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## Research Update:

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

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## Research Update:

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

## Overview

- We are affirming our 'AAA/A-1+' long and short-term ratings on Victoria.
- The stable outlook reflects our view that the government will largely achieve its revenue forecasts and will maintain its fiscal discipline, allowing it to strengthen its cash operating surplus over the forward estimates.

## Rating Action

On Nov. 8, 2013, Standard & Poor's Ratings Services affirmed its 'AAA/A-1+' ratings on the Australian state of Victoria. The outlook remains stable.

## Rationale

The ratings on the State of Victoria reflect our view of the strong institutional framework for state governments in Australia, combined with Victoria's very positive financial management; strong and resilient economy; its very positive liquidity position; and manageable contingent liabilities. Partially offsetting these strengths are the state's moderate budgetary performance and flexibility, and its rising debt burden.

We consider Victoria's financial management to be very supportive of the state's creditworthiness. It has continued to demonstrate fiscal discipline through its response to ongoing revenue challenges. The government has made difficult political decisions, including containing wage growth and reducing the number of public servants. 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 in budgeting and accrual accounting. In our view, Victoria's own financial strength is evidenced by its prudent approach to debt and liquidity management, as well as the development of medium- and long-term fiscal and economic strategies. It has a history of economic reform that will over time increase the productivity of the state. We don't expect the commitment to fiscal discipline to change over the life of the current parliament.

The wealth and diversification of Victoria's economy support the rating. Victoria's Gross State Product (GSP) per capita (2012: about A\$58,000) is high by international standards and reflects the high standard of living enjoyed by Victorians. Growth has remain subdued over the past few years and is expected to strengthen in year ending June 30, 2014, as household consumption improves

along with higher dwelling and moderate business investment. Despite some recent high-profile redundancies, unemployment remains low while employment continues to strengthen.

We consider the institutional framework in Australia, which governs the relationship between the Commonwealth government and the states and territories to be 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 Australian are by the Commonwealth, while the states and territories have significant expenditure responsibilities including health and education. Consequently, Victoria—along with all Australian states—enjoys only moderate budgetary flexibility. Victoria relies on about 45% of its consolidated operating revenues from the Commonwealth.

Dictating the size of the grants Victoria receives from the Commonwealth is a system of fiscal equalization, which is administered by an independent commission. Under this system, Victoria is a donor state meaning that it receives less than its average per-capita share of the goods and services tax (GST) pool.

Further moderating the state's budgetary flexibility is the typical spend on capital expenditure. A capital expenditure program of greater than 15% 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%. 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.

Given weaker-than-expected revenue growth, and the limited revenue flexibility, Victoria's budgetary performance has weakened over the past few years. As a consequence, its debt burden has risen as the state relies more on external funding to deliver its capital projects. Our expectation is that as revenues strengthen and the state realizes the benefits of its fiscal discipline, its operating position both before and after capital expenditure will also strengthen and debt will peak at about 93% in fiscal 2015.

Further supporting the ratings is the manageable size of the state's contingent liabilities.

## **Liquidity**

We consider Victoria's liquidity as being a very positive ratings factor, reflecting its very positive level of coverage of its upcoming debt maturities and interest, as well as its exceptional market access. The government has set itself a minimum liquidity ratio of 80%, which is subject to a daily reporting regime. At Sept. 30, 2013, Victoria's short-term liabilities of A\$4.53 billion were offset by free cash and liquid assets of A\$5.86 billion, resulting in a debt-servicing ratio (12 months of maturing debt plus interest payments) of

129%.

## Outlook

The stable outlook reflects our expectation that Victoria will continue to demonstrate fiscal discipline, improving its cash operating position and reducing its reliance on external funding for its infrastructure needs over the medium term.

Downward pressure on the rating would occur if there is further weakening in the state's revenues without corrective action from the government, worsening its budgetary performance. This would be demonstrated if cash operating surpluses were less than 5% and after-capital account deficits were greater than 10% over a sustained period, or debt levels increased significantly due to a new and large capital program. In our view, we consider the likelihood of such a change in government policy as limited over the next two years.

## Published Rating Factor Scores

**Table 1**

| Summary Of Published Rating Factor Scores* |                            |
|--|----------------------------|
| RATING FACTOR                              | SCORE                      |
| Institutional framework                    | Predictable and supportive |
| Financial management                       | Very positive              |
| Liquidity                                  | Very positive              |

\*Standard & Poor's ratings on local and regional governments are based on, among other things, a scoring system that covers eight main rating factors, as further explained in our criteria (see below). We publish our scores for the three rating factors above.

## Key Statistics

**Table 2**

| Victoria (State of) Financial Statistics  |                     |          |           |           |           |
|---|---------------------|----------|-----------|-----------|-----------|
| (Mil. A\$)                                | Year ending June 30 |          |           |           |           |
|   | 2012 (A)            | 2013 (A) | 2014 (BC) | 2015 (BC) | 2016 (BC) |
| <b>From Cash Flow Statement</b>           |                     |          |           |           |           |
| <b>Receipts from operating activities</b> |                     |          |           |           |           |
| Payroll tax                               | 4458.45             | 4419.10  | 4636.20   | 4884.81   | 5146.82   |
| Conveyance duties                         | 3306.97             | 3276.10  | 3407.61   | 3652.97   | 3872.13   |
| All other taxes                           | 7606.88             | 7191.10  | 7762.29   | 8271.54   | 8555.71   |
| Sales of Goods and Services               | 3649.30             | 3583.60  | 4722.10   | 5113.30   | 5367.10   |
| GG Sales of Goods and Services            | 7033.00             | 7132.30  | 7631.30   | 7772.70   | 8052.30   |
| GST                                       | 10380.20            | 10989.50 | 11125.11  | 11513.98  | 12296.13  |
| Current grants                            | 10060.00            | 9777.15  | 10282.60  | 10728.38  | 11339.70  |

**Table 2**

| <b>Victoria (State of) Financial Statistics (cont.)</b> |            |            |            |            |            |
|---|------------|------------|------------|------------|------------|
| Interest income   | 489.20     | 428.60     | 379.60     | 390.40     | 396.10     |
| Dividends   | 456.60     | 607.80     | 399.50     | 408.40     | 440.70     |
| Mining royalties  | 65.60      | 45.10      | 47.50      | 48.60      | 49.80      |
| All other Revenue                                       | 1772.10    | 2052.40    | 1955.30    | 1771.20    | 1823.20    |
| Total Operating receipts                                | 49278.40   | 49502.65   | 52349.11   | 54556.27   | 57339.70   |
| <b>Payments from operating activities</b>               |            |            |            |            |            |
| Staff costs   | 17,704.50  | 18,548.60  | 18,743.70  | 19,501.10  | 20,150.90  |
| Goods and Services                                      | 19,608.90  | 18,781.60  | 20,121.30  | 20,448.10  | 20,502.00  |
| Interest costs  | 1,807.60   | 2,343.80   | 2,855.28   | 3,035.58   | 3,087.35   |
| Grants  | 5,886.00   | 5,623.20   | 5,384.40   | 5,519.60   | 5,741.20   |
| Other   | 2,807.00   | 2,929.80   | 3,364.50   | 3,426.20   | 3,497.30   |
| Total Operating costs                                   | 47,814.00  | 48,227.00  | 50,469.18  | 51,930.58  | 52,978.75  |
| Cash operating balance                                  | 1,464.40   | 1,275.65   | 1,879.93   | 2,625.69   | 4,360.95   |
| Capital expenditure                                     | (7,455.40) | (7,816.60) | (7,695.63) | (7,178.22) | (5,368.59) |
| Capital grants  | 2,378.00   | 1,221.85   | 1,712.70   | 1,383.62   | 1,190.20   |
| Sales of non-financial assets                           | 289.30     | 404.40     | 525.90     | 553.90     | 591.10     |
| Net Cash from Investing                                 | (4,788.10) | (6,190.35) | (5,457.03) | (5,240.70) | (3,587.29) |
| After-capital account balance                           | (3,323.70) | (4,914.70) | (3,577.10) | (2,615.00) | 773.66     |
| <b>Balance sheet (selective items)</b>                  |            |            |            |            |            |
| Financial assets  | 9057.10    | 9199.50    | 8956.00    | 9320.00    | 9702.90    |
| Gross debt  | 33766.90   | 43856.30   | 47846.32   | 50879.54   | 51254.33   |
| Unfunded superannuation                                 | 24200.00   | 25225.40   | 22100.00   | 21900.00   | 21600.00   |
| <b>RATIOS</b>   |            |            |            |            |            |
| Modifiable revenues as % of operating revenues          | 49.20%     | 48.72%     | 48.60%     | 48.39%     | 47.96%     |
| Capital expenditure as % of total expenditure           | 13.49%     | 13.95%     | 13.23%     | 12.14%     | 9.20%      |
| Operating balance as % of operating revenues            | 2.97%      | 2.58%      | 3.59%      | 4.81%      | 7.61%      |
| After-capital account balance as % of total revenues    | (6.40%)    | (9.61%)    | (6.55%)    | (4.63%)    | 1.31%      |
| Interest expense as % of operating revenues             | 3.67%      | 4.73%      | 5.45%      | 5.56%      | 5.38%      |
| Tax-supported debt as % of operating revenues           | 68.52%     | 88.59%     | 91.40%     | 93.26%     | 89.39%     |
| Unfunded superannuation as % of operating revenues      | 49.11%     | 50.96%     | 42.22%     | 40.14%     | 37.67%     |

A--Actual. BC--Base case.

**Table 3**

| <b>Victoria ( State of) Economic Statistics</b> |                                |                 |                 |
|---|--------------------------------|-----------------|-----------------|
|   | <b>--Year ending June 30--</b> |                 |                 |
|   | <b>2010 (A)</b>                | <b>2011 (A)</b> | <b>2012 (A)</b> |
| <b>Economic Statistics</b>                      |                                |                 |                 |
| Population                                      | 5,468,430                      | 5,534,526       | 5,623,492       |
| Population growth (%)                           | 1.36                           | 1.21            | 1.61            |
| GDP per capita (local currency) (single units)  | 54,113                         | 56,650          | 58,106          |
| Real GDP Growth (%)                             | 1.9                            | 2.7             | 2.3             |

**Table 3**

| Victoria ( State of) Economic Statistics (cont.) |      |      |      |
|--|------|------|------|
| Unemployment rate (%)                            | 5.47 | 4.93 | 5.50 |

A--Actual. Sources: Experian Ltd. and Standard & Poor's.

## Key Sovereign Statistics

See research update titled, "Ratings On Australia Affirmed At 'AAA/A-1+' On Monetary And Fiscal Flexibility; Outlook Remains Stable", July 17, 2013

## Related Criteria And Research

- International Local And Regional Governments Default And Transition Study: 2012 Saw Defaults Spike, March 28, 2013
- Public Finance System Overview: Australian States And Victorian Municipalities, Feb. 20, 2013
- Principles Of Credit Ratings, Feb. 16, 2011
- Methodology For Rating International Local And Regional Governments, Sept. 20, 2010
- Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper, Oct. 15, 2009

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 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.

## Ratings List

### Ratings Affirmed

|                              |                 |
|------------------------------|-----------------|
| Victoria (State of)          |                 |
| Victoria (Treasury Corp. of) |                 |
| Issuer Credit Rating         | AAA/Stable/A-1+ |
| Victoria (Treasury Corp. of) |                 |
| Senior Unsecured             | AAA             |
| Commercial Paper             | A-1+            |

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