

The Senate

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Economics Legislation Committee

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Provisions of the Future Fund Bill 2005

February 2006

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# Senate Economics Legislation Committee

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# CHAPTER 1

## Introduction

### Background

1.1 The Future Fund Bill 2005 was introduced into the House of Representatives on 7 December 2005 by the Treasurer, the Hon. Peter Costello, MP. It passed the House on 8 February 2006 without amendment and was introduced into the Senate on 9 February 2006.

1.2 On 8 December 2005, on the recommendation of the Senate Standing Committee for the Selection of Bills, the Senate referred the provisions of the Bill to the Economics Legislation Committee for inquiry and report by 21 February 2006.<sup>1</sup>

### Conduct of the inquiry

1.3 The Committee advertised the inquiry nationally and posted details on its internet site. In addition, it wrote to a number of organisations advising them of the inquiry and inviting them to make submissions.

1.4 The Committee received 4 submissions to its inquiry. These are listed at Appendix 1.

1.5 The Committee held public hearings at Parliament House in Canberra on Tuesday, 7 February 2006 and Thursday, 9 February 2006. Witnesses who presented evidence at these hearings are listed in Appendix 2.

1.6 The Hansards of the Committee's hearings and copies of all submissions are tabled with this report. These documents, plus the Committee's report, are also available on the Committee's website at [http://www.apf.gov.au/Senate/committee/economics\\_ctte/futurefund/index.htm](http://www.apf.gov.au/Senate/committee/economics_ctte/futurefund/index.htm).

1.7 The Committee thanks those who participated in this inquiry.

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1 Selection of Bills Committee, *Report No. 15 of 2005*.





## **CHAPTER 2**

### **Future Fund Bill 2005**

2.1 In September 2004 the Treasurer, the Hon. Peter Costello, MP, announced that future budget surpluses would be paid into a future fund to pay for the Commonwealth's unfunded superannuation liabilities. This Bill establishes such a fund with \$18 billion of seed capital.

#### **The Fund**

2.2 The Fund will be a financial asset fund consisting of cash and investments. All earnings are to be reinvested in it. Realised cash budget surpluses and the proceeds of any future asset sales are to be transferred to the Fund and the Government may also transfer some of its remaining equity in Telstra.

#### **The Board**

2.3 The Bill establishes the Future Fund Board of Guardians as a body corporate. It will consist of a Chair and 6 other members and will have the following functions:

- (a) to invest amounts in accordance with the Act;
- (b) such other functions as are conferred on it by the Act; and
- (c) to do anything incidental to or conducive to the performance of any of the above functions.

2.4 The Government has appointed Mr David Murray, former Chief Executive of the Commonwealth Bank of Australia, to chair the Board.

2.5 Board members are appointed on a part-time basis and their remuneration will be determined by the Remuneration Tribunal. They are eligible for appointment only if the responsible Ministers are satisfied that they have:

- (a) substantial credibility or expertise; and
  - (b) professional credibility and significant standing;
- in at least one of the following fields:
- (c) investing in financial assets;
  - (d) the management of investments in financial assets;
  - (e) corporate governance.

#### **The Future Fund Management Agency**

2.6 The Bill establishes a Future Fund Management Agency to assist and advise the Board. It will be a Statutory Agency for the purposes of the *Public Service Act 1999* and will be prescribed for the purposes of the *Financial Management and*

*Accountability Act 1997*. It will not have a legal identity separate from the Commonwealth. The Chair of the Board will be the Head of the Agency.

## **Structure of chapter**

2.7 This chapter sets out the major issues surrounding the Future Fund raised in evidence. Firstly, and at a fundamental level, it considers the broad concept of a future fund and analyses various arguments put for and against such a fund. It then turns to the issue of corporate governance, which featured prominently in the inquiry and was touched on in consideration of several topics. Finally the chapter focuses on four specific areas in the Bill that were brought to the Committee's attention. These include the structure chosen for the Board of Guardians; the power of Ministers to direct the Board in its endeavours; the restriction preventing the Fund from direct investment; and issues raised by Telstra concerning the transfer of the Government's equity in Telstra to the Fund.

## **Future Fund concept**

2.8 The Explanatory Memorandum (EM) notes that the Bill gives effect to a commitment made during the 2004 federal election campaign to establish a fund to meet unfunded superannuation liabilities. The underlying strategy is to allow the accumulation of assets in order to meet liabilities that will become payable at a time when spending pressures associated with an ageing population are likely to hit, strengthening the Government's balance sheet and helping to ensure the long-term sustainability of its finances.

2.9 However, the concept of a future fund is not universally supported, and a number of groups and individuals have opposed its establishment. Opposition to the establishment of the Fund is based on a range of arguments, which include:

- establishment of the Fund precludes other reform priorities, particularly tax reform;
- a future government may use the funds for other than the intended purpose – essentially a 'hollow log';
- the Fund represents a departure from the principle of conservative financial management by the Commonwealth; and
- funding public sector superannuation requirements is not the most important problem facing the Government and is insignificant compared to other major calls on the budget.

2.10 However, there also appears to be substantial support for the Future Fund concept. The Investment and Financial Services Association (IFSA), which made a submission to the inquiry, stated that it is 'supportive of the Bill and the underlying policy aim of ensuring intergenerational economic fairness.'<sup>1</sup>

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1 IFSA, *Submission 1*, p. 1.

2.11 The Bills Digest for the Bill lists a number of arguments for the concept, noting that the OECD considers that the Fund will reduce the call on the budget in future years, allowing future revenues to be allocated to priority areas such as health.<sup>2</sup>

2.12 Treasury representatives also advised the Committee that the concept of establishing a fund to address the issue of previously unfunded superannuation liabilities is not new, and that all state and territory governments have similarly taken action to address these liabilities.<sup>3</sup> Treasury provided the Committee with a table showing an outline of the state and territory arrangements which is reproduced at Appendix 3.

### ***Precluding other reform priorities***

2.13 A range of organisations and individuals argue that the funds to be transferred into the Future Fund would be better spent on other reform priorities, particularly taxation reform.

2.14 The National Farmers' Federation, for example, is on record as stating that no additional contributions to the Future Fund should be made until all reasonable calls on the Budget, including tax cuts, have been met.<sup>4</sup> The Bills Digest for the bill, published by the Parliamentary Library, provides a more comprehensive outline of the range of opposition to the Fund.

2.15 The Australian Chamber of Commerce and Industry (ACCI) which made a submission and gave oral evidence to the inquiry, opposed the establishment of the Fund, submitting that the money put into the Fund is not available for other reforms, particularly to the tax system. Mr Potter of the ACCI advised the Committee that there is an opportunity cost associated with placing the money in the Fund, when there are alternative uses for it:

...we consider money put into the Future Fund is money that you cannot use for other purposes. We consider the biggest benefit would come from tax reform. You could also argue there might be some other beneficial uses. For example, you could argue that the money could be used for large-scale infrastructure. We are not arguing that, but other people could.<sup>5</sup>

2.16 The ACCI maintains that allocating money to the Future Fund is the equivalent of a tax increase (or a forgone tax reduction) because the funds can't be returned to taxpayers as tax cuts. The ACCI sees tax reform, particularly cutting high marginal tax rates, as potentially producing a number of benefits within the economy,

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2 *Bills Digest*, 7 February 2006, no. 93, p. 8. The Digest contains a good discussion of the range of arguments in support of the Fund.

3 *Proof Committee Hansard*, 9 February 2006, p. 1.

4 Quoted from Parliament of Australia, Department of Parliamentary Services, *Bills Digest*, 7 February 2006, no. 93, p. 7.

5 *Proof Committee Hansard*, 9 February 2006, p. 18.

ultimately leading to '...a larger and more efficient economy, increasing Government revenue in the long run and making it easier for Governments to pay public sector superannuation when required'.<sup>6</sup>

2.17 In relation to the tax cuts/infrastructure spending argument put forward by the ACCI and others, Treasury representatives emphasised that the Future Fund is an 'ex post fund', that is, contributions are made to it after all other decisions, including those about whether there is any argument for introducing further tax cuts, have been made:

The contributions are sourced from realised surpluses after all other spending decisions have been made. That is an important point, because there has been quite a bit of discussion about the Future Fund versus infrastructure spending versus tax cuts et cetera....Contributions are sourced from the realised surpluses after the end of the financial year. There will, of course, be years when governments run surpluses for often quite sound economic reasons, and the key policy issue is whether it is financially prudent to then build those surpluses up as term deposits in the Reserve Bank with no particular purpose tag to those or whether they are invested with a particular purpose earning a higher rate of return.<sup>7</sup>

### ***A hollow log?***

2.18 The Future Fund will comprise a significant and increasing source of funds. Two of the witnesses who gave evidence to the inquiry expressed concern that it will be possible for future governments to gain access to these monies and use them for purposes other than those specified in the Bill.

2.19 Mr Maurice Kennedy, a private citizen and former senior officer of the Department of Finance, argued against the establishment of the Fund. He considered that the Fund would serve as a 'hollow log' for future governments to draw upon:

If the Future Fund or anything resembling it is permitted to come into existence, this parliament will have sanctioned the creation of a very large hollow log that will almost certainly be pillaged by some future government, whether willingly or reluctantly.<sup>8</sup>

2.20 The ACCI expressed similar concerns:

While the bill as it currently stands does have certain protections about where investments can occur, we are concerned that these investment parameters could change. For example, the parameters given to the Future Fund for its operation could be changed by different ministers, and even the legislation could be changed. I guess we are concerned that it will be a

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6 ACCI, *Submission 4*, p. 4.

7 *Proof Committee Hansard*, 9 February 2006, p. 1.

8 *Proof Committee Hansard*, 7 February 2006, p. 9.

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hollow log which future governments could use for suboptimal investment strategies.<sup>9</sup>

2.21 However, the Bill is drafted to prevent this from occurring by specifying, in Schedule 2, the circumstances under which amounts may be debited from the Fund. It states that the main purpose of the Fund is to discharge the Commonwealth's unfunded superannuation liability. A secondary purpose is to meet the costs of both the Board and the Agency.

2.22 In order to discharge unfunded superannuation liabilities, the Fund can only be drawn on from the earlier of the point at which Fund assets are sufficient to offset the unfunded liabilities and 1 July 2020.<sup>10</sup> For the purpose of discharging unfunded superannuation liabilities the Fund can only be drawn down to discharge the amount payable in a particular financial year.

2.23 Discharging liabilities consists of:

- meeting some or all of an unfunded superannuation liability that becomes payable in a financial year ending before 1 July 2020 but only where the balance of the Fund is equal to or greater than this liability at the start of the financial year in question; and/or
- meeting some or all of an unfunded superannuation liability that becomes payable in a financial year beginning on or after 1 July 2020, irrespective of whether or not the Fund contains enough assets to meet this liability.<sup>11</sup>

2.24 The Explanatory Memorandum states that in a financial year where unfunded superannuation liabilities are able to be discharged from the Fund, the Government will have the flexibility of deciding whether to discharge the unfunded liabilities from the Fund; rely on the special appropriations which exist in the legislation governing the various superannuation schemes (in which case payments will be made out of the budget); or some combination of both.<sup>12</sup>

2.25 Although the provisions in the Bill do prevent the use of the Fund prematurely or for non-superannuation purposes, witnesses asserted that it is not possible to completely insulate the Future Fund. Regardless of the prudential underpinnings in the Bill, future governments will be able to gain access to the funds by changing the law. Future Parliaments can amend legislation to enable the funds to be used for other purposes and to be accessed at different times to those currently specified. Mr Kennedy noted that:

In being created as such a long-term strategy, the Future Fund would inevitably find itself under the stewardship of different future Governments

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9 *Proof Committee Hansard*, 9 February 2006, p. 15. [Potter]

10 Explanatory Memorandum, p. 52.

11 Bills Digest, p. 39.

12 Explanatory Memorandum, p. 52.

and Parliaments with, perhaps, a vastly different make up to what we have come to expect, and for whom the policy agenda, and associated political and fiscal priorities, may profoundly differ from the present.

In other words, at some point, it is possible that an extant Future Fund – with its substantial accumulation of cash and investments – might be seen as an irresistible and expedient vehicle for a Government wishing to pursue, say, an interventionist development agenda. (Sadly, the examples of past WA and Victorian State Governments spring too readily to mind.) Thus, the Future Fund’s currently proposed focus, its prudential underpinnings and its regime of Parliamentary and public transparency, will be enshrined in law only until a future Parliament changed the law to suit a different agenda.<sup>13</sup>

2.26 Furthermore, the Australian Chamber of Commerce and Industry is concerned that even without amending the legislation, there is scope in the bill for the Government to direct the Fund to invest in 'nation-building' investments that are not designed to maximise returns to the Fund.<sup>14</sup>

2.27 The Committee acknowledges that future Parliaments can amend legislation to respond to the needs of the day, but is of the view that for the purposes of assessing the Bill under its current inquiry it must look at the Bill as it stands before the Parliament, and not focus on amendments that might be made in unforeseeable circumstances by a future government.

### ***Departure from conservative financial management***

2.28 Mr Kennedy expressed concern that the proposed Fund represents a departure from the long established principle of conservatism in Commonwealth financial stewardship. He stated that the *Financial Management and Accountability Act 1997* permits the Minister for Finance and the Treasurer to invest public monies in 'authorised investments' and establishes both Ministers as corporations for this purpose. He said that 'authorised investments' included conservative, safe investments such as deposits with a bank, bonds etc, where there is no negative return on investments. However, he considered that the proposed Future Fund was to be managed more like a superannuation fund in which the fund managers sought to maximize the return on contributions. As such, it would be theoretically possible for returns to be negative. He maintained that this is inappropriate as it is public money that is under management, and the Commonwealth has a primary duty of care to the Australian people as a whole to exercise its trusteeship in a risk-averse way.<sup>15</sup>

2.29 The Committee disagrees. This fund is being established for a specific purpose, namely to fund what are currently unfunded superannuation liabilities, rather than unallocated funds in the consolidated revenue fund. As such, the Committee

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13 Mr Maurice Kennedy, *Submission 3*.

14 *Proof Committee Hansard*, 9 February 2006, p. 18. [Potter]

15 Mr Maurice Kennedy, *Submission 3*.

considers that the management of these funds in a way that is not dissimilar to a superannuation fund, following a strategy of maximizing returns (and by implication, accepting that there may be some risks of occasional negative returns) is appropriate.

***Is there a need to fund public sector superannuation?***

2.30 A number of commentators have argued that unfunded public sector superannuation requirements do not represent a major drain on the Government's budget, and that the current arrangements under which funding is provided from consolidated revenue should continue.

2.31 Mr Kennedy was one of those who argued that there is no requirement to set aside specific funds to meet future superannuation liabilities. He told the Committee that while this was a growing liability, it would level out in the future. He also pointed out that this liability was relatively insignificant compared with other unfunded liabilities:

The provision for future benefits is now paid for by departments as they go. What we are looking at with the \$140 billion is people like me, who have already retired and who get a superannuation pension. I and people like me are not going to go on forever. So in real terms this \$140 billion is going to decline. The amount of superannuation liability, as I say in my submission, pales into insignificance compared to the statutory liability for social welfare. So I am not sure why they picked on superannuation as the target for a future fund.<sup>16</sup>

2.32 In a similar vein, he told the Committee that successive governments had come to recognise that hypothecating<sup>17</sup> specific revenues to specific spending purposes are 'almost always ill-conceived and come to be regretted by the Executive'. He argued that this was because it constrained budget flexibility, and created a precedent for other areas of expenditure demanding the same treatment. He claimed that this was why the National Welfare Fund was abandoned as a means of hypothecating revenue to health and welfare benefits.<sup>18</sup>

2.33 The ACCI also argued that there was no need to set aside funds now to meet future unfunded liabilities and presented a table derived from the Intergenerational Report 2002 which shows unfunded government superannuation declining from 0.6 per cent of GDP in 2001-02 to 0.3 per cent in 2041-42.<sup>19</sup>

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16 *Proof Committee Hansard*, 7 February 2006, p. 12.

17 Hypothecate – to pledge to a creditor as security without delivering over; mortgage (Macquarie Dictionary Second revised edition).

18 Mr Maurice Kennedy, *Submission 3*.

19 ACCI, *Submission 4*, p. 6.

2.34 Treasury representatives briefly addressed this issue in evidence, pointing out that the unfunded superannuation liability is the largest on the Government's balance sheet, and the proposed fund 'is essentially about balance sheet management'.<sup>20</sup>

2.35 The Committee agrees. While public sector superannuation is not likely to be the Government's single largest future liability, it is and will continue to be the largest which is a vested entitlement for an identified set of individuals. Unlike social welfare, it is presently determinable. As such, it is prudent to make provision for it.

### **Corporate governance issues**

2.36 A number of corporate governance issues were raised by contributors to the inquiry. These included the appointment of members of the board; and voting policy in relation to companies in which the Future Fund may have a shareholding.

2.37 For its part, IFSA expressed general satisfaction with most of the proposed governance arrangements, including board member duties and conflicts of interest; board member remuneration; annual reporting requirements; and transparency in relation to investment activities and mandates. IFSA did draw the Committee's attention to one area not covered in the Bill and Explanatory Memorandum, namely a proxy voting policy. IFSA recommended that the Fund adopt a position in relation to this issue which is consistent with that contained in its *Blue Book*, a position which IFSA considers represents industry best practice.<sup>21</sup>

2.38 Mr Easterbrook of Corporate Governance International thought that IFSA's view was 'a little bit optimistic'. He told the Committee that he considered there should be 'some sort of best-practice nomination procedure' for members of the board; and that there should be 'some insulation from government or political patronage' in the appointment of board members.<sup>22</sup>

2.39 Mr Easterbrook considered that the Future Fund provides a major opportunity to be a market leader in terms of best practice, and identified two particular areas for consideration, specifically voting policy and engagement with companies in which a shareholding is held. In relation to voting policies, and specifically, voting mechanisms, Mr Easterbrook said:

I think it is now accepted that best practice is that funds should vote their shares in all cases and should make sure that their voting is well considered. To that end, I would hope that the fund would be transparent....It should have a policy to vote, where it can, on all the shares it holds....In addition,

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20 *Proof Committee Hansard*, 9 February 2006, p. 1.

21 IFSA, *Submission 1*.

22 *Proof Committee Hansard*, 7 February 2006, p. 16.



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it should report that it has voted on all, how it has voted on each and why it has voted on each.<sup>23</sup>

2.40 In relation to major shareholders engaging with companies on governance issues, Mr Easterbrook said that this was important for maintaining long-term value:

The other main area in governance is how you address important governance issues in companies, which have a major impact on long-term value. We only have to look at what has happened in AWB to see how bad governance can lead to significant loss for shareholders. That area is called 'engagement with companies on important long-term governance issues', which covers board structure, strategy and other issues of that nature.<sup>24</sup>

2.41 The same point is made in the IFSA *Blue Book*, where Guideline 1 for fund managers emphasises that fund managers should establish direct contact with companies including constructive communication with both senior management and board members about performance, corporate governance and other matters affecting shareholders' interests.<sup>25</sup>

2.42 Mr Easterbrook also raised the issue of how the Chair of the board is appointed. He maintained that while the initial Chair might be appointed by the Government, the board itself should play a role in the appointment of subsequent chairs:

...in any well-run best-practice organisation, the chair should emerge out of the nomination process within the board itself. The board, as part of its nomination process in making recommendations on choosing board members, should have the same [role] in terms of the chairman and successive chairmen—again with a view to getting the best person in that role and avoiding political patronage.<sup>26</sup>

2.43 The Committee questioned Treasury and Department of Finance representatives about Mr Easterbrook's advice. Treasury officers provided the following responses:

With respect to your second point about compulsory voting, there is a section in the bill, section 24, that deals with that. It is in a sense broadly covered under the first clause concerning a matter relating to international best practice for institutional investment. The board itself will need to develop policies with respect to voting and how it exercises those voting rights.

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23 *Proof Committee Hansard*, 7 February 2006, p. 17.

24 *Proof Committee Hansard*, 7 February 2006, p. 17.

25 IFSA, *Blue Book – Corporate Governance, a guide for fund managers and corporations*, October 2004, p. 11.

26 *Proof Committee Hansard*, 7 February 2006, pp 17–18.

In the explanatory memorandum it indicates: The Board is required to publish and comply with a number of policies on its investment activities. In particular it lists a number of those including—and this is on page 18: This may include matters such as how the Board will exercise any voting rights ...<sup>27</sup>

2.44 The Committee agrees that the governance principles put in place for the Future Fund are sound, but draws the attention of the responsible Ministers to Mr Easterbrook's comments for further consideration. It may be appropriate to include principles in the directions to be given to the Board provided for under the investment mandate provisions of the Bill.

### **Structure of the Board of Guardians**

2.45 The Board of Guardians will be a body corporate with perpetual succession that is a separate legal identity to the Commonwealth. The Board will have the power to do all things necessary or convenient to ensure that it can perform its functions. However, it cannot hold money or real or personal property in its own right. All money and real or personal property is held for and on behalf of the Commonwealth.

2.46 The Committee was interested in the unusual structure of the Board.<sup>28</sup> Officers from the Departments of Finance and Administration and the Treasury explained that while the structure chosen may be considered to be a hybrid model, it has been used elsewhere within the Commonwealth, for example by regulatory bodies such as the Australian Competition and Consumer Commission (ACCC):<sup>29</sup>

This model is probably most commonly used for regulatory bodies, the ACCC being the most common example, where a collective group of people, whether you call them a board or commissioners, is given the decision making power for the main policy purpose. In the case of a regulator it is for those regulatory decisions; in our case it is for the investment decisions. You retain in the agency itself [a Financial Management and Accountability] Act model where you have a single person, a chief executive, who is responsible for the financial management of the entity.<sup>30</sup>

2.47 According to Treasury representatives, the Government wished to strike a balance between achieving independent decision making about the investment management of the Fund while at the same time retaining the beneficial ownership of the Fund with the Commonwealth:

While it could be described as a unique governance arrangement, it is one that suits the overall policy framework. It draws in the collective decision making that one would normally find under, for instance, the

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27 *Proof Committee Hansard*, 9 February 2006, pp 6 and 7.

28 *Proof Committee Hansard*, 7 February 2006, p. 5.

29 *Proof Committee Hansard*, 9 February 2006, p. 2. [Flavel and Doran]

30 *Proof Committee Hansard*, 9 February 2006, p. 2. [Doran]

Commonwealth Authorities and Companies Act, where you have a board, but at the same time is covered by the provisions of the Financial Management and Accountability Act with respect to the handling of public money.<sup>31</sup>

### **Investment mandate – the power to direct**

2.48 Clause 18 of the Bill contains the provisions that require the responsible Ministers to give the Board of Guardians of the Future Fund written directions. Ministers are required to give the Board at least one direction, and may give more than one. Subclause 18(2) provides that Ministers must have regard to:

- maximising the return earned on the Fund over the long term, consistent with international best practice for institutional investment, and
- such other matters as the responsible Ministers consider relevant.

2.49 Under subclause 18(3), the directions given by Ministers are to be known collectively as the 'investment mandate'.

2.50 According to the Bills Digest, concerns are held in some quarters that a government may give directions to the Board to invest in a particular manner that may owe more to political than investment considerations.<sup>32</sup> The ACCI for example expressed concern that these provisions could allow a government to invest in 'nation building' investments:

...my understanding is that the bill does give quite a bit of leeway to the government to direct the Future Fund to do things or to not do things. Our first concern is that, without changing the legislation, the government of the day could change that mandate in a way that would not be maximising the returns to the Future Fund. For example, they could direct the fund to invest in 'roads to nowhere' or in various other things. Taking into account the fact that they cannot invest in assets directly, they might still be able to invest in 'roads to nowhere' indirectly through setting up a company to do the investment in 'roads to nowhere'.<sup>33</sup>

2.51 Mr Easterbrook of Corporate Governance International was of the view that Ministers' powers to issue directions and interfere with the operation of the Fund are considerable and should be limited. He emphasised the importance of transparency in decision making, concluding that 'transparency is probably quite good but could be beefed up'.<sup>34</sup>

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31 *Proof Committee Hansard*, 9 February 2006, p. 2. [Flavel]

32 *Bills Digest*, p. 19.

33 *Proof Committee Hansard*, 9 February 2006, p. 18.

34 *Proof Committee Hansard*, 7 February 2006, p. 17.

2.52 Treasury representatives discounted the possibility that the investment mandate provisions could be used to direct the board to invest in a way that was not in accordance with maximizing the Fund's long-term returns:

With respect to the power of direction...there is only one main ministerial power of direction, which is clause 18 of the bill, which is essentially the investment mandate. That is quite important, because it provides a mechanism for the government of the day to articulate to the board its expectations about the performance of the fund, expected rates of return, tolerance for risk et cetera. ...Any directions provided by ministers cannot be inconsistent with other provisions in the bill. That is spelt out in clause 7 of proposed section 18, which includes the object clause of the bill. Ministers must have regard to maximising the long-term returns on the fund. And the board itself has a statutory obligation, outlined in the bill itself, in clause 10 of proposed section 18, to seek to maximise long-term returns.<sup>35</sup>

2.53 Treasury officers also advised the Committee of the other safeguards built into the Bill, which include the tabling of directions in Parliament; a requirement that the Board has the opportunity to comment on directions; and such comments to be tabled in Parliament as well. Treasury concluded that these provisions establish 'quite a transparent process'.<sup>36</sup> The Committee agrees.

### **Restrictions on investment**

2.54 As previously mentioned, the Future Fund will be a financial asset fund consisting of cash and investments of the Fund. Income derived from investments, a return of capital or any other financial distributions are to be reinvested in the Fund. In the performance of its investment functions, the Board of Guardians must seek to maximise the return earned on the Fund over the long term, consistent with international best practice for institutional investment. However, the Board must take all reasonable steps to comply with the investment mandate.

2.55 The restriction on direct investment, such as in property, infrastructure or other projects provoked some discussion at the Committee's hearings. Mr Easterbrook was concerned that in order to gain exposure to the above asset classes the Fund would only be able to invest in pooled funds. He told the Committee that there are serious governance deficiencies in the listed trust sector and his preference from a corporate governance point of view would be for direct investment in property assets.<sup>37</sup>

2.56 Mr Martine, General Manager, Budget Policy Division, Department of the Treasury, told the Committee that the rationale for restricting the Fund's investments

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35 *Proof Committee Hansard*, 9 February 2006, pp 1–2.

36 *Proof Committee Hansard*, 9 February 2006, p. 2.

37 *Proof Committee Hansard*, 7 February 2006, pp 16–17.

to financial assets only was so that the Board would be able to make decisions that are independent from the Government.<sup>38</sup> If it was allowed to invest in non-financial assets the budget bottom line would be affected by its investments. This would then link its actions to the Government's fiscal management and it would not be possible for the Government and the Board to act independently of each other:

But with an independent board the government of the day would have no control when it was formulating its budget, setting its fiscal strategy and trying to target a surplus, a balanced budget, a deficit or whatever. That would be the case if you had an independent board making decisions at any time on buying and selling non-financial assets. Given that the intention of this is long-term investment—and we think we will achieve that objective—it can invest through investment vehicles to get exposure to asset classes of infrastructure or property et cetera.<sup>39</sup>

## **Telstra issues**

2.57 The status of the Board as a separate legal identity to the Commonwealth is especially significant as regards Telstra Corporation Limited because of the consequences that flow if the Government transfers some of its equity in Telstra to the Future Fund. Telstra raised three issues with the Committee relating to changes in ownership of its shares. These are:

- notification of when the Government intends to transfer Telstra shares to the Future Fund;
- notification of any Ministerial direction to the Fund when that direction applies to Telstra's shares held by the Board of Guardians; and
- the implications of the transfer of shares to the Fund for Telstra's tax position. The Committee considers these issues below.

### ***Notification before Telstra shares are transferred to the Future Fund***

2.58 Part 3 of Schedule 1 of the Bill deals with transfers of financial assets to the Future Fund. Subclause 6(5) specifies that a transfer of Telstra shares to the Fund is not a Telstra sale scheme for the purposes of the *Telstra Corporation Act 1991*. However, under various provisions of the Telstra Corporation Act, if a share in Telstra is an investment of the Future Fund then that share is taken to be held by a person other than the Commonwealth. Transferring shares in this way will move the legal ownership from the Commonwealth to the Future Fund Board of Guardians but the beneficial ownership will remain with the Commonwealth.

2.59 The shift in ownership of the shares has implications for the management of Telstra. The proportion of equity in Telstra owned by the Government determines whether or not various pieces of Commonwealth legislation apply to the company. For

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38 *Proof Committee Hansard*, 9 February 2006, pp 11–12.

39 *Proof Committee Hansard*, 9 February 2006, p. 12.

example, whilst the Government owns 51 per cent or more equity, provisions in Commonwealth Acts dictate Telstra's policies on such matters as maternity leave, long service leave, employee superannuation payments and other human resource management issues. They also impose freedom of information obligations on the company. Further, the Commonwealth Auditor-General is also Telstra's auditor.

2.60 Another threshold that has implications for Telstra is when the Commonwealth's holding falls below 15 per cent.<sup>40</sup> When that occurs for example, Telstra will no longer be required to provide a corporate plan to the Commonwealth, nor will the Communications Minister have a power to direct Telstra.

2.61 Telstra is concerned that because there is no explicit requirement in the Bill, it may receive insufficient notice to enable it to alter its operations, policies and practices, and also to appoint an auditor once the Commonwealth Acts no longer apply.<sup>41</sup> Telstra submitted that it requires at least sixty days' notice before the transfer of any Telstra shares either into or out of the Future Fund so that it can implement the necessary changes to its systems and appoint an auditor.<sup>42</sup>

2.62 The Committee considers that it is reasonable that Telstra be given some notice before the Government transfers its shares. However, the Committee considers that sixty days' notice is an unreasonably long period. Mr Gration, Company Secretary, Telstra conceded that sixty days would be very ambitious.<sup>43</sup> While the Committee does not anticipate that the Minister would transfer Telstra shares to the Fund and simply inform the company after the event, it notes the point made by Mr Gration that there needs to be a framework in the Act that ensures notification is appropriate and takes place,<sup>44</sup> and draws this view to the Government's attention.

### ***Notification before any ministerial direction is given to the Board***

2.63 Under Schedule 1, clause 8, the nominated Minister may give the Board of Guardians written directions about financial assets transferred to the Fund. This would encompass Telstra shares transferred to the Fund. Such directions may:

- (a) require the Board not to realise the financial assets before the end of a specified period; or
- (b) relate to the exercise by the Board of specified:
  - (i) rights (including voting rights); or
  - (ii) powers;

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40 *Proof Committee Hansard*, 7 February 2006, p. 2. [Gration]

41 Telstra Corporation Limited, *Submission 2*; and *Proof Committee Hansard*, 7 February 2006, p 6. [Gration]

42 Telstra Corporation Limited, *Submission 2*.

43 *Proof Committee Hansard*, 7 February 2006, p. 7.

44 *Proof Committee Hansard*, 7 February 2006, p. 3.

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conferred on the Board in its capacity as the holder of the financial assets.

2.64 Subclause 8(10) requires the Chair of the Board of Guardians to cause a copy of the ministerial direction to be published on the Internet as soon as practicable after the direction is given. Telstra would like to be given notice of the direction prior to the Minister giving it to the Chair of the Board so that Telstra is kept informed of directions relating to its shares.<sup>45</sup> Telstra also recommends that a time limit of no more than two business days is placed on the publication of ministerial directions on the Internet to ensure timely disclosure to the market of all information as it relates to Telstra shares:

...from a governance perspective, we do not think it is sufficient simply that that is posted in some corner of the internet. We think that it would be of great interest to the market, that it ought to be told to the company and that the company would then make a disclosure to the ASX to say, 'You, the market, ought to be aware that, while you thought it was David Murray voting five per cent of the shares, he has in fact been given a direction as to how to exercise that power to vote.' That is something that the minister is already required by the bill to put on the internet. I think all we are asking for there primarily is that we be given notice that that has occurred as well as the posting on the internet so that we can inform the market that that has occurred.<sup>46</sup>

2.65 The Committee draws these views to the Government's attention for consideration.

### ***Taxation implications***

2.66 The effect on Telstra of various provisions of the taxation legislation depends on the ownership of shares in the company. For example, loss recoupment rules allow companies to carry forward incurred losses to future income years and claim a tax deduction in relation to those losses if they are able to satisfy the Continuity of Ownership Test (COT) in the *Income Tax Assessment Act 1997*. Telstra is concerned that its tax position should not be prejudiced by the transfer of its shares to the Future Fund by the Commonwealth and thus a potential change in ownership.<sup>47</sup>

### ***Response of the Department of Finance and Administration***

2.67 The Department of Finance and Administration advised the Committee that it did not necessarily agree that the transfer of shares to the Future Fund will affect the determination of ownership of Telstra.<sup>48</sup> It considers that if there are any issues, they

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45 Telstra Corporation Limited, *Submission 2*.

46 *Proof Committee Hansard*, 7 February 2006, p. 7. [Gration]

47 Telstra Corporation Limited, *Submission 2*.

48 Department of Finance and Administration, *Additional Information*.

are capable of being resolved administratively and it is not convinced of the need for any change to either the Bill or the Telstra Act as suggested by Telstra.

**Recommendation**

**2.68 The Committee recommends that the Senate pass the Future Fund Bill 2005.**

Senator George Brandis  
**Chair**



# **LABOR SENATORS' ADDITIONAL COMMENTS**

Labor Senators are of the view that the governance arrangements for the Future Fund do not meet the Government's 2005 Budget commitment that the Fund will be managed by an independent statutory board and that the Board will be free to set the investment strategy and the strategic asset allocation of the Fund.

The Board of Guardians do not have the same legal protections afforded to Commonwealth superannuation Boards. In addition, the power to direct the Board is general and goes beyond maximising long-term returns and extends to 'such other matters as the responsible Ministers consider relevant (Subclause 18(2)'. This exposes the Fund to a higher level of Ministerial interference than would be the case if the Board's functions were limited to maximising the return on the Fund across a balanced investment portfolio.

The legislation empowers the Ministers to dismiss Board members for 'inadequate performance'. This extremely broad and ill-defined power adds to the risk of undue political interference in investment decisions of the Fund.

Senator Ursula Stephens  
**Deputy Chair**

Senator Ruth Webber



# **SUPPLEMENTARY REMARKS**

## **SENATOR ANDREW MURRAY**

At 2.7 the Main Report says:

...the chapter focuses on four specific areas in the Bill that were brought to the Committee's attention. These include the structure chosen for the Board of Guardians; the power of Ministers to direct the Board in its endeavours; the restriction preventing the Fund from direct investment; and issues raised by Telstra concerning the transfer of the Government's equity in Telstra to the Fund.

For the purpose of these Supplementary Remarks I will raise just two issues: appointments on merit and institutional voting.

### **The Appointments on Merit**

Wherever appointments are made to institutions set up by legislation, independent statutory authorities or quasi-government agencies, the processes by which these appointments are made should be transparent, accountable, open and honest.

It is still the case that appointments to statutory authorities are left largely to the discretion of ministers with the relevant portfolio responsibility.

There is no umbrella legislation that sets out a standard procedure regulating the procedures for the making of appointments. Perhaps most importantly there is no external scrutiny by an independent body of the procedure and merits of appointments.

An independent body should be given the responsibility of scrutinising government appointments against a set of established criteria.

This system works well in the United Kingdom after the 1995 Nolan Commission. Lord Nolan managed to persuade the UK government to accept that appointments should be based on merit. Lord Nolan set out key principles to guide and inform the making of such appointments:

- a minister should not be involved in an appointment where he or she has a financial or personal interest;
- ministers must act within the law, including the safeguards against discrimination on grounds of gender or race;

- all public appointments should be governed by the overriding principle of appointment on merit, except in limited circumstances;
- political affiliation should not be a criterion for appointment;
- selections on merit should take account of the need to appoint boards that include a balance of skills and backgrounds;
- the basis on which members are appointed and how they are expected to fulfil their roles should be explicit; and the range of skills and backgrounds that are sought should be clearly specified.

In response to the Nolan Committee's recommendations, the United Kingdom government subsequently created the office of Commissioner for Public Appointments, which has a similar level of independence from the government as the Australian Auditor-General, to provide an effective avenue of external scrutiny.

The Democrats have used the Nolan Committee's recommendations in our persistent campaign for appointments on merit amendments in various items of legislation because they are tried and tested.

Meritorious appointments are the essence of accountability. We will move appointment on merit amendments to this Bill.

### **Institutional voting**

In the OECD Principles of Corporate Governance it says the following concerning disclosure of voting:

The exercise of ownership rights by all shareholders, including institutional investors should be facilitated.

Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights. The voting record of such investors should also be disclosed to the market on an annual basis.<sup>1</sup>

The Democrats believe that the trustees and managers of superannuation funds and managed investment schemes have a fiduciary duty to act in the best interests of their members and beneficiaries. We believe that a trustee can only satisfy their fiduciary obligations by taking an active interest in material corporate governance activities of their equity investments.

Material corporate governance activities would include voting on constitutional issues and decisions on the election and remuneration of directors.

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1 OECD Principles of Corporate Governance Draft Revised Text, January 2004, p. 7.

We note that Mr Easterbrook of Corporate Governance International goes further, but we believe that at least voting on these three matters should be mandatory.

We will amend the legislation to extend the requirement to vote on material corporate governance resolutions to the Future Fund managers.

There is also the question of proxy voting, which we will seek to address.

Senator Andrew Murray



# **Appendix 1**

## **Submissions Received**

| <b>Submission<br/>Number</b> | <b>Submitter</b>                                       |
|------------------------------|--|
| 1                            | Investment & Financial Services Association Ltd (IFSA) |
| 2                            | Telstra Corporation Ltd                                |
| 3                            | Mr Maurice Kennedy                                     |
| 4                            | Australian Chamber of Commerce and Industry (ACCI)     |





## **Appendix 2**

### **Public hearings and witnesses**

#### **Tuesday, 7 February 2006 - Canberra**

CANNON, Mr Saul Richard, General Counsel  
Telstra

EASTERBROOK, Mr Alexander Arthur Douglas, Principal/Director  
Corporate Governance International

GRATION, Mr Douglas Carlyle, Company Secretary  
Telstra

KENNEDY, Mr Maurice John  
Private capacity

#### **Thursday, 9 February 2006 - Canberra**

CAMPBELL, Ms Kathryn, General Manager, Financial Management Group  
Department of Finance and Administration

DORAN, Mrs Karen Elizabeth, Division Manager, Superannuation and Governance  
Division, Department of Finance and Administration

FLAVEL, Mr Matthew James, Manager  
Financial Frameworks and Management Unit, Budget Policy Division  
Department of the Treasury

HEAZLETT, Mr Mark Henry, Branch Manager, Telstra 3 Sales Task Force  
Department of Finance and Administration

MARTINE, Mr David John, General Manager, Budget Policy Division  
Department of the Treasury

POTTER, Mr Michael James, Director, Economics and Taxation  
Australian Chamber of Commerce and Industry



## Appendix 3

### State and Territory Superannuation Funding Arrangements

| State/Territory              | Name of super fund manager                      | Date for full funding | How does the government make contributions to the fund?  |
|------------------------------|---|-----------------------|--|
| New South Wales              | Liability Management Fund (LMF)                 | 2030                  | Government makes monthly contribution to the LMF. Contribution based on tri-annual actuarial assessment aimed at offsetting unfunded component of liability.                                   |
| Queensland                   | QIC   | Fully funded          | Superannuation liability fully funded by government through employer contributions.  |
| Victoria                     | Government Superannuation Office (GSO)          | 2035                  | Annual appropriation based on actuarial advice that is consistent with the aim of 100 per cent funding of the unfunded superannuation liabilities by 2035.                                     |
| Western Australia            | Government Employee Superannuation Board (GESB) | 2025 (approx)         | Standard appropriation each year to the GESB reflecting employer contributions and to meet unfunded component of two closed WA schemes. West State Super only open scheme but is fully funded. |
| South Australia              | Funds S.A.                                      | 2034                  | Annual appropriation to Funds S.A. each year representing funding for unfunded component and employee contributions.   |
| Northern Territory           | Commissioner of Superannuation                  | 2060                  | All schemes unfunded, except for Parliamentary scheme. Liabilities for all unfunded schemes met with re-current revenue directly from the budget each year.                                    |
| Tasmania                     | Retirement Benefits Fund                        | 2018                  | Government makes employer contributions to the Fund. Additional contributions also made to offset unfunded component of liability.   |
| Australian Capital Territory | Superannuation Provision Account (SPA)/Comsuper | 90% funded by 2040    | Standard appropriation from SPA each year in line with actuarial assessment of unfunded liability.   |