MOODY'S INVESTORS SERVICE

Credit Opinion: Victoria (State of) Australia

Global Credit Research - 22 Feb 2016

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)	2011	2012	2013	2014	2015	2016B	2016MYR
Net Direct and Indirect Debt/Revenues (%)	49.7	58.3	61.8	63.9	60.4	n/a	n/a
Net Direct and Indirect Debt/Gross State Product (%)	7.2	8.5	8.9	9.7	9.0	n/a	n/a
Cash Financing Surplus (Requirement)/Revenues (%)	-4.3	-3.3	-6.7	0.2	-0.5	-2.7	-1.9
Gross Operating Balance/Revenues (%)	5.5	5.6	4.0	8.3	6.8	6.8	7.5
Interest Payments/Revenues (%)	2.1	2.6	3.7	4.1	3.9	3.8	3.8
Intergovernmental Transfers/Revenues (%)	48.7	47.2	45.1	48.0	45.6	46.1	45.4
Real Gross State Product growth (% change)	2.6	1.9	1.0	1.0	2.5	2.5	2.5

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 ample financial flexibility and a diverse economic base that supports its operations. The state's general government sector moved into a balanced position in FY2013/14, fiscal year ended June 2014, following a series of deficits that it started to incur in FY2007/08. The improved financial performance reflects strong revenue growth and the government's budgetary redress measures with a focus on slower growth in current expenditures. The state's debt burden remains manageable, and should remain stable as its improved financial performance is sustained. A continued commitment to prudent fiscal practices, however, is important to maintain the state's credit outlook given upward pressures on expenditures.

National Peers

Victoria's Aaa rating is well placed when compared to most Australian states and territories, whose ratings range from Aa2 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 rebalancing of the country's economy in the wake of the mining investment boom

--Well-established institutional framework, providing fiscal flexibility

--Debt burden stabilizing

--Improved fiscal results reflect prudent financial management and strong revenue growth

Credit Challenges

Victoria's credit challenges include:

--Risks to fiscal outcomes emanate from expenditure pressures

--Lower operating balances provide less of a buffer to fund large capital investments

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 the Commonwealth government in the event that the entity faced acute liquidity stress.

Baseline Credit Assessment

DIVERSE ECONOMIC BASE TO BENEFIT FROM REBALANCING OF THE COUNTRY'S ECONOMY IN THE WAKE OF THE 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 5.9 million inhabitants. Its economy has grown at an average annual compound growth rate of 2.1% over the past decade, below the national rate of 2.7%. 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 domestic and international migration, have been an important contributor to growth.

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

However, the rebalancing of the country's economy -- in the wake of a fall-off in mining investment nationally -- towards consumption and other forms of investment strengthens the state's economic prospects, given its more diverse economic base and absence of mining activities. In particular, Victoria is benefitting from the lower Australian dollar and low interest rates which are supporting its manufacturing, higher education and tourism sectors.

As such, Victoria's economy grew by 2.5% in FY2014/15, much faster than the 1.0% rise registered in the prior year and above the national rate of 2.3%, reflecting strong growth in household consumption, dwelling and business investment. The state anticipates a similar rate of economic growth in FY2015/16. Positive economic trends are also reflected in improvements in the unemployment rate, growth in employment and strong population growth.

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 with the tools to respond to adverse budgetary developments. The states can adjust own-source revenues, including payroll taxes, 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 46% 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.

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 that could potentially mitigate the impact of the reductions.

DEBT BURDEN STABILIZING

Victoria's debt burden is manageable and favorable when compared to its peers. Following sharp rises in earlier years, its debt burden peaked at 63.9% of revenues and 9.7% of GSP in FY2013/14, and it is forecast to decline to 49.2% of revenues and 7.4% of GSP by FY2015/16, stabilizing thereafter. This decline incorporates the sale of the Port of Melbourne, which is now anticipated to be postponed to FY2016/17. As a result, its debt burden will remain close to 60% of revenues in FY2015/16.

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).

The state's liquidity position is favorable with financial assets of AUD7.2 billion (beginning of FY2015/16), which is sufficient to cover total annual cash requirements; including AUD5.5 billion in debt maturities and AUD1.8 billion in new money requirements. Substantial financial assets held by the TCV are conservatively invested in strongly rated, liquid securities.

Victoria's unfunded superannuation liability registered 49.6% of revenues and 7.2% of GSP in FY2014/15, 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.

IMPROVED FISCAL RESULTS REFLECT PRUDENT FINANCIAL MANAGEMENT AND STRONG REVENUE GROWTH

Following a five-year period through FY2012/13, when general government sector deficits (net lending result) averaged 4.3% of revenues annually, the state moved into a surplus position in FY2013/14, which was maintained in FY2014/15 to reflect stronger growth in revenues, particularly from taxes and to a lesser extent, through controls over spending.

In FY2014/15, the state generated a surplus equal to 1.7% of revenues as revenues rose over budget by 1.6% and just under the 1.9% rise in current expenditures, with the resultant smaller gross operating balance offset by a

AUD1 billion reduction in capital expenditures. In part, results were boosted by an additional AUD544 million in one-time dividends from WorkSafe, Transport Accident Commission and other government corporations. When these dividends and non-cash transfers from VicTrack -- that are netted off of its capital expenditures -- are excluded the state would have generated a small deficit equal to 1.7% of revenues.

The FY2015/16 budget projected a minor deficit, equal to 0.3% of revenues as the state had forecast that revenues would increase by 3.7% and greater than a 3.1% rise in current expenditures, along with an increase in capital spending. However, more recent mid-year estimates indicate that the state will likely exceed this target with a small surplus now anticipated -- equal to 0.6% of revenues -- largely due to stronger growth in property related conveyancing duties, while employee costs were held close to the budget estimates.

Over the medium term, the FY2015/16 budget projects small average surpluses over the next four years equal to 0.8% of revenues and rising to a solid 3.4% of revenues in FY2018/19, reflecting growth in tax revenues and GST grants as well as expenditure restraints. The forecast assumes that revenues would rise 3.4% on average, while expenditures are slated to grow by a slower 3.0%, with the resultant gross operating balances offsetting rising capital expenditures. More recent mid-year estimates indicate that the state may outperform its projections with an average surplus of 1.4% due to the lower level of capital expenditures now projected; excluding non-cash transfers from VicTrack, the mid-year estimates project that deficits will average 1.6% of revenues.

The state's consolidated sector -- which includes the general government sector and public corporations -- also improved in recent years, and in FY2014/15, the deficit was equal to a modest 1.8% of revenues. In FY2015/16, the mid-year report forecast a significant surplus equal to 8.7% of revenues, however this result incorporates the sale of the Port of Melbourne, which will likely be postponed until FY2016/17. Excluding these proceeds the deficit would be equal to 3.9% of revenues. On average, excluding the asset sale, the state anticipates that deficits will average a moderate 2.8% of revenues, which is significantly better than many years of large deficits, averaging 12.4% of revenues in the four years through FY2012/13.

RISKS TO FISCAL OUTCOMES EMANATE FROM EXPENDITURE PRESSURES

The state's plan to remain in a surplus for most years over the medium term will be challenged by the need to continue to achieve low rates of spending growth, which is budgeted to rise by only 2.2%, for example, in FY2016/17 and 3.0% on average over the next four years.

In particular, achieving low growth in employee and health costs will be challenging, given the higher rate at which they have been rising. For example, the budget targets a 3.6% annual average rise in employee costs from FY2016/17 through FY2018/19 which is much below the higher 8.2% budgeted for 2015/16; although mid-year estimates indicate these costs will rise by a lower 6.3%. Also healthcare is forecast to grow at low rate of 3.2% on average from FY2016/17 through FY2018/19, which is well below the 6.2% projected for FY2015/16.

The state's achievement of a lower rate of expenditure growth in some prior years indicate that the targeted spending rates are attainable, but ongoing government commitment to fiscal prudence will be important in maintaining this trend.

Fiscal outcomes are also likely to be challenged by slower revenue growth which could be exacerbated by the reliance on one-time revenues in some years. The state is forecasting average annual increases of 7.2% in GST-backed Commonwealth grants and 4.0% rises in taxes over the next four years; the latter reflects strong growth in payroll, land and insurance taxes offsetting flat growth in property-related conveyancing duties following several years of double-digit growth. Support from one-time revenues such as elevated dividend payments and the sale of the Port of Melbourne also boost results but not on a sustainable basis.

The cancelation of the East/West link road project may have some negative budget implications for the state, including the potential need to return AUD1.5 billion in Commonwealth grants and the uncertainty of the receipt of the second AUD1.5 billion tranche of these grants that may not be forthcoming if the state does not reach an agreement with the Commonwealth. We note that the state still has ample flexibility to offset any impacts by reprioritizing capital expenditures.

LOWER OPERATING BALANCES PROVIDE LESS OF A BUFFER TO FUND LARGE CAPITAL INVESTMENTS

While the state has anticipated that the debt burden will ease in line with a forecast narrowing in consolidated government sector cash deficits over the medium term, its ambitious capital program, including major road and public transport projects -- such as the AUD9 billion to AUD11 billion Melbourne Metro rail project -- could lead to greater debt accumulation, given lower buffers offered by the state's gross operating balances.

The FY2015/16 budget projects that the state's gross operating balances will average 6.9% over the four years from FY2014/15 through FY2017/18 which is narrower than the larger 9.7% average forecast in its FY2014/15 budget. As such, the state has less room to maneuver should capital costs rise beyond the current projections.

Extraordinary Support Considerations

The high likelihood of extraordinary support from the Commonwealth government of Australia, reflects Moody's assessment of the incentive provided by the risk to the Commonwealth government's reputation if Victoria were to face acute liquidity stress, 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).

The idiosyncratic risk scorecard and BCA matrix, which generate estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, are tools used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by these tools provide a good statistical gauge of stand-alone credit strength and, in general, higher ratings can be expected among issuers with the highest scorecard-estimated BCAs. Nevertheless, the scorecard-estimated BCAs 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. Scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Concomitantly, the limited number of variables included in these tools cannot fully capture the breadth and depth of our credit analysis.

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	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	7	89.11	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 (%)	3	6.83	12.5%	2.25	30%	0.68
Interest payments / operating revenues (%)	5	3.93	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	3	60.40	25%			
Short-term direct debt / total direct debt (%)	1	5.10	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						2.22(2)
Systemic Risk Assessment						Aaa
Suggested BCA						aa1

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