Chapter 3

Key Issues and Recommendation

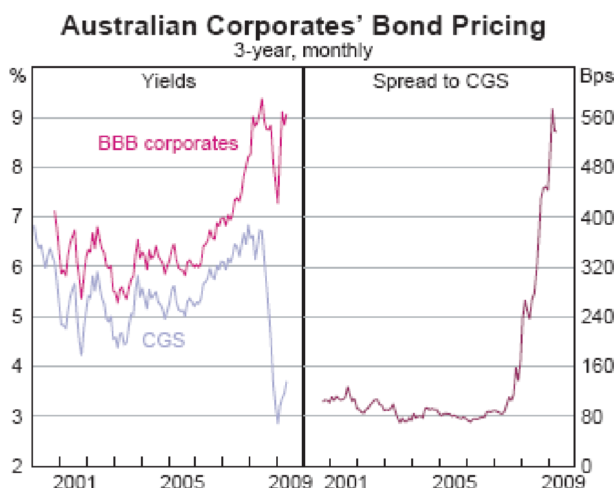
Key issues raised during the inquiry

3.1 The key issue raised during the inquiry related to the states' attitudes towards debt and the impact of their credit rating on their borrowing capacity. Other issues raised related to the size of any contingent liability for the Commonwealth and how the guarantee will affect state bond markets.

States and Debt

3.2 The global recession, especially to the extent that it had its genesis in reckless lending, has been associated with increased caution by lenders. This has translated into higher interest rate spreads – the gap between yields on AAA securities and those with lower ratings has widened. This has been particularly notable for lower-rated corporate paper (Chart 1) but has also been evident in yields on supranational and semi-government paper (Chart 2). The states are competing in financial markets with bank securities and deposits, which increasingly have national government guarantees.[1]

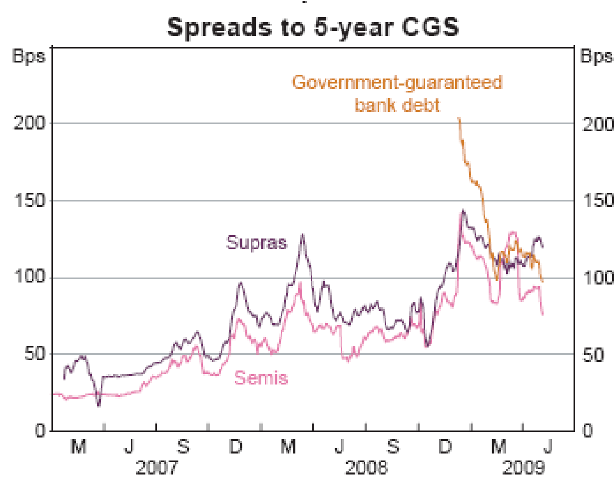
Chart 1: Commonwealth Government Securities and lower-rated instruments



Source: Reserve Bank of Australia, *Statement on Monetary Policy*, May 2009, p 56.

1 For example, in Australia, under the Financial Claims Scheme total deposit balances up to $1 million per customer held in eligible authorised deposit-taking institutions are automatically guaranteed by the Australian Government without charge. For customers with total deposit balances over $1 million, the bank can access a government guarantee through the Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding by applying to the Reserve Bank of Australia; RBA, *Financial Stability Review*, March 2009, p 43.

Chart 2: Commonwealth Government Securities and lower-rated instruments



Source: Reserve Bank of Australia, *Statement on Monetary Policy*, May 2009, p 46.

3.3 Ratings agencies are also more cautious, leading to states fearing that increased borrowings may lead to a credit rating downgrade and a subsequent increase in their borrowing costs:

> By way of example of the importance of the Guarantee, we have recently seen the downgrade of Queensland's credit rating. This ratings downgrade, a result of the impacts of the crisis on government receipts coupled with that State's forward infrastructure programme, saw Standard & Poors and Moody's downgrade the State from AAA to AA+ and AA1 respectively. …The result of this downgrade is an interest rate increase of 40 basis points on existing debt facilities, equivalent to approximately $200 million in additional annual repayments.[2]

3.4 The downgrading of Queensland Government's credit rating in February 2009 affected all the states:

> …following the downgrade of Queensland's credit rating, all states and territories were having difficulties accessing credit markets, not just Queensland.[3]

3.5 A ratings downgrade will also affect the availability (and hence cost) of funds because some investors are restricted by their mandates to only invest in AAA securities.

3.6 However, the states continue to have relatively manageable debts (Table 2) by most metrics. (For example, the Maastricht criteria only require debt to be under 60 per cent of GDP and many countries are able to borrow comfortably with debt in

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2 Infrastructure Partnership Australia, *Submission 1*, p 1.

3 Ms Sue Vroombout, Treasury, *Proof Committee Hansard*, 10 June 2009, p 2.

excess of GDP.) The states' credit ratings are all either AAA or only one notch below (Table 3).

Table 2: Non-financial public sector (NFPS) borrowing as a % of GSP/GDP

	2000-01	2007-08	2010-11 (f)
New South Wales	10	9	13
Victoria	5	5	11
Queensland	12	15	23
Western Australia	10	7	13
South Australia	9	6	12
Tasmania	24	10	14
Australian Capital Territory	5	4	7
Northern Territory	26	14	17
States	*9*	*9*	*15*

Source: Department of the Treasury, information provided to Secretariat, 15 June 2009.

Table 3: State credit ratings

	S&P's	**Date of Most Recent Rating or Confirmation**	**Moody's**	**Date of Most Recent Rating or Confirmation**
New South Wales	AAA/Negative/A-1+	29/07/2008	Aaa/Stable/P-1/P-1	21/01/2009
Queensland	AA+/Stable/A-1+	20/02/2009	Aa1/Stable	20/05/2009
Victoria	AAA/Stable/A-1+	5/05/2009	Aaa/Stable/Aaa/Aaa/P-1	22/01/2009
Western Australia	AAA/Stable/A-1+	14/05/2009	Aaa/Stable/Aaa/P-1	22/01/2009
South Australia	AAA/Stable/A-1+	4/06/2009	Aaa/Stable/Aaa/Aaa/P-1	4/06/2009
ACT	AAA/Stable/A-1+	5/05/2009	N/A	
Tasmania	AA+/Stable/A-1+	12/11/2008	Aaa/Stable/P-1	28/01/2009
Northern Territory	N/A		Aa1/Stable/Aa1	21/01/2009

Source: Department of the Treasury, provided to Secretariat on 11 June 2009

3.7 Views differ about whether the states have excessive or overly cautious amounts of debt. The recent Select Committee on State Government Financial Management gave two instances of differing views:

> …the issue of government debt is particularly concerning. In the past two state budgets, we have seen a dramatic escalation of borrowings…[4]
>
> …the borrowing and debt positions of the Australian states and territories have been overly conservative for some time. This has been associated with a significant underinvestment in Australia's infrastructure…It is difficult to rationalise the excessive focus on reducing debt. It has little basis in good economic management but seems rather to be driven by an ideological position.[5]

Contingent liability for the Australian government

3.8 The guarantee will increase the Australian government's contingent liabilities. Some press reports suggest that the amounts involved could exceed $100 billion for existing bonds and a possible additional $60 billion over the next three years in additional bonds.[6]

3.9 When questioned about the potential size of the contingent liability, Ms Vroombout of the Treasury explained:

> **Ms Vroombout**—[States] do not have to nominate a maximum amount. They can say, for example, 'We want to guarantee our Q23s', so all the bonds that we issue into a Q23 line will be guaranteed.
>
> **Senator BUSHBY**—So that line could be unlimited in relation to contingent liability for the Commonwealth?
>
> **Ms Vroombout**—It could be.[7]

3.10 The extent of the contingent liability will depend on how many states avail themselves of the guarantee. So far, only New South Wales has publicly indicated that it intends to use it.[8]

3.11 The guarantee is only temporary, and its uptake will decline further as economic conditions stabilise:

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4 Dr Bruce Flegg, then Queensland shadow treasurer, cited in Select Committee on State Government Financial Management, *Report*, p 36.

5 Australian Industry Group, cited in Select Committee on State Government Financial Management, *Report*, p 37.

6 D Crowe, 'Swan throws debt lifeline to the states', *Australian Financial Review*, 26 March 2009, p 1.

7 Ms Sue Vroombout, *Proof Committee Hansard*, 10 June 2009, p 3.

8 Ms Sue Vroombout, *Proof Committee Hansard*, 10 June 2009, p 5.

> A potential positive, I have to say, for the state funding issue, if you like, is that if these recessionary conditions across the world abate, the banks' reliance on the government guarantee should reduce. I mean, there is already some evidence of this, I would say. In recent months, Australian banks have been able to issue bonds in their own name without the government guarantee, which is good.[9]

3.12 The Australian government can also limit its exposure by increasing the price it charges for the guarantee.

3.13 Treasury noted the existing process by which loans will continue to be monitored and assessed:

> There is a longstanding Loan Council process in which the Commonwealth and the states and territories provide their nominations as to the amount of borrowing. If they breach that cap within a two per cent margin they have to go back to the Loan Council members and indicate their new borrowing requirement.[10]

3.14 The Government views the likelihood of a state default as 'remote and unquantifiable.'[11]

3.15 The guarantee may allow states to use the Australian government's AAA rating to access cheaper funds, but a question was raised whether it could also reduce the incentive for fiscal responsibility. Bearing responsibility for raising funds in their own name, instead of relying on the Commonwealth to borrow funds on their behalf, has arguably forced the states to be more cautious in their borrowing and use of funds to ensure that they preserve their own credit rating.

3.16 The issue was raised that, with their borrowings guaranteed, could the states be less vigilant in ensuring that contracts they enter with infrastructure providers are equitable in where they assign risk? That is, in order to enter favourable contracts, the states may be willing to bear a greater risk than they otherwise would because they know that the Commonwealth will 'pick up the bill' in the case of the project failing.

3.17 During the hearing, Ms Marisa Purvis-Smith outlined that credit rating agencies were unlikely to consider the presence of the guarantee when assessing a state's fiscal position. She said

> The guarantee over state and territory borrowing will ensure that the securities of each state will have a triple-A rated guarantee. But the credit rating agencies will still rate the state based on each individual balance

9 Mr Peter Jolly, *Proof Committee Hansard*, 10 June 2009, p 3.

10 Ms Vroombout, Treasury, *Proof Committee Hansard*, 10 June 2009, p 3.

11 *Treasurer Press Release*, 25 March 2009.

> sheet and fiscal position of the state. So the Commonwealth guarantee does not necessarily ensure the credit rating of the state itself.[12]

3.18 This therefore makes it unlikely that the states will take on excessive debt or take on excessive risk since it would still affect the overall credit rating of their state, and this would then make their Commonwealth guarantee more expensive.

Fee structure

3.19 One other concern raised during the inquiry was about how the Commonwealth would set fees for a guarantee if a state government credit rating dropped below AA1/AA+. In the Treasurer's media release of 25 March 2009, fees for existing and new debt issues for AAA and AA1/AA+ ratings were announced. When asked about what would happen if a state's rating dropped below this, Treasury said:

> We will then develop a fee structure for a state with a rating below AA plus, based on what we observe in the market as a consequence of the downgrade.[13]

Time limit

3.20 In the Treasurer's press release of 25 May 2009, the Treasurer said that the Guarantee would be 'time-limited.'[14] There is no time limit contained in the legislation, nor is there a limit on the amount of money that can be paid out.

3.21 Treasury explained:

> …like the wholesale funding guarantee for the banks, the deed of guarantee will outline that the guarantee will continue to operate until market conditions normalise. There will not be a specific time limit…[15]

Benefits from the guarantee

3.22 The guarantee should allow the states to borrow at yields closer to those of a AAA borrower. Indeed, this effect is already evident. The Reserve Bank has commented:

> In March, the Australian Government announced that it would be willing to guarantee the debt of the states…While the relevant legislation is still to be passed by Federal parliament, spreads on their debt have narrowed significantly.[16]

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12 Ms Marisa Purvis-Smith, Department of the Treasury, *Proof Committee Hansard*, 10 June 2009, p 4.

13 Ms Sue Vroombout, *Proof Committee Hansard*, 10 June 2009, p 5.

14 Treasurer Press Release 25 March 2009.

15 Ms Sue Vroombout, *Proof Committee Hansard*, 10 June 2009, p 2.

16 Reserve Bank of Australia, *Statement on Monetary Policy*, May 2009, p 46.

3.23 There has been broad support for the initiative. Mr Peter Jolly of nabCapital said the guarantee was a positive for state governments and should ease concerns over funding.

> It takes away some of the concerns they had over fiscal position of the states… We saw Queensland downgraded and NSW put on negative watch. That should alleviate all of those issues.[17]

3.24 Infrastructure Partnerships Australia also outlined their support saying:

> Simply put, the future of some of Australia's most urgent and important economic and social infrastructure projects is at significant risk at the very time that increased infrastructure expenditure is urgently required to provide economic stimulus and boost employment…In order to address the shortfall of funding impacting on private infrastructure development, IPA encourages the Commonwealth and State Governments to use the State Borrowing Guarantee to provide gap funding to private infrastructure providers and to reduce refinancing risks for existing assets.[18]

3.25 The Tasmanian Government was also supportive, commenting:

> Tasmania strongly supports the policy intent underlying the Bill.[19]

3.26 They elaborated:

> Tascorp [the government borrowing agency] needs to raise around $1.5 billion from the markets over the next three years. Without the guarantee, this borrowing requirement would be very difficult given the current state of global credit markets…[20]

3.27 The Bill was also favourably received by bond dealers.[21]

Committee View

3.28 All submissions to the inquiry supported the bill on the basis that the guarantee is critical in providing certainty for investors and allowing states to access the funds needed for large, infrastructure investment programmes. Such programmes will be an important measure to provide short term stimulus and liquidity to the national economy and well as long-term benefits to productivity.

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17 Mr Peter Jolly, quoted in *The Sydney Morning Herald* 'Canberra to Guarantee State Debt' 25 March 2009.

18 Infrastructure Partnerships Australia, *Submission 1,* p 2.

19 Tasmanian Department of Treasury and Finance, *Submission 2*, p 2.

20 Tasmanian Department of Treasury and Finance, *Submission 2*, p 2.

21 D Crowe, 'Swan throws debt lifeline to the states', *Australian Financial Review*, 26 March 2009, p 1.

3.29 The Committee is confident that, as the credit rating agencies are unlikely to consider the guarantee when making an assessment about the fiscal position of a state, there is still sufficient incentive for states to manage their borrowing programme responsibly. The guarantee is very unlikely to be called on, but should allow the states to raise funds for needed infrastructure projects at lower cost.

Recommendation

3.30 The Committee recommends that the Senate pass the bill.

Senator Annette Hurley

Chair