Credit Opinion: Victoria (State of) Australia

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Australia

Ratings

Category	Moody's Rating
Treasury Corporation of Victoria	
Outlook	Stable
Bkd Issuer Rating	Aaa
Bkd Senior Secured -Dom Curr	Aaa
Bkd Bonds -Dom Curr	Aaa
Commercial Paper	P-1

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Key Indicators

Victoria (State of) Australia

(As at June 30)	2004	2005	2006	2007	2008B	2008E
Net Direct and Guaranteed Debt/Total Revenue (%)	39.5	42.4	41.6	36.4	33.8	41.4
Net Direct and Guaranteed Debt/Gross State Product (%)	5.2	5.6	5.6	5.1	4.5	5.8
Cash Financing Surplus (Requirement)/Total Revenue (%)	0.8	1.9	0.3	-0.3	-1.9	1.5
Gross Operating Balance/Total Revenue (%)	7.2	6.5	6.6	7.7	5.2	6.4
Interest Payments/Total Revenue (%)	1.9	1.4	1.4	1.3	1.4	1.4
Intergovernmental Transfers/Total Revenue (%)	44.3	45.1	45.7	44.7	47.2	46.2
Real Gross State Product growth (% change)	4.4	2.4	2.5	2.7	3.3	3.8

Opinion

SUMMARY RATING RATIONALE

Moody's assigns long-term debt and issuer ratings of Aaa to the Treasury Corporation of Victoria (TCV), the entity which issues debt on behalf of the State of Victoria and its government owned corporations. Moody's also assigns a short term rating of Prime-1 to TCV's commercial paper program. TCV's debt is guaranteed by the State of Victoria and the rating reflects the state's credit quality.

Victoria's credit quality reflects a sound record of financial performance underpinned by the state's prudent fiscal practices along with strength in tax revenues and commonwealth grants, a modest debt burden stemming from positive cash operations over many years, and a sizable and diversified economic base which amply supports the state's financial obligations. A rise in capital spending recently has resulted in moderate deficits in the general government sector and a somewhat larger deficit in the state's consolidated operations. The state is projected to remain in a deficit over the medium term as the government and its corporations upgrade infrastructure in an environment of slower revenue growth; however, Victoria is well placed to absorb these deficits given its low debt burden.

Credit Strengths

Victoria's credit strengths include:

--Low debt burden

--Strong financial performance supported by prudent fiscal management and revenue growth

--Diverse economic base

--Well-established institutional framework, providing fiscal flexibility

Credit Challenges

Victoria's credit challenges include:

--Potential for slower revenue growth

--Higher capital spending levels to lead to increased borrowing

Rating Outlook

The outlook is stable, based on Moody's assessment that the state's strong financial profile and low debt burden position it well to absorb financing deficits (net borrowing result) and an associated increase in debt burden anticipated over the medium term.

What Could Change the Rating - Down

An unlikely scenario combining a severe decline in the housing market and economic recession along with a significant change in the government's prudent fiscal polices that would lead to a rapid accumulation of debt, could have an adverse impact on the rating.

DETAILED RATING CONSIDERATIONS

The application of Moody's Joint-Default Analysis methodology to regional and local governments (RLGs) requires two key inputs: a baseline credit assessment (BCA) on a scale of 1-21, in which 1 represents the lowest credit risk (equivalent to Aaa), which is a measure of the RLG's stand-alone credit strength, and an assessment of the likelihood that the higher-tier government would act to prevent a default by the RLG. In the case of Victoria, Moody's assigns a BCA of 1, which places the state in the Aaa rating bracket before any consideration of the likelihood that the Commonwealth of Australia (Aaa, stable) would act to prevent a default by the state. To complete the analysis, Moody's assigns a very high likelihood of extraordinary support from the commonwealth government, reflecting Moody's assessment of the risk to Australia's reputation if Victoria, or any state or territory were to default.

Baseline Credit Assessment

Victoria's BCA of 1 reflects the following factors:

Financial Performance and Position - Following many years of robust financial performance, characterized by surplus operations, the state's general government sector moved into a minor deficit position in 2005/06 equivalent to -1.4% of revenues, which narrowed to -0.7% of revenues in 2006/07. These trends reflect a rise in capital investments as the state upgrades schools, roads, hospitals and public housing, as well as growth in current expenditures as Victoria seeks to enhance education, police and healthcare services. At the same time revenue growth is slowing as a result of land tax relief measures and a stabilization of property transfer taxes. In 2007/08 the state budgeted for a deficit of -2.7%, however estimates indicate that stronger growth in tax revenues and increased commonwealth grants should contribute towards an improved result.

The state's consolidated operations (non-financial public sector) are also in a deficit position because of pressures facing a number of the state's corporations. The operations of government-owned water corporations have weakened due to sluggish revenues associated with a severe drought and the need to make considerable investments in infrastructure. Urban rail corporations are also planning significant investments in new rail cars. As such, the non-financial public sector recorded a deficit equivalent to -2.8% of revenues in 2006/07, which is projected to widen to -7.4% in 2007/08. Over the medium term, deficits of the consolidated sector are projected to widen further to an average -9% of revenues as the state implements significant investments in a water desalination plant and pipelines to combat water shortages related to drought and a comprehensive plan to improve and expand transit services.

Debt Profile- The state's modest debt burden reflects many consecutive years of positive cash operations and the application to debt reduction of proceeds from a vast privatization of state electricity corporations in the 1990s.

Net direct and guaranteed debt was a moderate 36.4% of revenues (5.1% of GSP) in 2007 compared to 45%

(6.2% of GSP) in 2001. In line with Moody's internationally comparable debt ratios, "net debt" subtracts the debt of self-supporting public corporations. The positive performance of the state's water corporations eases the state's debt burden as these companies' debt is self-supported through tariffs. Substantial financial assets held in liquid investments provide an ample cushion for debt obligations (these amounts are not netted off of Moody's debt ratios).

Over the medium term the debt burden is projected to rise as the state nearly doubles the size of its stock of debt to fund its A$30 billion four-year capital program, however, given that a significant portion of the debt will be directed towards self-supporting state corporations, the state's net and guaranteed debt should remain manageable.

Governance and Management Factors - Strong governance and management factors include multi-year budget projections, prudent forecasts and contingency provisions which have contributed to a strong record of meeting or exceeding targets over many consecutive years. Substantial financial assets held by the Treasury Corporation of Victoria are conservatively invested in strongly rated, liquid securities. Highly informative and comprehensive annual financial statements as well as periodic interim statements offer a significant degree of transparency.

Economic Fundamentals- Victoria's sizable and diversified economic base amply supports its financial obligations. The state which represents nearly 25% of Australia's output has grown at a pace similar to the nation over the past decade. Population gains spurred by international migration contribute to growth.

In 2006/07 Victoria's economy expanded by 2.7% below the national rate of 3.2%. A serious drought detracted from economic expansion (the state estimated that it detracted 0.5% percentage points from growth) offset by strength in consumption and business investment. In 2007/08, a recovery in housing investment and agricultural sectors along with consumption and still high levels of business investment--offset only partially by weak exports--was initially forecast to boost growth by 3.25%. Recent estimates indicate that growth could exceed the forecast as business investment and household consumption are growing faster than anticipated and will likely offset weaker trends in housing and exports.

Robust growth in jobs has led to low unemployment rates--estimated to be 5% in 2007 while participation rates have risen. Victoria's relatively large manufacturing sector continues to be challenged by the appreciation of the Australian dollar and restructuring among older industrial sectors.

Operating Environment - The national operating environment in which Victoria operates is typical of advanced industrial economies -- characterized by high GDP per capita, low GDP volatility and a high ranking on the World Bank's Government Effectiveness Index - suggesting a minimal level of systemic risk. As such, conditions that historically precede national crises that are associated with RLG defaults are not present in Australia.

Institutional Framework - The institutional framework which encompasses the arrangements determining intergovernmental relations and jurisdictional powers and responsibilities, is well-established and stable. Australian states and territories retain policy flexibility over own source revenues and discretion over expenditure decisions which provides them the tools to respond to adverse budgetary developments.

The strong financial support provided by the Commonwealth government through fiscal transfers to all states is also a key factor in Victory's ratings. Grants amount to 45% of the state's general government operations. A significant portion of grants are distributed according to a formula that seeks to reduce revenue raising and cost disparities between jurisdictions.

Extraordinary Support Considerations

Victoria's rating of Aaa reflects the BCA of 1 and a very high likelihood that the commonwealth government would act to prevent a default by Victoria. This conclusion reflects Moody's assessment of the incentive provided by the risk to the commonwealth government's reputation if Victoria were to default, as well as indications of support stemming from the strong system of commonwealth-state transfers.

Moody's assigns a high default dependence level reflecting the joint exposure of the economies of the state and commonwealth governments to national economic trends, as well as a medium level of fiscal transfers from the commonwealth government.

Output of the Baseline Credit Assessment Scorecard

The BCA scorecard (presented below) generates an estimated BCA of 2 for Victoria, close to the rating committee's assigned BCA of 1.

The BCA scorecard, which generates estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, is a tool used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by the scorecard provide a good statistical gauge of stand-alone credit strength; however, the estimated BCAs generated by the scorecard do not substitute for rating committee judgments regarding individual baseline credit assessments, nor is the scorecard a matrix for automatically assigning or changing these assessments. Concomitantly, scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Moreover, the limited number of variables included in the scorecard cannot fully capture the breadth and depth of our analysis. Nevertheless, the performance statistics captured in the scorecard are important and, in general, higher ratings can be expected among issuers with the highest rankings from the scorecard.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's assigns national scale ratings in certain local capital markets in which investors have found the global rating scale provides inadequate differentiation among credits or is inconsistent with a rating scale already in common use in the country. Moody's National Scale Ratings are opinions of the relative creditworthiness of issuers and issues within a particular country. While loss expectation will be an important differentiating factor in the ultimate rating assignment, it should be noted that loss expectation associated with National Scale Ratings can be expected to be significantly higher than apparently similar rating levels on Moody's global scale. Moody's National Scale Ratings rank issuers and issues in order of relative creditworthiness: higher ratings are associated with lower expected credit loss.

National Scale Ratings can be understood as a relative ranking of creditworthiness (including relevant external support) within a particular country. National Scale Ratings are not designed to be compared among countries; rather, they address relative credit risk within a given country. Use of National Scale Ratings by investors is only appropriate within that portion of a portfolio that is exposed to a given country's local market, taking into consideration the various risks implied by that country's foreign and local currency ratings.

The Moody's Global Scale rating for issuers and issues in local currency allows investors to compare the issuer's/issue's creditworthiness to all others in the world, rather than merely in one country. It incorporates all risks relating to that country, including the potential volatility of the national economy.

Country Ceilings for Foreign Currency Obligations

Moody's assigns a ceiling for foreign-currency bonds and notes to every country (or separate monetary area) in which there are rated obligors. The ceiling generally indicates the highest rating that can be assigned to a foreign-currency denominated security issued by an entity subject to the monetary sovereignty of that country or area. In most cases, the ceiling will be equivalent to the rating that is (or would be) assigned to foreign-currency denominated bonds of the government. Ratings that pierce the country ceiling may be permitted, however, for foreign-currency denominated securities benefiting from special characteristics that are judged to give them a lower risk of default than is indicated by the ceiling. Such characteristics may be intrinsic to the issuer and/or related to Moody's view regarding the government's likely policy actions during a foreign currency crisis.

Baseline Credit Assessment

Moody's baseline credit assessment incorporates the government's intrinsic credit strength and accounts for ongoing operating subsidies and transfers from the supporting government. In effect, the baseline credit assessment reflects the likelihood that a local government would require extraordinary support.

Extraordinary Support Considerations

Extraordinary support is defined as action taken by a supporting government to prevent a default by a regional or local government (RLG) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as either low (0% - 30%), moderate (31% - 50%), high (51% - 70%), very high (71% - 95%) or fully supported (96% - 100%).

Default Dependence

Default dependence reflects the likelihood that the credit profiles of two obligors may be imperfectly correlated. Such imperfect correlation, if present, has important diversifying effects which can change the joint-default outcome. Intuitively, if two obligors' default risks are imperfectly correlated, the risk that they would simultaneously default is smaller than the risk of either defaulting on its own.

In the application of joint-default analysis to RLGs, default dependence reflects the tendency of the RLG and the supporting government to be jointly susceptible to adverse circumstances leading to defaults. Since the capacity of the higher-tier government to provide extraordinary support and prevent a default by an RLG is conditional on the solvency of both entities, the more highly dependent -- or correlated -- the two obligors' baseline default risks, the lower the benefits achieved from joint support. In most cases, the close economic links and/or overlapping tax bases and/or close intergovernmental fiscal arrangements between different levels of government result in a moderate to very high degree of default dependence.

Default dependence is described as either low (0% - 30%), moderate (31% - 50%), high (51% - 70%) or very high (71% - 100%).

Rating Factors

Victoria (State of) Australia

Baseline Credit Assessment Scorecard - 2005	Value	Score	Sub-Factor Weighting	Sub-Factor Total	Factor Weighting	Total
Factor 1: Operating Environment						
National GDP pc PPP ($US)	30,880	1	50.0%	1.50	50.0%	0.75
National GDP Volatility (%)	3.1	3	25.0%			
National Gov't Effectiveness (World Bank Index)	1.95	1	25.0%			
Factor 2: Institutional Framework						
Predictability, Stability, Responsiveness	1	1	50.0%	1.00	10.0%	0.10
Fiscal Adequacy - Own-source revenues	1	1	16.7%			
Fiscal Adequacy - Spending	1	1	16.7%			
Fiscal Adequacy - Extent of borrowing	1	1	16.6%			
Factor 3: Financial Position & Performance						
Interest Payments/Operating Revenue (%)	1.6	1	25.0%	4.75	10.0%	0.48
Cash Financing Surplus(Req)/Total Revenue (%)	1.3	6	25.0%			
Gross Operating Balance/Operating Revenue (%)	7.2	9	25.0%			
Net Working Capital/Total Expenditures (%)	11.9	3	25.0%			
Factor 4: Debt Profile						
Net Direct and Guaranteed/Operating Revenue (%)	42.4	3	33.4%	8.00	10.0%	0.80
Short-term Gross Direct Debt/Gross Direct Debt (%)	20.8	6	33.3%			
3 Yr Chg in Net Direct & Guar Debt/Op Rev (%)	15.2	15	33.3%			
Factor 5: Governance & Management						
Fiscal Management	1	1	40.0%	1.00	10.0%	0.10
Investment & Debt Management Approach	1	1	20.0%			
Transparency & Disclosure (A)	1	1	15.0%			
Transparency & Disclosure (B)	1	1	15.0%			
Institutional Capacity	1	1	10.0%			
Factor 6: Economic Fundamentals						
Regional or Local GDP pc PPP - Estimated ($US)	31,300	1	100.0%	1.00	10.0%	0.10
Total Score [1]						**2.32**

[1] Scores less than, or equal to, 1.49 map to a BCA of 1; scores greater than 1.49, but equal to or less than 2.49, map to a BCA of 2; scores greater than 2.49, but equal to or less than 3.49, map to a BCA of 3; etc.