This involves one part of the Government paying another part, minus the costs of determining the tax liability (the compliance costs). Other significant Crown-controlled investment funds, ACC and EQC, are not subject to income tax. The Guardians made a submission to the Tax Working Group that they should be exempt from paying tax. They believe that their tax treatment is inconsistent with how sovereign wealth funds are dealt with around the world as well as with ACC in New Zealand.

The Guardians would also like to see lower rates of tax on large-scale infrastructure projects with a certainty that they will stay low, because they entail long-term investment decisions. For example, the light rail project could last until the end of the century and the rates of tax matter over that long term. They believe such an approach would be consistent with competing jurisdictions such as Australia and Canada in terms of providing longer-term confidence around tax rates.

We expressed scepticism, noting that the Guardians appeared to want both a higher Government contribution to the Fund and no tax. They said that taxing the Fund does not work when the Government’s contributions are turned off. When contributions are turned on, they have less of an issue, but they note that in the past contributions have been suspended for a long period of time. They want stability in their tax position regardless of whether the Government is making contributions or not.

We note that the Treasury’s main concern about making the Fund exempt, which it raised with the Tax Working Group, is the loss of flexibility. If the Fund is paying tax, the Government could reduce or suspend contributions and still have a source of revenue to pay for public goods and services, without raising other taxes or borrowing. This is not the case when the Fund is not paying tax.

We pointed out that for direct investments in the economy, if the Fund is not taxed, it has a competitive advantage. It may therefore be harder to compare how it is performing against others in the market. We also pointed out that the Fund would not then be investing in all of the things that Government does, such as health and education, and this could have a distortionary effect on decisions.

Investing in New Zealand assets

A significant portion of the New Zealand Superannuation Fund is invested offshore. However, in 2009 the Minister of Finance issued a ministerial directive that the Guardians should increase the Fund’s investments in New Zealand assets. If the Fund is to have a higher proportion of assets in New Zealand, the Guardians must have sufficient capacity and capability to make active, direct investments. To help achieve this, two years ago the

Guardians established an investment hub to research and shape new direct investment opportunities in New Zealand.

At present over $6 billion is invested in New Zealand through the investment hub, across all aspects of the capital markets. The investment hub activity is about finding market-failure areas where the Fund’s capital might be a catalyst for overcoming some barriers.

We heard that the Guardians are having conversations with iwi groups, iwi trusts, hapū, and Māori investment vehicles which have land. The Fund has access to capital that they can use to develop the land. They have been looking at fisheries, where the ownership structures are challenging but where New Zealand performs well compared to overseas. They are also looking at construction, KiwiBuild, and light rail.

We acknowledged that the Fund is a big player in the New Zealand market, with capital and a skill set that others do not have. The Guardians said the investment hub concept is about partnership, and they are conscious that they generally have the largest amount of capital on the table as well as the expertise. One control on this possible imbalance is that, under legislation, the Guardians cannot control any entity. Because of this, the collective approach is a critical aspect to how they address market opportunities.

The Guardians’ place in the public service

The Guardians are a part of the state services and come under the definition of a Crown entity. They submitted last year suggesting that the changes being made in the State Sector and Crown Entities Reform legislation should not apply to them. They sought to be exempted from having the State Services Commissioner decide the remuneration and terms and conditions of their chief executive, as they do not believe that that is appropriate for them. Under the Guardians’ proposed model, they would consult the Government but the final decision over CEO appointments and remuneration would rest with the Board.

They believe that the Fund operates at arm’s length from the Government and is therefore more similar to a State-Owned Enterprise (SOE). The Guardians do not require Government funding other than for directors’ fees and they have a separate legal existence. We suggested that SOEs usually pay tax, so an exemption from tax would suggest they are closer to the Crown. They believe the rationale for the tax is entirely separate because the Fund is part of the Government’s balance sheet.

Climate change strategy of the Fund

All of the investment decisions made by the Guardians are based on expected financial returns. Their climate change investment strategy is about risk, and because the horizon for superannuation is very long, the Fund is projected to keep growing through to the end of the century, based on the Treasury’s models. The Guardians therefore need to think about risks that will manifest over that time.

The Guardians do not think that markets price climate change risk properly. Their strategy is firstly to reduce risk through adaptation. This means changing the shape of the portfolio to reduce risk exposure, for example investments in activities with relatively high carbon emissions. They are finding opportunities created by the transition to a low carbon energy system. For example, they have invested in a vehicle called Longroad in the USA, which is developing solar and wind farms for power generation. They are also looking at other alternative energy and energy-efficiency investments like LanzaTech, a New Zealand company that produces fuel from waste gases.

We asked how the Guardians use their investment power to push companies in a particular direction. They said they engage actively with companies, and have a climate change policy about how they will vote on climate change matters. They also ask companies they work with what their strategy is to deal with the risks that are inherent in their business.

Ethical investment

The Guardians have a responsible investment framework which is a critical part of their investment strategy. The core part of that strategy focuses on their values which are based on international conventions, New Zealand laws, and expressions from New Zealand citizens. They exclude companies that do not fit these values from their portfolio, such as tobacco companies and cluster ammunition. They also have discussions with companies which they do not believe are fulfilling their obligations as good corporate citizens.

The main changes in terms of ethical investments have involved de-carbonising the Guardians' main listed portfolios. In June 2017, they sold about $950 million of global stocks and upgraded the rest of the portfolio. In June 2018 they continued to refine and further exclude some companies which are heavily carbon-exposed. They also excluded some cannabis stocks.

The Guardians receive enquiries from the public and under the Official Information Act about their views on the investments in the Fund. Their strategy is to be clear on their website, providing information about how they make decisions, and what their investment framework is.

Threshold for investment

We noticed that the Fund had purchased small vineyards and properties in New Zealand and thought that those assets would be below the Fund's usual investment threshold. Given its significant level of capital, the threshold for a worthwhile investment is roughly $100 million. This has not changed much in recent years.

The Guardians said they had invested indirectly in the smaller vineyards and properties. They identify market opportunities and give a mandate to investors and venture capitalists who act on their behalf as the investment manager. For example, firms such as Movac, Pioneer, or Direct Capital can access parts of markets that the Guardians cannot efficiently reach. The Fund holds the assets as fund investment vehicles.

The Guardians have mandates with various companies on different terms. Some mandates, such as with Morrison & Co and FarmRight, involve those firms finding the assets and considering them in the context of the broader portfolio. The Guardians might have the final say over the investments. Those firms are not the investment holder; the assets sit entirely within the Fund.

Memorandum of Understanding with Te Pūia Tāpapa Fund

In March 2018, the Fund signed a Memorandum of Understanding with Te Pūia Tāpapa Fund establishing a preferred partnership agreement. They have not made any investments yet, but are meeting regularly to discuss opportunities. Everybody in the partnership is incentivised to try to find good investments because there have been challenges to get this type of collective together over the years.

Appendix

Committee procedure

We met on 20 February and 3 April 2019 to consider the annual review of the Guardians of New Zealand Superannuation. We heard evidence from the Guardians, and received advice from the Office of the Auditor-General.

Committee members

Michael Wood (Chairperson)
Hon Amy Adams
Kiritapu Allan
Andrew Bayly
Rt Hon David Carter
Tamati Coffey
Hon Judith Collins
Ian McKelvie
Willow-Jean Prime
Dr Deborah Russell
David Seymour
Fletcher Tabuteau
Dr Duncan Webb

Advice and evidence received

We received the following documents as advice and evidence for this annual review. They are available on the Parliament website, www.parliament.nz, along with a transcript of our hearing.

Office of the Auditor-General, Briefing on the Guardians of New Zealand Superannuation and the New Zealand Superannuation Fund, dated 20 February 2019.

Guardians of New Zealand Superannuation, responses to annual review questions 2017-18.