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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 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 Sept. 5, 2014, Standard & Poor's Ratings Services affirmed its 'AAA/A-1+' ratings on the Australian State of Victoria. The outlook remains stable.

Rationale

The ratings affirmations on the State of Victoria reflect our view of the extremely predictable and supportive institutional framework benefiting state governments in Australia, plus the state's very strong financial management, economy, and 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 extremely predictable and supportive 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 one of the strongest in the world. Within this system, however, there is a degree of structural imbalance between the revenue powers and expenditure responsibilities. This is because 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, which is 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.

Nevertheless, Standard & Poor's considers Victoria's financial management to be very strong as the state has effectively managed this average budgetary flexibility, which supports the state's creditworthiness. The government

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continues to demonstrate fiscal discipline through its response to ongoing revenue challenges, and has made difficult political decisions, including containing wage growth, reducing the number of public servants, and introducing modest revenue measures before an election. The government's financial management strength also benefits from the Australian system, which incorporates a high degree of transparency, including full consolidation of government businesses into budgets and accrual accounting. In our view, Victoria has demonstrated its own financial strength through 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.

Victoria's wealthy and diverse economy is very strong compared to its peers. Its Gross State Product (GSP) per capita of about A$58,000 (US$58,000) between 2010 and 2013 is high by international standards. Even though growth has been subdued over the past few years with real GSP increasing by only 1.6% in 2013, it is expected to strengthen to about 2% and 2.5% in fiscal 2014 and 2015 as household consumption improves along with higher dwelling and moderate business investment. Despite some recent high-profile redundancies, unemployment is moderate on an historical basis and is likely to be close to its peak.

Further, Victoria's budgetary performance is strong. We expect that the government's commitment to fiscal discipline and the stabilization of its own-source revenues will result in its nonfinancial public sector's cash operating surpluses averaging 5.8% of operating revenues (after Standard & Poor's adjustments) between 2013 and 2017. In our view, the Victorian government's budgetary performance is benefiting from several years of strong fiscal discipline, as evidenced by more rapid revenue growth than expenditures between 2014 and 2017. In our base-case forecast, the state's after-capital account deficits are expected to average about 1.8% of total revenues between 2013 and 2017. Victoria's after-capital account will benefit from raising additional revenue through the long-term lease of the Port of Melbourne Corp. (Port Melbourne) and the sale of assets such as the Rural Finance Corp. This scenario assumes lower tax and GST receipts, some increase in goods and services expenditure, and a 10% underspend of Victoria's capital program compared to the government's budget.

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; so a significant portion of its revenues is not under the state's direct control. Under this system, Victoria is a donor state, meaning that it receives less than its average 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 to peak at 89% of operating revenues in 2015 before falling to about 73% of operating revenues in 2017. Reflecting weaker-than-expected revenue growth in recent years, Victoria's debt burden increased as the state relied more on external funding to deliver its capital projects. Nevertheless, we expect the state to cash fund a higher proportion of capital expenditure as its operating position and after-capital account balance strengthen following improved revenue growth and the long-term lease of the Port Melbourne and sale of other assets. This is likely to reduce the rate of borrowing. We expect the government to use the proceeds from leasing the Port Melbourne to repay debt in 2016. Victoria's interest expenses will average about 5% of operating revenues between 2014 and 2016, before falling below 5%.

Further, supporting the ratings on Victoria is its low level of exposure to contingent liabilities. Contingent liabilities are about A$1.1 billion and include guarantees, indemnities and warranties, and legal proceedings and disputes. The state also has other liabilities that include its statutory insurance companies.

Liquidity

We consider Victoria's liquidity to be exceptional. This reflects the state's average level of coverage of its upcoming debt maturities and interest of about 100%, as well as its strong market access. The government has set itself a minimum liquidity ratio of 80%, which is subject to a daily reporting regime.

We forecast that Victoria will hold on average about A$5.938 billion of liquid assets (after Standard & Poor's haircuts) over the next 12 months to cover upcoming maturities of A$3.124 billion and interest payments of A$2.833 billion. Victoria's liquid assets include about A$825 million of cash, A$3.990 billion of government bonds (after haircuts), and A$1.123 billion of other investment-grade bonds.

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—a trend that we expect to remain so. We expect Victoria will be able to access capital-market funding, as it has done in the past. We also expect the Commonwealth to provide support if needed, as demonstrated recently by the Commonwealth guarantee of Australian state government debt during the 2008-2009 financial crisis.

Victoria's liquidity is managed by the Treasury Corp. of Victoria (TCV), which also manages the state's debt issuance. Further, the whole-of-government Liquidity Management Strategy developed by the Department of Treasury and Finance, in conjunction with TCV, supports the state's liquidity. The strategy includes a contingency plan for dealing with abnormal disruption in financial markets or adverse liquidity conditions specific to the state. We consider it unlikely that TCV will deviate from its current approach to liquidity.

Outlook

The stable outlook reflects our expectation that Victoria will continue to demonstrate fiscal discipline and successfully execute its financial strategy. Delivery of this strategy will further support the government's strong budgetary performance.

Downward pressure on the rating would occur if there was a weakening in Victoria's revenues without corrective action from the government and if debt levels increased significantly due to a new and large capital program. In particular, a downgrade could arise if this scenario results in the state's cash operating surpluses averaging less than 5% and after-capital account deficits being greater than 10% over a sustained period. In our view, we consider that there is a low likelihood of such a change in government policy over the next two years that would result in such a scenario.

Ratings Assessment Snapshot

Table 1

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

*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.

Key Statistics

Table 2

Nonfinancial Public Sector	2013A	2014E	2015BC	2016BC	2017BC
Adjusted Cash Figures (mil. A$)					
Operating Revenue					
Tax receipts	14,886	16,473	17,601	18,055	19,032

Table 2

Nonfinancial Public Sector (cont.)					
Sales of goods and services nonmodifiable	3,584	4,327	4,736	4,609	4,371
Sales of goods and services modifiable	7,132	7,434	7,094	7,406	7,413
Current grants	9,777	10,502	10,969	11,615	11,553
GST	10,990	11,368	11,645	12,437	13,220
Dividends	608	420	441	635	886
Interest income	429	364	364	392	409
Other revenue	2,098	1,827	1,906	2,196	1,892
~of which mining royalties	45	48	50	50	50
Total Operating Revenue	49,503	52,716	54,757	57,345	58,775
Operating Expenditure					
Staff costs	18,549	18,944	19,252	20,230	20,851
Payments for goods and services	18,782	20,276	21,394	20,204	20,150
Interest costs	2,344	2,787	2,833	2,657	2,556
Grants	5,623	5,187	5,448	5,664	6,116
Other	2,930	3,445	3,457	3,507	3,683
Total operating expenditure	48,227	50,639	52,384	52,260	53,356
Cash operating balance	1,276	2,077	2,372	5,084	5,419
Net cash from investing	(6,190)	(4,142)	(5,239)	1,273	(5,594)
After-capital account balance (cash surplus/deficit)	(4,915)	(2,065)	(2,867)	6,358	(175)
Balance Sheet					
Financial assets	9,200	9,032	9,170	9,518	9,667
Tax-supported debt	43,856	45,921	48,788	42,430	42,606
Unfunded superannuation liability	25,225	23,297	22,995	22,646	22,156
Ratios					
Modifiable revenues/Adjusted operating revenues	48.72%	48.82%	48.58%	48.23%	48.21%
Capital expenditure/Total expenditure	13.95%	11.63%	13.01%	11.65%	12.13%
Operating balance/Adjusted operating revenues	2.58%	3.94%	4.33%	8.87%	9.22%
After-capital account balance/Total revenues	(9.93%)	(3.92%)	(5.24%)	9.70%	(0.29%)
Interest expense/Adjusted operating revenue	4.73%	5.29%	5.17%	4.63%	4.35%
Total tax-supported debt/Consolidated operating revenues	88.59%	87.11%	89.10%	73.99%	72.49%
Unfunded superannuation liability/Adjusted operating revenues	50.96%	44.19%	42.00%	39.49%	37.70%

A—Actual. BC—Base case. E--Estimate.

Key Sovereign Statistics

Table 3

Commonwealth of Australia - Selected Indicators											
	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Nominal GDP (US$ bil)	854	1,056	927	1,142	1,387	1,532	1,563	1,449	1,452	1,478	1,537
GDP per capita (US$)	40,994	49,673	42,722	51,825	62,081	67,423	67,567	61,693	60,924	61,090	62,605
Real GDP growth (%)	3.8	3.7	1.7	2.0	2.2	3.6	2.7	2.9	2.7	3.0	3.0

Table 3

Commonwealth of Australia - Selected Indicators (cont.)											
Real GDP per capita growth (%)	1.9	1.6	(0.3)	0.4	0.8	1.8	0.9	1.4	1.2	1.5	1.5
Change in general government debt/GDP (%)	0.2	0.9	4.8	5.5	4.5	5.8	3.0	3.9	2.3	0.9	0.4
General government balance/GDP (%)	1.4	1.6	(2.6)	(5.3)	(4.0)	(4.2)	(2.6)	(3.9)	(2.3)	(0.9)	(0.4)
General government debt/GDP (%)	9.6	9.7	13.9	19.0	22.0	26.6	29.0	32.0	33.2	32.6	31.3
Net general government debt/GDP (%)	1.6	(2.4)	1.7	8.2	11.8	16.9	18.2	19.8	21.4	21.3	20.6
General government interest expenditure/revenues (%)	1.6	1.6	1.7	2.4	3.2	3.5	3.7	4.3	3.9	4.0	3.9
Other dc claims on resident non-govt. sector/GDP (%)	131.8	144.7	148.3	149.5	145.3	149.3	154.1	157.7	161.5	163.1	164.1
CPI growth (%)	3.0	3.4	3.1	2.3	3.1	2.3	2.3	2.7	2.7	2.5	2.5
Gross external financing needs/CARs +use. res (%)	225.9	227.6	278.1	248.3	224.8	241.8	243.3	231.9	234.6	232.1	228.1
Current account balance/GDP (%)	(6.1)	(6.7)	(3.4)	(5.0)	(3.0)	(3.2)	(3.8)	(2.7)	(3.6)	(3.4)	(2.8)
Current account balance/CARs (%)	(25.1)	(27.2)	(12.7)	(21.6)	(11.9)	(12.8)	(16.2)	(10.5)	(14.0)	(12.9)	(10.6)
Narrow net external debt/CARs (%)	265.8	266.0	237.3	264.3	252.4	234.8	236.0	245.4	250.7	247.3	241.3
Net external liabilities/CARs (%)	254.1	245.0	224.5	243.3	236.6	219.4	208.3	226.8	239.8	243.7	244.3

Other depository corporations (dc) are financial corporations (other than the central bank) whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. CARs--Current account receipts.

Related Criteria And Research

Related Criteria

- Methodology For Rating Non-U.S. Local And Regional Governments, June 30, 2014

Related Research

- Public Finance System Overview: Australian States And Victorian Municipalities, Feb. 20, 2013
- 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 Assessment 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.

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.