Moody's Investors Service

Submission to Australian Senate's Select Committee on State Government Financial Management
May 1, 2008
Moody's Ratings of Australian States

I. Introduction

Moody's welcomes this invitation to provide a submission to the Senate Select Committee on State Government Financial Management on our assessment and outlook for the credit quality of Australian states/territories.

Moody's currently has credit ratings on seven of the eight Australian states/territories, assigning Aaa ratings to New South Wales, Victoria, Queensland, Western Australia, South Australia and Tasmania, and a Aa1 rating to the Northern Territory. Moody's does not currently rate the Australian Capital Territory. The high ratings[1] reflect our view of the positive underlying credit position of the states, supported by their sound financial performance and favorable debt profiles. In addition, the ratings of Tasmania and Northern Territory are elevated by our assessment that there is a strong probability that the Commonwealth Government would come to the aid of any state or territory in the event of a fiscal crisis. All of the ratings assigned have stable outlooks.

The favorable underlying credit position of the Australian states/territories reflects their sound financial performance, characterized by many years of surplus operations supported by strong growth of tax revenues and Commonwealth transfers along with prudent financial management. The states' low debt burdens and correspondingly moderate debt service costs are of key importance to credit quality. The strong system of intergovernmental fiscal transfers and many years of economic expansion are also rating positives. Credit challenges facing the states stem from rising budgetary pressures for service enhancements and associated wage costs, and, more importantly, from the potential debt impact of large capital improvement programs being implemented by most states.

II. How Does Moody's Rate Australian States?

We would like to briefly outline the meaning of Moody's ratings and the analytic approach taken by Moody's in rating local and regional governments. The International Public Finance Group at Moody's covers the credit quality of 291 local and regional governments outside of the United States.

Moody's credit ratings are forward looking opinions that address just one characteristic of fixed income securities – their creditworthiness. Ratings are not statements of fact about past occurrences or guarantees of future performance and they do not constitute a recommendation to buy, sell or hold a security. Ratings are designed exclusively for the purpose of ranking bonds according to their relative credit risk and do not take into consideration factors such as the direction of future market prices, an

[1] Only 13.4% of the 291 local and regional governments rated outside the US are rated Aaa.

investor's investment objectives, or the investor's risk parameters. Ratings are internationally comparable and at the same time they must acknowledge the particular circumstances of each individual country or region.

The factors that determine credit quality for local and regional governments, both quantitative and qualitative, are grouped into six categories. These categories can be broadly organized into general risks and specific risks. The first two factors, or general risks, are those that apply to all local and regional governments in a country and are related to its economic strength and stability, as well as the institutional framework that allots powers and responsibilities between the national government and the local and regional government sector:

- Operating Environment
- Institutional Framework

The remaining four factors speak to specific risks which are those that are reflected by the status and performance of individual Australian states/territories:

- Finances and Budgetary Performance
- Debt Profile
- Governance and Management
- Economic Fundamentals

III How Do These Rating Factors Apply to Australian States/Territories

- **General Factors: Operating Environment and Institutional Framework**

The Operating Environment refers to the national economic and political context in which local and regional governments function. It revolves around the national circumstances that affect the risk of a broad economic, financial market or political crisis. In assessing this factor, Moody's considers the nation's susceptibility to systemic shock by reviewing current economic circumstances and recent economic and financial history.

The operating environment for Australian states/territories is typical of advanced industrial economies as reflected in the country's relatively high GDP per capita, low GDP volatility and high ranking on the World Bank's government effectiveness index. These characteristics suggest a low level of systemic risk, as reflected in the Aaa ratings assigned to Australia's country ceiling and debt.

The Institutional Framework encompasses the arrangements that determine intergovernmental relations and shape local and regional government powers and responsibilities. This factor addresses a local and regional government's public policy responsibilities and the adequacy of its fiscal powers to meet them. It also addresses the way in which these responsibilities and powers may be altered, whether by a higher tier entity or by the local and regional government itself.

Institutional Framework Underpins States/Territories' Ratings In Moody's view, the institutional framework in Australia is well-established and stable and is a key support of the Aaa/Aa1 ratings. It provides Australian states/territories with policy flexibility over own-source revenues and discretion over expenditure decisions which provide them the tools to respond to adverse budgetary developments.

The strong financial support provided by the Commonwealth Government through fiscal transfers to all states and territories is a key factor in the ratings. A significant portion of grants is distributed according to a formula that seeks to reduce revenue-raising and cost disparities between jurisdictions. The states/territories also receive grants that are earmarked for specific purposes. It is Moody's view that while changes to arrangements can be made on a unilateral basis by the Commonwealth Government, the Commonwealth is unlikely to make drastic changes that would unduly harm states.

The fiscal framework benefits from states/territories' autonomy, including the ability of states/territories to raise tax rates without restriction. However, states/territories have a relatively narrow range of taxes at their disposal as major revenue sources such as personal and corporate income tax and value added tax are held by the Commonwealth (although the GST is transferred to the states). This contrasts, for instance, with Canadian provinces, which collect a much broader range of taxes, including income tax and sales taxes, while Italian regions and German states have access and control over a much narrower range of taxes than do the Australian states/territories.

The proportion of Australian states/territories own source revenues has declined over the past ten years (first due to a high court decision to declare certain state taxes illegal and later with the elimination of some own source taxes as part of national tax reform). This has reduced, to a moderate extent, the states/territories' ability to adjust revenues as a policy response to fiscal difficulties. It can exacerbate issues of government accountability as tax collections do not closely match expenditure responsibilities. This concern is offset in part by the overall predictability and stability of the intergovernmental grant system which makes a significant contribution to state/territory revenues. The much higher reliance on Commonwealth grants by the Northern Territory and Tasmania results in a significantly lower degree of own source revenue flexibility compared with other states; both of these states, however, also benefit from a more secure source of income given that a greater proportion of grants are distributed according to the equalization formula under current arrangements.

States/territories also have full authority to adjust a significant portion of their expenditures although they are subject to political constraints with regard to reducing staffing levels or cutting back on essential services such as health, educational, community services and public security costs.

- **State Specific Factors:**

- **Finances and Budgetary Performance**

The ability of local and regional governments to implement policy decisions that generate balanced or positive fiscal outcomes which enhance long-term financial strength is a credit positive. The bottom line in Moody's analysis of financial performance is an assessment of the government's ability to cover all its costs, including debt service.

Robust Revenue Growth and Prudent Financial Management Boost Sound Record of Surplus Operations. The positive financial performance of Australian states/territories has been characterized by many years of surplus operations covering both operating and capital expenditures [net lending/(borrowing) result] for the general government sector and moderate deficits when operations of government corporations are included. General government surplus operations have spanned many consecutive years in most cases. Favorable results have been amply supported by robust revenue growth owing to many years of economic expansion in Australia and particularly strong growth in the property market which underpins major state government taxes including conveyancing duties and land taxes. At the same time, states/territories benefited from growth in fiscal transfers as the national economy expanded. While the states/territories have not shown equal facility in containing current expenditures in the face of fast growing revenues, generally they have implemented conservative budgetary practices and fiscal policies designed to minimize indebtedness. Sound fiscal management is evidenced by budget outcomes that typically exceed projections year after year.

Deficits Emerge as Most States/territories Embark on Major Infrastructure Spending. In recent years, some states/territories have shifted their financial goals from surplus operations and an easing of the debt burden to a greater focus on building up capital infrastructure financed to a greater extent by debt. As a result, deficits are emerging in many states/territories and are expected to persist over the medium term. Some states/territories are projecting fairly significant deficits, particularly in their consolidated sectors.

Moody's believes states/territories are well placed to absorb deficits because of a strong financial position built up over many years; we would anticipate that given conservative budgeting practices, deficits will likely be more moderate than projected. Wage hikes and increased demand for services have created fairly rapid rates of growth in health, policing and community services, which could create challenges should revenues not grow at historic rates. These costs will be harder to reign in than capital spending and will in some cases require greater cost control efforts than have been undertaken in the past. Given the states/territories' large capital improvement programs and reported labor shortages, states/territories will also have to maintain strong vigilance over capital expenditures to contain cost escalation.

In the event of a national economic slowdown, states/territories would also have to contend with slower growth in Commonwealth grants--to the extent that GST revenues, the backbone of unconditional transfers, decline. It is our view that should a more complicated fiscal environment eventuate, states/territories will likely implement the appropriate corrective policy measures to ensure that credit quality is maintained.

- **Debt Profile**

Moody's relates the government's debt level to measures of ability to pay such as the size of the government's revenue flow and the jurisdiction's economic output, as measured by GDP. Contingent liabilities, such as unfunded superannuation liabilities, are also of key importance to our analysis.

Debt Burden is Low Compared to International Peers. The Australian states/territories support very low debt burdens[2] when compared with their international peers. Low gearing is a reflection of prudent financial management, a cautious approach to debt issuance in the past and in some cases, privatization of large utility assets, the proceeds of which were used to retire debt. New South Wales, Victoria and South Australia have the lowest indebtedness levels, with debt to GDP of between 5 and 7%, followed by Western Australia and Queensland between 8 and 10%, and Northern Territory and Tasmania at just over 20%. This compares to Canadian provinces whose debt burden ranges from 16% to 42%--with the exception of Alberta at 2%--and the German Lander, ranging from 17% to 115%--with the exception of Bavaria at 7%.

The nominal amount of the states/territories' gross debt outstanding has remained fairly stable despite positive financial performance because the states/territories maintain debt levels at certain levels for debt management purposes. The debt burden of the states/territories have eased or remained stable in most cases over the past five years as revenues and the economy have expanded.

The states' treasury corporations typically retain holdings of significant liquid assets which provide an important cushion for debt obligation and mitigate market access issues. In most cases, if required states could meet debt obligations even in the absence of capital market access for a six to twelve month period. While financial assets are not netted out of Moody's ratios, we do take into account that the considerable holdings of cash and marketable securities afford the states an important operating cushion.

In some states/territories unfunded superannuation liabilities represent a relatively large liability, but most have made considerable strides in reducing these liabilities principally through the closure of most defined benefit plans. It should be noted that only Queensland's superannuation liabilities are fully funded.

Borrowing Requirements to Rise to Fund Infrastructure. The debt burden of most of the states will likely rise over the medium term as the states/territories embark on significant capital improvement programs to build roads, schools, hospitals, power plants, ports, and rail systems. States/territories are also engaging in substantial investments in water facilities, such as desalination plants, to ensure water supply in the face of concerns regarding climate change. Most jurisdictions have begun to ramp up spending in recent years and over the next four years capital spending is projected to reach a considerable A$172 billion (from 2007/08 through 2010/2011), a near doubling compared to A$97 billion spent over the four years through 2006/2007. Approximately 40% of the combined programs or A$72 billion is expected to be funded through borrowing, although there is a large range between the states. Of key importance to containing debt increases will be the ability of states/territories to control escalations in construction and wage costs related to reported labor shortages. While Moody's will closely monitor the impact that increased borrowing could potentially have on credit quality, the impact of

[2] Moody's calculates debt burden ratios (net and guaranteed debt to GDP and to revenues) utilizing gross debt of the consolidated state sector, net of public corporations that are self-supporting through tariffs or user charges (and therefore not considered a burden on the tax base). Moody's debt ratios are internationally comparable and were developed to facilitate comparisons between the Australian states/territories and the 291 rated local and regional governments worldwide.

rising debt levels on debt burden is expected to be offset by growing revenues and economic expansion. Also, a significant portion of debt will be issued for large utility companies that are self-supported through user charges which are regulated.

- **Governance and Management**

Multi-Year Planning and Significant Degree of Transparency. The Australian states/territories compare favorably to their international peers on governance and management factors. Multi-year budget projections, prudent forecasts and contingency provisions have contributed to a strong state record of exceeding targets over many consecutive years. States forecast accrual and cash operations for their core general government sector and public corporations for four years, and frequent reporting and updating of these estimates is provided. Comprehensive annual statements and periodic interim statements offer a significant degree of transparency.

- **Economic Fundamentals**

A local or regional government's ability to service its debt depends on, among other factors, the sufficiency and reliability of its future revenues. These are tied in part to the local economy's ability to generate necessary revenues. In addition, the local economy and population mix are key determinants of spending needs. A jurisdiction undergoing economic expansion with growing job opportunities may experience rapid population growth, generating increased service demands and requiring costly infrastructure upgrades.

States/territories Well Positioned to Face Potential Effects of Global Economic Conditions. An unprecedented 17-year trend of economic expansion and strong housing markets have supported robust growth in state/territory revenues. The real estate boom of the mid 2000s provided large revenue windfalls supported by burgeoning conveyancing duties and other taxes associated with the property market. The pace of growth for these revenues has slowed in tandem with a calmer - but still stable - housing sector, although interest rates hikes over the past year pose a risk to the outlook.

In recent years, growth rates between states/territories have diverged, with Western Australia, Queensland and Northern Territory now benefiting from booming resource sectors which has led to rapid economic expansion, while "non-resource" states are growing more slowly as they have been affected to a greater degree by drought conditions, appreciation of the Australian dollar and a higher interest rate environment. These factors along with the current global credit tightening and less supportive world economic conditions could lead to a slowdown in the states' economic performance, although recent trends indicate that the continued growth in China is likely to mitigate potential impacts. It is Moody's view that Australian states/territories are well positioned to face less supportive economic conditions and given their fiscal prudence would likely respond with appropriate policy actions, if required.

IV Appendix: Note on Joint Default Analysis

Moody's applies a joint default analysis methodology to its ratings of local and regional governments. The JDA methodology aims to incorporate in a systematic way the likelihood that a higher tier government would provide extraordinary support to a local or regional government in a crisis situation in order to prevent a default by the local or regional government. The likelihood of this support is based on a number of factors, including the credit strength of the higher tier government, the policy stance of the higher tier government towards lower tier governments and the potential political embarrassment on the domestic or international stage that could impact the higher tier government's reputation or the reputation of the other local/regional governments within the country.

This evaluation requires two key inputs: a baseline credit assessment (BCA) on a scale of 1-21 (in which 1 represents the lowest credit risk), which is the measure of the local government's standalone credit strength, and an assessment of the likelihood that the higher tier government would act to prevent a default by the local government. First Moody's assigns a BCA to each Australian state/territory and to complete the analysis Moody's assigns a very high likelihood of extraordinary support from the Commonwealth Government, reflecting Moody's assessment of the risk to the Commonwealth's reputation in the unlikely event that any state or territory were to default.

Moody's assigns a BCA of 1 to New South Wales, Victoria, Queensland, Western Australia and South Australia, which places these states in the Aaa rating bracket before any consideration of the likelihood that the Commonwealth of Australia would act to prevent a default by the state. The BCA of Tasmania is 2, equivalent to a Aa1, and the BCA of the Northern Territory is 3, equivalent to a Aa2. As the result of the very high likelihood of Commonwealth support these entities' ratings are lifted by one notch to Aaa and Aa1, respectively.