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Research Update:

Ratings On Australian State of Victoria Affirmed At 'AAA/A-1+'; Outlook Remains Stable

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Overview

- We are affirming our 'AAA/A-1+' long and short-term ratings on Victoria.
- The ratings on the State of Victoria reflect our view of Australia's extremely predictable and supportive institutional framework, plus the state's very strong financial management and economy, and its exceptional liquidity.
- The stable outlook reflects our view that the government will largely achieve its financial forecasts, allowing it to strengthen its cash operating surplus over the forward estimates, and that it will successfully refinance its upcoming debt maturities.

Rating Action

On Aug. 28, 2015, Standard & Poor's Ratings Services affirmed its 'AAA/A-1+' ratings on the Australian State of Victoria. The outlook remains stable.

Rationale

The rating affirmation on the State of Victoria reflects our view of the extremely predictable and supportive institutional framework benefiting state governments in Australia, plus the state's very strong financial management and economy, and its exceptional liquidity. The ratings also reflect Victoria's strong budgetary performance and low contingent liabilities. Victoria's average budgetary flexibility and its moderate debt burden partially offset these strengths.

Australia's institutional framework underpins the ratings on Victoria. The institutional framework governs the relationship between the Commonwealth government and the states and territories, and we consider it to be extremely predictable and supportive, and one of the strongest in the world. Within this system, however, there is a degree of structural imbalance between revenue powers and expenditure responsibilities. The bulk of revenues raised in Australia are by the Commonwealth government, while the states and territories have significant expenditure responsibilities including health and education. The horizontal fiscal equalization system within Australia is administered by an independent commission. This system, the distribution of the goods and services tax (GST), results in our assessment of Victoria—along with most Australian states and territories—as having average budgetary flexibility. For example, more than 40% of Victoria's consolidated operating revenues come from the Commonwealth.

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Victoria's financial management is very strong and supports the state's creditworthiness. The government's financial management strength is also reflective of the system in Australia, which incorporates a high degree of transparency, including full consolidation of government businesses into budgets and accrual accounting. In our view, Victoria's own financial strength is evidenced by its prudent approach to debt and liquidity management. We consider the state's financial objectives and targets are not particularly onerous and their qualitative nature makes measuring success challenging. Meanwhile, the latest budget forecasts higher operating expenditure than previously expected, reflecting the government's election commitment of higher service delivery. Slippage in either the revenues or expenditures forecasts could put pressure on the state's budgetary performance and its creditworthiness in the long run. Further, although, the government's approach to negotiating the cancelation of the East-West Link toll way raised some sovereign risk concerns with investors and companies involved, we do not believe these concerns will have a substantial adverse impact in the long run.

Victoria's economy is very strong compared to peers. The wealthy and diverse economy supports the ratings on Victoria. Victoria's Gross State Product (GSP) per capita of about A$59,500 (US$56,300) between 2012 and 2014 is high by international standards. Growth has been subdued over the past few years with real GSP growth of 1.7% in 2014 and 1.6% in 2013, but is expected to pick up to about 2.25% in the year ended June 30, 2015, aided by a lower exchange rate and interest rates. Further, solid dwelling and moderate business investment should support growth. Unemployment, at 6.2%, is moderate on an historical basis and is likely to be close to its peak.

Victoria's budgetary performance is strong and we expect its nonfinancial public sector's cash operating surplus to average about 6.7% of operating revenues (after Standard & Poor's adjustments) between 2014 and 2018. Although it is in a strong position, the 2015-2016 budget forecasts higher cash operating expenditure (3.8% higher from 2016-2018) than previously, reflecting the state government's election commitments to increase service delivery including higher staffing expenses (2.5% higher), which tend to be relatively inflexible and difficult to reduce, if needed. If costs are not controlled, it could put pressure on the state's budgetary performance and creditworthiness in the long run. Supporting this strong position are its small after-capital account deficits of 0.2% of total revenues over the same period, and benefit from additional revenue following the long-term lease of the Port of Melbourne Corp. (Port Melbourne). Reflecting the Commonwealth's current policy of not providing future grants of A$1.5 billion for the construction of East-West Link, we have removed this from our base case. We have included the existing A$1.5 billion that the Commonwealth has already provided as the state is in negotiations to retain these grants for other projects.

Partially offsetting these strengths is Victoria's average budgetary flexibility. Australia's fiscal equalization system dictates the size of grants Victoria receives from the Commonwealth. Under this system, Victoria is a donor state, meaning that it receives less than its per-capita share of the

GST pool. Further moderating the state's budgetary flexibility is the typical spend on capital expenditure. A capital expenditure program of greater than 15% of total expenditures can often provide additional flexibility as it may mean that several projects can be delayed or cancelled. Victoria's average capital expenditure as a percentage of total expenditure is however, generally less than 15% of total expenditures. In our view, Victoria's budgetary flexibility as defined by Standard & Poor's is unlikely to strengthen without a significant change in Australia's institutional framework.

We forecast Victoria's moderate debt burden will reduce from its peak of 89% of operating revenues in fiscal 2013 and fall to about 74% of operating revenues in 2018. As Victoria's operating position and after-capital account balance strengthen following improved revenue growth and the long-term lease of the Port Melbourne, we expect it to cash fund a higher proportion of capital expenditure. This is likely to reduce the rate of borrowing. We expect the government to use the proceeds from leasing Port Melbourne to repay debt in 2016. Victoria's interest expenses will average less than 5% of operating revenues between 2015 and 2017.

Further, supporting the credit ratings is the state's low level of exposure to contingent liabilities. Contingent liabilities are about A$750 million and include guarantees, indemnities and warranties, and legal proceedings and disputes. It also has limited exposure to other liabilities and which includes the state's statutory insurance companies.

Liquidity

We consider Victoria's liquidity to be exceptional, reflecting its debt-servicing ratio of cash and liquid assets as a percentage of debt maturities and interest payments in the next 12 months of 76%, and its strong access to external liquidity and potential Commonwealth support, if needed. We expect the state's debt-servicing ratio to improve and remain more than 100% in early 2016.

The government has a self-imposed minimum liquidity ratio of 80%, which is subject to a daily reporting regime. We expect Victoria's debt-servicing ratio to temporarily fall below 80% before the government leases the Port of Melbourne. The state plans on using proceeds from the lease of Port of Melbourne to repay its debt. Therefore, it has deliberately refinanced all of its recently maturing debt in the short-term market to avoid penalties associated with early repayment of long-term debt. This deliberate strategy has temporarily increased the proportion of debt maturing within the next 12 months, hence reducing its liquidity ratio. The state's liquidity strategy should result in its debt-servicing ratio averaging more than 100% of debt and interest payments in the long run.

We forecast that Victoria will hold on average about A$5.4 billion of liquid assets (after Standard & Poor's haircuts) over the next 12 months to cover upcoming maturities of A$4.3 billion and interest payments of A$2.8 billion.

Victoria's access to external liquidity is strong, in our view. Similar to Germany and Canada, the Australian states utilize a well-developed capital market for their funding. The capital markets in Australia are deep and liquid, and are expected to remain so. Victoria's individual characteristics support its access to external liquidity. Historically, Victoria has not experienced difficulty in accessing Australian and international markets, and our expectation is that this will continue. We also expect the Commonwealth to provide support if needed. A recent example of the type of support a state may receive was the guarantee of Australian state government debt during the 2008 2009 financial crisis.

Outlook

The stable outlook reflects our expectation that Victoria will continue to manage its fiscal position in line with our forecasts over the next two years, including returning its debt-servicing ratio to more than 100% in early 2016. Specifically, we expect the state's operating surpluses will remain above 5% of operating revenues while after-capital account deficits will average less than 5% of total revenues. Further, interest expenses will average less than 5% of operating revenues.

Downward pressure on the rating would occur within the next two years if there was a weakening in Victoria's budgetary performance and debt burden. This could occur if there was slippage in revenues or expenditures without corrective action from the government, resulting in cash operating surpluses averaging less than 5% or after-capital account deficits greater than 5% over a sustained period. In addition, debt levels could increase due to a large capital program resulting in interest expenses averaging more than 5% of operating revenues and/or debt rising to more than 120% of operating revenues. We consider this scenario unlikely over the next two years.

Key Statistics

Table 1

State of Victoria Financial Statistics

Mil. A$	**--Year end June 30--**				
Non-Financial Public Sector	**2014 A**	**2015 E**	**2016 BC**	**2017 BC**	**2018 BC**
Adjusted Cash Figures					
Operating Revenue					
Tax Receipts	16,324	18,047	18,568	19,354	19,752
Sales of Goods and Services Non-Modifiable	4,852	4,575	4,474	4,273	4,484
Sales of Goods and Services Modifiable	7,381	7,233	7,531	7,730	7,811
Current Grants	11,544	11,101	11,825	11,548	12,607
GST	11,507	12,013	12,879	13,615	14,521
Interest income	370	361	368	388	397

Table 1

State of Victoria Financial Statistics (cont.)					
Dividends	266	705	831	744	746
Other revenue	1,832	2,212	1,978	1,813	1,986
~of which mining royalties	52	51	51	51	51
Total Operating Revenue	54,129	56,298	58,505	59,516	62,355
Operating Expenditure					
Staff costs	18,904	19,287	20,693	21,361	22,309
Payments for goods and services	20,317	21,341	21,943	21,782	22,597
Interest costs	2,723	2,707	2,722	2,656	2,744
Grants	5,042	5,515	5,837	6,202	6,433
Other	3,607	3,393	3,843	3,904	3,365
Total Operating Expenditure	50,593	52,243	55,037	55,904	57,448
Cash Operating Balance	3,536	4,055	3,468	3,612	4,907
Net Cash from Investing	(4,691)	(4,980)	1,688	(5,455)	(6,077)
After-capital account balance (cash surplus/deficit)	(1,155)	(925)	5,156	(1,843)	(1,170)
Balance sheet					
Tax-supported debt	45,594	45,846	42,432	44,516	46,045
Unfunded Superannuation Liability	21,882	19,480	18,897	17,755	17,142
RATIOS					
Modifiable Revenues/Adjusted Operating Revenues (%)	47.28	48.92	48.08	48.64	47.47
Capital Expenditure/Total Expenditure (%)	12.77	11.32	10.35	11.61	10.50
Operating Balance/Adjusted Operating Revenues (%)	6.53	7.20	5.93	6.07	7.87
After-Capital Account Balance/Total Revenues (%)	(2.03)	(1.60)	7.75	(3.00)	(1.86)
Interest Expense/Adjusted Operating Revenue (%)	5.03	4.81	4.65	4.46	4.40
Total Tax-Supported Debt/Consolidated Operating Revenues (%)	84.23	81.43	72.53	74.80	73.84
Unfunded Superannuation Liability/Adjusted Operating Revenues (%)	40.43	34.60	32.30	29.83	27.49

A--Actual. BC--Base case. E--Estimate.

Ratings Score Snapshot

Table 2

Ratings Score Snapshot	
Key Rating Factors	
Institutional Framework	Extremely predictable and supportive
Economy	Very strong
Financial Management	Very strong
Budgetary Flexibility	Average
Budgetary Performance	Strong
Liquidity	Exceptional
Debt Burden	Moderate
Contingent Liabilities	Low

Table 2

Ratings Score Snapshot (cont.)
*Standard & Poor's ratings on local and regional governments are based on eight main rating factors listed in the table above. Section A of Standard & Poor's "Methodology For Rating Non-U.S. Local And Regional Governments," published on June 30, 2014, summarizes how the eight factors are combined to derive the rating.

Table 3

Victoria (State of) Economic Statistics

	2012 (A)	2013 (A)	2014 (A)
Economic Statistics			
Population	5,632,521	5,735,007	5,841,667
Population growth (%)	1.71	1.82	1.86
GSP per capita (local currency)	58,482	59,531	60,521
Real GSP Growth (%)	2.3	1.5	1.7
Unemployment rate (%)	5.4	5.75	6.2

A--Actual. GSP--Gross state product

Key Sovereign Statistics

Sovereign Risk Indicators, June 30, 2015. Interactive version available at http://www.spratings.com/sri

Related Criteria And Research

Related Criteria

- Methodology For Rating Non-U.S. Local And Regional Governments, June 30, 2014
- Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs, Oct. 15, 2009

Related Research

- Public Finance System Overview: Australia's Institutional Framework For States And Territories Is One Of The Strongest In The World, Feb. 12, 2015
- International Local And Regional Governments Default And Transition Study: 2012 Saw Defaults Spike, March 28, 2013

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Ratings Affirmed

Victoria (State of)	
Issuer Credit Rating	AAA/Stable/A-1+

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.