FitchRatings

June 23, 2022

Mr. Bernard Gastin
Executive Director - Department of Treasury and Finance
Victoria, State of
1 Treasury Place
Melbourne,VIC 3002
Australia

Dear Mr. Gastin:

Re: Fitch rating assignment regarding Treasury Corporation of Victoria

Fitch (see definition below) assigns the following ratings.

Treasury Corporation of Victoria	LC LT IDR	AA+ ●	New Rating
	LC ST IDR	F1+	New Rating
	LT IDR	AA+ ●	New Rating
	ST IDR	F1+	New Rating

RATINGS KEY	OUTLOOK	WATCH
Positive	⊕	◆
Negative	⊖	◆
Evolving	●	◆
Stable	●	

Applicable Criteria: Government-Related Entities Rating Criteria, International Local and Regional Governments Rating Criteria, Public Sector, Revenue-Supported Entities Rating Criteria

Treasury Corporation of Victoria's (TCV) long- and short-term ratings are aligned with Fitch's internal assessment of the credit quality of the State of Victoria (VIC) in accordance with our Government-Related Entities (GRE) Rating Criteria.

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Derivation Summary

The ratings are based on VIC's SCP of 'aa+', assigned under Fitch’s International Local and Regional Governments (LRG) Rating Criteria as a combination of a 'Stronger' risk profile and debt-sustainability score in the 'a' category. The Long-Term IDRs of 'AA+' are driven by the SCP with no other factor affecting the ratings.

VIC's Short-Term IDR is 'F1+' as its Long-Term IDR lies between 'AAA' and 'AA-', according to our LRG criteria.

Fitch classifies Australian states and territories as 'Type A' LRGs based on their structural attributes, such as their material share of general government expenditure, including responsibilities for health and education spending, tax-sharing arrangements with the federal government and ability to incur and sustain budgetary deficits.

TCV is integral to our rating assessment of VIC, given its central function within the state’s financial management framework. TCV is the debt-issuing entity for the VIC government and state authorities and provides a range of financing and investment services for the state. We consider the credit profile of TCV as inherently linked to that of the VIC government due to its key role in the state's financial management and the state’s full guarantee of its debt obligations.

Fitch regards TCV as a government-related entity (GRE) under our GRE rating criteria and equalises its ratings to those of VIC. The rating equalisation does not depend on our assessment of the strength of linkage between the two entities and the state's incentive to support the GRE, as VIC provides a full guarantee for TCV's debt obligations, which acts as an overriding single factor leading to rating equalisation under the criteria. As a result, the key rating drivers reflect those of the state.

Key Rating Drivers

'Stronger' Risk Profile: VIC is evaluated across six risk factors, which we assess as 'Stronger' (revenue robustness, revenue adjustability, expenditure sustainability, liabilities and liquidity robustness and liabilities and liquidity flexibility) or 'Midrange' (expenditure adjustability). We do not assess any factors as 'Weaker'.

The ‘Stronger’ risk profile assessment reflects a negligible risk relative to international peers that the state’s ability to cover debt service with its operating balance may weaken unexpectedly over the forecast horizon (FY22-FY26) because of revenue that is lower than our expectations or expenditure above expectations, or because of an unanticipated rise in liabilities or debt-servicing requirements.

'Stronger' Revenue Robustness: VIC enjoys broadly stable revenue, which is supported by a diverse economy and strong growth prospects, despite exposure to economic cycles and the temporary disruptions of the pandemic. The state economy is large, contributing around a quarter of national GDP, with a large services sector and limited industry concentration. Economic growth correlates to national growth while population growth is above the national average. Around half of the state’s revenue comes from federal grants, which are allocated under a well-established and stable transfer system, and a further third from a broad range of state taxes. VIC’s Fitch-adjusted total revenue CAGR for FY17-FY21 was 4.9%, above both the state’s GDP growth of 3.7% and national GDP growth of 4.5%.

'Stronger' Revenue Adjustability: Australian states have unrestricted ability to adjust own-source revenue, although typically avoid major changes due to political pressure or to remain competitive with domestic peers. Budgetary flexibility is partially restrained by a large system of federal transfers, which provides around half of the states' total revenue, although the large economy and taxpayer base of VIC provide it with a high degree of revenue independence and additional fiscal leeway relative to interstate peers. Fitch estimates that additional revenue that VIC could generate via taxation adjustments would cover over 200% of a reasonably expected decline in revenue, within an acceptable affordability range for taxpayers. This indicates a 'Stronger' assessment of revenue adjustability under our criteria.

'Stronger' Expenditure Sustainability: States are responsible for non-cyclical expenditure, such as education, and moderately countercyclical expenditure, including healthcare. Social welfare is covered by the central government, which alleviates major counter-cyclical spending at the state level. VIC has a good record of control over its expenditure over time, which delivered sustained operating surpluses prior to the significant pandemic disruptions from the latter half of FY20. We expect the state will remain committed to financial discipline to deliver on its fiscal strategy, which includes a return to operating surpluses over time, despite the current cost pressure from its health response and stimulus spending relating to the pandemic.

'Midrange' Expenditure Adjustability: Australian states' broad expenditure responsibilities restrict their ability to reduce spending in response to shrinking revenue, despite their extensive powers to manage the delivery of their public services. Staff costs contribute around 37% of VIC's total Fitch-adjusted expenditure, and key public services of health and education around 49%. We consider these cost areas offer limited flexibility to reduce. Capex accounted for 13.6% of Fitch-adjusted expenditure in FY21, which we expect will increase to an average of around 18% over FY22-FY26 with the state's expanded capital programme. Capex provides some budgetary flexibility via the ability to reduce or defer capital projects. Overall, we estimate that around 84% of VIC's total costs are inflexible, which is within our criteria threshold of between 70% and 90% for a 'Midrange' assessment of expenditure adjustability.

'Stronger' Liabilities and Liquidity Robustness: VIC takes a prudent approach to management of its debt and liabilities and maintains extensive, well established access to capital markets via its central financing authority – Treasury Corporation of Victoria (TCV). TCV provides tailored loans and financing, advisory, and investment services to the state government and state-related entities and sources funds by issuing a range of debt instruments in large and liquid domestic and international financial markets to institutional investors. The debt profile is long-dated with an even spread of maturities, and interest rate and foreign exchange risks are actively managed via predominantly local currency debt, issuance of fixed rate bonds and hedging. In the absence of formal prudential regulation, TCV and the state government demonstrate control over borrowing levels via consistent capital market discipline and scrutiny.

'Stronger' Liabilities and Liquidity Flexibility: TCV has well-established access to capital markets to support its funding requirements and maintains large internal liquidity resources with prudent liquidity controls, including pre-funding of maturing debts. Successful debt issuance is assisted by an extensive dealer panel and a large investor base. Major banks dominate TCV's bond holder profile with around 29% at April 2022, with domestic asset managers at 25% and the Reserve Bank of Australia holding 17%. In addition, TCV debt is a tier 1 asset for Australian banks under the Basel III framework, which supports demand for TCV debt in both normal and difficult market conditions. TCV had large holdings of liquid financial assets at 30 April 2022 of AUD14.8 billion and AUD17.4 billion for the total state sector.

Debt Sustainability: 'a' Category

VIC’s debt sustainability assessment is based on a rating case scenario representing Fitch's view of the state’s likely debt trajectory and fiscal performance to the financial year ending June 2026 (FY26), allowing for some downside risk. Our primary rating metric for ‘Type A’ LRGs is the economic liability burden, which combines the state's net adjusted debt and a pro rata share of federal debt, relative to state GDP (the pro rata share of federal debt is calculated based on a mix of the state's shares in the nation's GDP and population).

The metric therefore takes account of Australia’s federal debt, which we project will rise in each year of the rating case forecast period, but as a share of GDP the debt ratio will stabilise around FY24 and begin to decline slightly from FY25. We expect the stabilisation of VIC's debt to GDP ratio will be more protracted and expect it to continue to rise over our forecast horizon to FY26, although at a slowing rate. We expect the debt ratio may stabilise around FY27. The economic liability burden will rise to 76.3% in FY26 under our rating case, from 65.6% in FY21. This is in the 'a' category range of 70%-100%.

Fitch’s key secondary metric, the payback ratio (operating balance / net adjusted debt), will improve to 34.1x in FY26 under our rating case scenario, from -10.7x in FY21. This is in the 'b' category.

The assessment is based on the state's direct debt rising sharply to AUD179.8 billion in FY26, from AUD78.0 billion in FY21, and net adjusted debt to AUD199.9 billion in FY26, from AUD105.1 billion in FY21. Fitch’s calculation of the state’s net adjusted debt includes senior unsecured debt and other liabilities that we view as debt-like, such as public-private partnerships, leases, service concessions and superannuation liabilities, and nets out the state’s cash, short-term liquid investments and investments dedicated to debt retirement.

Fitch does not override the debt sustainability score indicated by the primary metric on account of the weaker payback ratio, due to the primary metric being at the stronger end of the ‘a’ category. The debt sustainability score recognises the strength and diversity of VIC’s underlying economy and taxpayer base and the state’s ability to return to a healthy fiscal position over time via a disciplined approach to its fiscal management. The debt sustainability assessment also takes account of the state’s strong liquidity with ready access to large and liquid debt markets and significant contingent liabilities from the state’s guarantee of TCV’s debt obligations

Rating Case Scenario Assumptions

Fitch's rating case is a "through-the-cycle" scenario, which incorporates a combination of revenue, cost and financial risk stresses. It is based on FY17-FY21 figures and FY22-FY26 projected ratios. The key assumptions for the scenario include:

- Operating revenue CAGR of 4.0% in FY22-FY26 (FY17-FY21: 4.5%);

- Operating expenditure CAGR of -0.4% in FY22-FY26 (FY17-FY21: 10.4%);

- Net capex to average AUD14.8 billion in FY22-FY26 (FY17-FY21: AUD8.6 billion);

- Cost of funds to average 3.7% in FY22-FY26 (FY21: 4.1% Fitch-estimated average cost of funds)

Sovereign assumptions:

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- National real GDP growth ranging from 0.8% to 4.5% over the FY22-FY26 period, guided by Fitch's Australian sovereign forecasts incorporated in its June 2022 Global Economic Outlook report with economic stresses added.

- Federal government debt increasing annually from AUD843.9 billion in FY21 to AUD1,122.5 billion in FY26.

Summary of Other Rating Factors

VIC does not benefit from any ad-hoc support factors from the federal government, such as additional revenues, one-off adjustments to equalisation transfers, special access to federal tax revenues or exemption from expenditure obligations.

We do not identify any asymmetric risk factors.

Rating Sensitivities

Factors that could, individually or collectively, lead to negative rating action/downgrade:

A rating downgrade could result from a deterioration in VIC's budgetary performance from a failure to control capex and deliver on its fiscal targets, leading to larger or more prolonged deficits and higher debt levels than we currently project in our rating case scenario. This could result in a softening of VIC's risk profile from its current 'Stronger' level, particularly from a weaker assessment of VIC's expenditure sustainability, or a weaker debt sustainability score from an economic liability burden exceeding 80% on a sustained basis in our rating case scenario and no clear downward trend in payback ratio towards the 'a' category (less than 13x).

Negative rating action on Fitch's internal assessment of the State of Victoria would be mirrored in TCV's ratings.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

Positive rating action could result from an improvement in the state's fiscal position via a more rapid return to sustained operating surpluses than projected in our rating case and control of capex, leading to improved debt metrics. This would also likely reflect a stronger recovery in the state economy than we currently project. This outcome would be evident in an economic-liability burden comfortably below 70% on a sustained basis in our rating-case scenario together with evidence of a steady downward trend in the payback ratio towards the 'a' category.

Positive rating action on Fitch's internal assessment of the State of Victoria would be mirrored in TCV's ratings.

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We are pleased to have had the opportunity to be of service to you. If we can be of further assistance, please contact Paul Norris, Director at +61 2 8256 0326.

Sincerely,

Fitch Australia Pty Ltd

Agreement ID# 142696

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