MOODY'S
INVESTORS SERVICE

Credit Opinion: Victoria (State of) Australia

Global Credit Research - 25 Feb 2015

Australia

Ratings

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

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Key Indicators

Victoria (State of) Australia (As at June 30)	2009	2010	2011	2012	2013	2014	2015B	2015MYR
Net Direct and Indirect Debt/Revenues (%)	46.0	45.5	50.5	57.9	61.8	63.9	n/a	n/a
Net Direct and Indirect Debt/Gross State Product (%)	6.4	6.9	7.5	8.4	8.9	9.6	n/a	n/a
Cash Financing Surplus (Requirement)/Revenues (%)	-3.4	-3.0	-4.3	-3.3	-6.7	0.2	-2.1	-0.7
Gross Operating Balance/Revenues (%)	4.5	5.6	5.5	5.6	4.0	8.3	7.2	6.8
Interest Payments/Revenues (%)	1.6	1.9	2.1	2.6	3.7	4.1	4.2	4.0
Intergovernmental Transfers/Revenues (%)	48.3	51.0	48.7	47.2	45.1	48.0	47.0	46.4
Real Gross State Product growth (% change)	1.3	1.7	1.8	2.7	2.1	1.7	2.5	2.3

Opinion

SUMMARY RATING RATIONALE

Moody's assigns long-term debt and issuer ratings of Aaa to the Treasury Corporation of Victoria (TCV), the entity that issues debt on behalf of the State of Victoria and its government-owned corporations. 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 long-term historical record of sound financial performance, ample financial flexibility and a diverse economic base that supports its operations. The state's general government sector returned to a balanced position in FY2013/14, the first time since FY2008/09. Deficits in those years reflected less robust revenue growth, while current and capital spending remained elevated. The improved financial performance reflects the government's implementation of a budgetary redress program to return its financial operations to surplus. The state's debt burden, while remaining manageable, rose sharply, but should stabilize as its improved financial performance is sustained. A continued commitment to conservative fiscal practices is important to maintain the state's credit outlook.

National Peers

Victoria's Aaa rating is well placed when compared to most Australian states and territories, whose ratings range from Aa1 to Aaa, reflecting their better financial and debt metrics, and disciplined fiscal management.

Credit Strengths

Victoria's credit strengths include:

--Diverse economic base to benefit from the easing in the country's mining investment boom

--Well-established institutional framework, providing fiscal flexibility

--Improved fiscal results reflecting prudent financial management

--Debt burden set to stabilize after sharp rise

Credit Challenges

Victoria's credit challenges include:

--Rapid rise in debt burden in recent years reflects large capital investments

--Risks to fiscal outcomes emanate from potential for slower revenue growth

Rating Outlook

The outlook is stable.

What Could Change the Rating - Down

A loosening in the government's resolve to maintain budget balance as planned and the associated constraint in debt accumulation could result in downward pressure on the rating.

DETAILED RATING CONSIDERATIONS

Victoria's rating combines (1) a baseline credit assessment (BCA) of aaa, and (2) a high likelihood of extraordinary support coming from Commonwealth government in the event that the entity faced acute liquidity stress.

Baseline Credit Assessment

DIVERSE ECONOMIC BASE TO BENEFIT FROM THE EASING IN THE COUNTRY'S MINING INVESTMENT BOOM

Victoria's sizable and diversified economic base amply supports its financial obligations. The state is the second largest by economic size -- contributing to 22% of Australia's output -- and by population -- with 5.7 million inhabitants. Its economy has grown at an average annual compound growth rate of 2.5% over the past decade, below the national rate of 2.8%. The state's economy is diversified, and key economic activities include finance and insurance services, manufacturing, professional and technical services, healthcare and higher education. Population gains, spurred by international migration, have been an important contributor to growth.

Victoria's higher reliance on manufacturing in comparison with other states, has exposed it to restructuring among older industrial sectors. In particular, the retrenchment of the automobile sector -- including the closure of Ford's operations by 2016 with the loss of 2,500 jobs and Toyota's by 2017 with 1,200 jobs, along with many thousands of related parts manufacturers -- will negatively affect employment, but this is mitigated by the sector's relatively small proportion of the state's total employment of 2.9 million.

At the same time, the state's prospects have strengthened in the wake of a fall-off in mining investment nationally, given its more diverse economic base and absence of mining activities. In addition, some of the macroeconomic conditions related to the mining boom -- which proved disadvantageous to Victoria -- such as the higher exchange rate - have eased substantially. In particular the lower exchange rate is expected to benefit the manufacturing and higher education sectors.

Victoria's economic growth slowed in FY2013/14 to 1.7%, below the rate of 2.1% in FY2012/13 and lower than the national rate of 2.5%, reflecting weaker trends in housing construction, and business investment, offset in part by growth in exports. The state anticipates that economic growth will increase by a stronger 2.3% in FY2014/15, supported by lower interest and exchange rates.

WELL-ESTABLISHED INSTITUTIONAL FRAMEWORK, PROVIDING FISCAL FLEXIBILITY

Arrangements with the Commonwealth provide Australian states with policy flexibility over own-source revenues and discretion over expenditure decisions, thereby providing them the tools to respond to adverse budgetary developments. The states can adjust own-source revenues, including payroll tax, property-related conveyancing duties, gambling taxes, motor vehicle taxes and other income, without restraint. Similarly the states have the capacity to ease back on the rate of current and capital spending, if required.

The strong financial support provided by the Commonwealth government through fiscal transfers to all states is also a key factor in Victoria's ratings, with grants contributing to 48% of its budget. A significant portion of grants are distributed according to a formula that seeks to reduce revenue-raising and cost disparities between jurisdictions. The Commonwealth Grants Commission will complete a five-year methodology review this year, with an outcome also expected in 2015. While at this stage any potential impact for the state is unclear, we do not anticipate that the Commonwealth would adopt changes that would have significant adverse effects for any jurisdiction without compensating adjustments.

In addition, conditional grants are provided to the states under periodic agreements. Victoria also benefited significantly from Commonwealth stimulus funding provided under the Nation Building - Economic Stimulus Plan and grants for major infrastructure projects.

The impact of the Commonwealth's FY2014/15 budget, which announced reductions for health and education grants to the states, is not yet clear, although the largest effects will not appear until FY2017/18 when the framework for indexing healthcare grants will significantly change. But in the interim period, the Commonwealth is studying the current tax regime and state/Commonwealth responsibilities to better align state and commonwealth revenues and expenditures which could potentially mitigate the impact of the reductions.

IMPROVED FISCAL RESULTS REFLECT PRUDENT FINANCIAL MANAGEMENT

In FY2013/14, Victoria's financial results improved significantly as revenues grew strongly -- in particular property-related conveyancing duties rose 20% over budget -- and as the state successfully implemented expenditure controls as part of its budgetary redress program. A headline surplus (including capital outlays) equal to 2.4% of revenues was recorded, compared to the budgeted deficit of 3.8% of revenues and the 4.9% deficit registered in the prior year. Although the result was inflated by the advance of a AUD1 billion Commonwealth capital grant scheduled for FY2014/15 and non-cash transfers of assets from VicTrack that were netted off capital expenditures, the underlying result - a minor deficit equal to 0.8% of revenues -- still represents important fiscal progress.

At the same time, the state was able to contain expenditures close to budget, a testament to fiscal prudence. While overall current expenditures grew over the year by 4.3%, on an underlying basis they rose by a more modest 2.1%; this excluded a court settlement for the Tatts Group of AUD540 million and accounting changes for superannuation expenses. The outcome largely reflects strong controls over personnel costs that rose a minor 0.2% over budget and 0.9% over the year.

In FY2014/15, the state budgeted for a surplus equal to 0.7% of revenues as revenues are set to rise by 3.5% to reflect strong growth in taxes - up 7.2% -- as well as higher grants. By contrast, expenditures are forecast to rise by a lesser 2.8%. Mid-year estimates indicate that the state will likely exceed its target with a surplus equal to 1.1% of revenues, despite the receipt of lower land taxes, because of lower capital expenditures and the receipt of one-time dividends from the Victorian workcover authority and other entities, but also due to non-cash transfers from VicTrack.

Over the medium term, the state's budget projected surpluses in all years, averaging 0.7% of revenues through FY2017/18 reflecting ongoing expenditure restraints, as well as solid growth in tax revenues and GST grants. The forecast assumes that revenues would rise 3.7% on average, while expenditures are slated to grow by a slower 2.6%, with the resultant higher gross operating balances offsetting rising capital expenditures.

The state's consolidated sector -- which includes the general government sector and public corporations -- also improved in FY2013/14 with a deficit equal to a modest 2.0% of revenues and forecast to average 0.5% over the next four years. Deficits would average a larger 3.7% of revenues, if the proceeds of asset sales and non-cash VicTrack transfers are excluded; mid-year results indicate they will average a lower 2.8% of revenues. These improvements follow many years of large deficits -- averaging 10.3% of revenues in the four years through

FY2013/14 due to a large ramp-up in water and rail-related infrastructure investment and also a deterioration in the operating performance of public corporations.

DEBT BURDEN SET TO STABILIZE AFTER SHARP RISES

Victoria's debt burden is manageable and favorable when compared to its peers. Following sharp rises in recent years, the debt burden is expected to stabilize and then decline in line with a significant narrowing in the consolidated state sector cash deficits. In FY2013/14, debt was 63.9% of revenues and 9.6% of GSP, and it is forecast to decline to 53.9% of revenues and 8.1% of GSP by FY2017/18.

In line with Moody's internationally comparable debt ratios, "net direct and indirect debt" subtracts the debt of self-supporting public corporations. The positive performance of the state's water corporations eases its debt burden as these companies' debt is self-supporting through tariffs. All debt is issued through the State's Treasury Corporation, TCV, and on-lent to the general government and public corporations. In addition, TCV borrows to pre-finance large upcoming maturities and to maintain a presence in diverse capital markets. Debt issued for these purposes is offset by substantial financial assets held in liquid investments, providing an ample cushion for these debt obligations (these amounts are not netted off Moody's debt ratios).

Victoria's unfunded superannuation liability registered 52.9% of revenues and 7.3% of GSP in FY2013/14, which is in the mid-range compared to other Australian states/territories. Trends in the liability can fluctuate significantly from year to year due to changes in the discount rate used to calculate the liability. Any concerns related to the size of superannuation liabilities are mitigated by the closure of the state's defined benefit schemes in 1993. The state has a targeted goal of achieving full funding by 2035.

The state's liquidity position is favorable with financial assets of AUD7.1 billion (beginning of FY2014/15), which is more than sufficient to cover total annual new money requirements; including AUD2.9 billion in debt maturities and AUD3.1 billion budgetary requirements. Substantial financial assets held by the TCV are conservatively invested in strongly rated, liquid securities.

RAPID RISE IN DEBT BURDEN IN RECENT YEARS REFLECTS LARGE CAPITAL INVESTMENTS

While Victoria's debt burden remains moderate when compared to peers, it has risen sharply in recent years, climbing to 63.9% of revenues and 9.6% of GSP in FY2013/14, up from 37.2% and 5.1% in FY2007/08. These rises reflected the cash deficits that emerged as the state undertook a sizeable capital improvement program, while maintaining current spending at high levels in a less supportive revenue environment.

While the state has anticipated that the debt burden will ease in line with a forecast significant narrowing in consolidated government sector cash deficits over the medium term, potential slippage in these estimates would result in higher debt levels which would be a credit negative. Furthermore, these projections include proceeds from the planned sale of the Port of Melbourne in FY2015/16. Finally the state is still formulating its capital improvement plan which has the potential to increase debt levels beyond the next four years.

RISKS TO FISCAL OUTCOMES EMANATE FROM POTENTIAL FOR SLOWER REVENUE GROWTH

Fiscal outcomes may be challenged by slower revenue growth and the difficulty of maintaining low spending rates over the medium term as forecast. According to the mid-year report, the general government sector surplus may slip back into a minor deficit beginning in FY2015/16 and average 0.2% of revenues over the next four years due to less robust assumptions for tax and grant revenues. The state's GST growth assumptions of 7% over next three years are still quite robust and may not fully incorporate the risk that declining commodity prices may increase the share of grants to the states that are more reliant on mining.

In addition, the state will find it challenging to continue to achieve low rates of spending growth--now set to rise by only 0.6% for example in FY2015/16 and 2.6% on average over the next four years. The state's achievement of a low 2.1% rise in spending in FY2012/13, and 2.1% (underlying basis) in FY2013/14 indicates that the low rates of growth are attainable, but ongoing government commitment to fiscal prudence will be important to maintaining this trend.

The recent cancelation of the East/West link road project may have some negative budget implications for the state including the potential need to return Commonwealth grants or pay penalties to the concessionaire, although these are still being negotiated, and the state has ample flexibility to offset any impacts by reprioritizing capital expenditures.

Extraordinary Support Considerations

Moody's assigns a high likelihood of extraordinary support from the Commonwealth government of Australia, reflecting 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.

Output of the Baseline Credit Assessment Scorecard

In the case of Victoria, the BCA matrix generates an estimated BCA of aa1, close to the BCA of aaa assigned by the rating committee.

The matrix-generated BCA of aa1 reflects (1) an idiosyncratic risk score of 2 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a systemic risk score of Aaa, as reflected in the Australian Government rating (Aaa, stable).

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".za" for South Africa. For further information on Moody's approach to national scale credit ratings, please refer to Moody's Credit rating Methodology published in June 2014 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings".

The Moody's Global Scale rating for issuers and issues 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.

Baseline Credit Assessment

Baseline credit assessments (BCAs) are opinions of entity's standalone intrinsic strength, absent any extraordinary support from a government. Contractual relationships and any expected ongoing annual subsidies from the government are incorporated in BCAs and, therefore, are considered intrinsic to an issuer's standalone financial strength.

BCAs are expressed on a lower-case alpha-numeric scale that corresponds to the alpha-numeric ratings of the global long-term rating scale.

Extraordinary Support

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%), strong (51% - 70%), high (71% - 90%) or very high (91% - 100%).

Rating Factors

Victoria (State of) Australia

Baseline Credit Assessment Scorecard	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Factor 1: Economic Fundamentals						
Economic strength	7	89.33	70%	5.2	20%	1.04
Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	1		50%	1	20%	0.20
Financial flexibility	1		50%			

Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	5	4.67	12.5%	2.5	30%	0.75
Interest payments / operating revenues (%)	5	3.16	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	3	61.80	25%			
Short-term direct debt / total direct debt (%)	1	3.70	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	1			1	30%	0.30
Investment and debt management	1					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						2.29(2)
Systemic Risk Assessment						Aaa
Suggested BCA						aa1

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