The McGraw·Hill Companies

STANDARD & POOR'S

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The Secretary
Senate Standing Finance and Public Administration
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Mr Palethorpe,

Standard & Poor's Submission to Select Committee on State Government Financial Management

Thank you for the invitation in your letter of 22 February to make a submission to the Senate's select committee on state government financial management.

Let me begin with a brief description of Standard & Poor's and our role in capital markets. Standard & Poor's is a leading provider of financial market intelligence. Our Ratings Services division has been assigning credit ratings since 1916. With its head office in New York, Standard & Poor's has a global network of approximately 8,500 employees in 23 countries, assigning credit ratings to entities in over 100 countries.

We have been active in Australia since Standard & Poor's first assigned ratings to the Commonwealth of Australia in the mid-1970s. The forerunner to Standard & Poor's (Australia), Australian Ratings Pty. Ltd., first assigned ratings in the Australian market in 1982. Standard & Poor's currently maintains ratings on over 800 entities in Australia making it the leading provider of Australian credit ratings to the local market. These activities cover a broad range of sectors, including governments and government enterprises and authorities; utilities; infrastructure entities and projects; private sector corporations across most industry sectors; banks and non-bank financial institutions; structured finance programs and transactions; life and non-life insurance entities; and managed funds and mutual trusts. In Australia, Standard & Poor's has a staff of more than 150 employees making it the fifth largest operation in Standard & Poor's global network.

I would also like to discuss the nature of our credit ratings. At their core, Standard & Poor's credit ratings represent our opinion of the likelihood that a particular obligor or financial obligation will timely repay owed principal and interest. Put another way, we assess the likelihood, and in some situations the consequences, of default. Furthermore, ratings speak to one topic and one topic only — credit risk. Ratings clearly do not address whether investors should "buy", "sell" or "hold" rated securities for example. Finally, we do not advise. It is against our code of conduct for the Ratings Services group to create, design, structure, consult or advise on a particular transaction or entity. Therefore, our comments are provided in the context of the impact of the trends you have identified on the states' credit quality.

<u>Australian state government credit quality is strong</u>

As a general observation, the credit quality of the Australian states and territories is very high. New South Wales, Victoria, Queensland, South Australia, Western Australia and the Australian Capital Territory are all rated 'AAA', which is Standard & Poor's highest rating and reflects our assessment of an extremely strong ability to meet financial commitments on an obligation. Tasmania is rated 'AA+', a rating which differs from 'AAA' only to a small degree and represents a very strong ability to meet a financial commitment. The Northern Territory is not rated. Standard & Poor's rates about 190 sub-sovereign governments in the developed world outside the United States and only about 16% are rated 'AAA'.

To help put these ratings in perspective, Standard & Poor’s regularly monitors the transition and default history of entities at various rating levels. The 2007 global corporate default study analyses the rating histories of 13,162 companies that were rated by Standard & Poor's as of Dec. 31, 1980, or that were first rated between that date and Dec. 31, 2007. Using that database, only 0.5% of entities rated ‘AAA’ had defaulted within seven years. This compares with a default rate of 0.6% of entities rated in the ‘AA’ category; 1.3% default rate of ‘A’ category ratings; 4.2% of ‘BBB’ category ratings; 15.4% of ‘BB’ ratings; 29.9% of ‘B’ ratings; and 50.2% of ‘CCC/C’ ratings.

Budgeted increases in debt are consistent with the states’ high ratings

A clear trend has emerged in state budgets over the past few years suggesting increased appetite for debt-funded capital spending. Standard & Poor’s believes that the budgeted increase in debt remains consistent with high ratings for three reasons:

1. The overall debt burden remains low. Although the increase in debt is large in magnitude, it comes from a low base. State balance sheets are strong, following the fiscal consolidation and falling debt of the mid- to late-1990s arising from a combination of improved operating performance, reduced capital spending and (in some cases) assets sales. This was in contrast to the late 1980s and early 1990s which were characterized by fiscal weakening and growing debt due to a combination of profligate policy and a deep recession.
2. Budgetary performance is adequate. The increased debt is being used to fund capital spending and is set against a backdrop of operating positions which are typically in surplus. In the past few years, many state governments have taken measures to significantly improve their operating position, largely through various efficiency drives and tighter budgetary control.
3. There has been and is expected to be no material deterioration in the other factors considered by Standard & Poor’s in assessing sub-sovereign credit quality: economy; system support and predictability; management capacity and institutional stability; financial flexibility; liquidity and debt management; and off-balance sheet liabilities.

As a cautionary note, however, states cannot continue to increase net debt levels at this rate indefinitely and still maintain their ‘AAA’ ratings. Furthermore, as debt increases, it becomes increasingly important to maintain an adequate operating surplus – particularly to guard against the risk of a slowing economy – if states wish to maintain their ‘AAA’ ratings.

Commonwealth-state relations support credit quality

Standard & Poor's believes that the Australian states and territories have limited fiscal flexibility, primarily resulting from the Australian institutional environment. In this environment, the Commonwealth holds most of the taxation powers, whereas the states have most of the responsibilities to deliver services. Although the states' fiscal flexibility tends to be a systemic weakness, a number of other factors, including strong fiscal management within these institutional constraints, have ensured that the states have been assigned high ratings. This issue is discussed in more detail in the attached paper: “Financial Flexibility – A Weak Point for all Australian States”.

Nevertheless, this weakness is largely offset by our view that the Australian system of support and transparency in inter-government relations is one of the strongest in the world. This issue is discussed in more detail in the attached paper: “System Support and Predictability for Australian State Governments”.

State ownership of utilities tends to increase risk

From a credit perspective, there is always a trade-off between diversity of revenue and business risk associated with ownership of government businesses, such as electricity businesses. This is because although investment in trading enterprises increases revenue flow for governments, this revenue is subject to more risk than taxes, fees and charges – particularly when the revenue is generated by businesses operating in competitive markets such as electricity generation.

This is not to say that ownership of such trading enterprises is inconsistent with high credit ratings – a number of states still own energy assets and maintain a ‘AAA’ rating. However, trading enterprise ownership does require offsetting strengths to achieve the ‘AAA’ rating. Just as South Australia’s weaker economy relative to peers requires a stronger balance sheet relative to peers to achieve a ‘AAA’ rating, those states with large ownership of higher risk trading enterprises require a stronger balance sheet than peers to mitigate the extra risk. The flip side of the same coin is that states without ownership of higher risk trading enterprises can hold higher levels of debt to fund other spending – such as roads and hospitals – than states that do own trading enterprises and still maintain similar credit quality.

<u>Further contact details</u>

I am pleased to have presented this submission and trust that you will find it useful. Standard & Poor’s understands that this submission may be made public at some stage and I can confirm that no portion of it is confidential.

Thank you also for the invitation to appear before the committee and expand on the submission. However, we believe that appearing before such a committee would be inconsistent with our role and must therefore decline. Nevertheless, we are happy to expand on any of the views in this submission in private with you or your representatives. To organize such a meeting, please contact Brendan Flynn, who is the team leader of our Sovereign and International Public Finance group, on (03) 9631 2042.

Yours Sincerely

Chris Dalton