

CHAPTER 4 – FINANCIAL SUSTAINABILITY OF VICTORIAN GOVERNMENT

- This chapter builds on the information presented in Chapter 3, by incorporating the broader public sector, through the addition of the State's public non-financial corporations (PNFCs) to the general government sector, thereby producing the non-financial public sector (NFPS).
- The PNFC sector is forecasting a net surplus from transactions of \$31 million in 2009-10. The net result from transactions is expected to improve over the remainder of the forward estimates period, largely due to strong growth in income from sales of goods and services by the water sector.
- NFPS capital spending on new infrastructure for the four years to 2012-13 will total \$32.1 billion. This represents a major increase compared to the four years to 2008-09, and reflects significant investment in water, transport and other essential infrastructure.
- NFPS net debt is expected to increase from 4.2 per cent of gross state product (GSP) in June 2009 to an estimated 10.0 per cent by June 2013. This reflects the State's strategy of using its strong financial position to respond to the economic downturn by investing in infrastructure that will stimulate economic growth and jobs in the short term, whilst increasing Victoria's future productive capacity in the longer term.
- NFPS net financial liabilities are expected to increase to 20.2 per cent of GSP by 2012-13, reflecting increases in borrowings and superannuation liabilities. Despite the increase, total net financial liabilities will remain at prudent and sustainable levels and are not expected to affect the State's triple-A credit rating.

INTRODUCTION

This chapter provides an overview of the activities of the broader public sector, by adding the State's PNFCs to the general government sector, to form the State's NFPS. The fiscal aggregates reported in this chapter are not targeted by the government's budget strategy, although they do contribute to the Government's objective to maintain net financial liabilities at prudent levels, including the maintenance of a triple-A rating.

FINANCIAL PERFORMANCE OF THE PUBLIC NON-FINANCIAL CORPORATIONS SECTOR

The PNFC sector comprises a wide range of entities that provide goods and services (of a non-financial nature) to the public while meeting commercial principles through cost recovery via user charges and fees. The most significant of the Victorian PNFCs are those providing water, housing, transport and port services.

Table 4.1: Public non-financial corporations operating statement for the financial year ending 30 June^(a)

	(\$ million)			
	2009-10 Budget	2010-11 Estimate	2011-12 Estimate	2012-13 Estimate
Revenue				
Interest	55.5	47.2	47.5	48.6
Dividends income tax equivalent and rate equivalent revenue	35.9	41.9	47.9	51.0
Sales of goods and services	4 148.6	4 514.2	4 980.3	5 351.6
Grants	2 851.7	2 516.4	2 376.2	2 385.5
Other current revenue	467.8	492.4	478.1	487.5
Total revenue	7 559.6	7 612.2	7 930.1	8 324.2
Expenses				
Employee expenses	803.4	831.2	854.9	875.5
Other superannuation	69.4	71.6	73.1	74.7
Depreciation	1 055.4	1 110.1	1 175.0	1 215.1
Interest expense	700.7	883.1	1 025.3	1 095.3
Other operating expenses	3 865.9	3 911.5	4 057.5	4 221.9
Grants and other transfers	943.7	558.2	283.8	245.6
Other property expenses	90.3	116.4	134.2	173.1
Total expenses	7 528.7	7 482.0	7 604.0	7 901.1
Net result from transactions – Net operating balance	30.8	130.2	326.1	423.1

Source: Department of Treasury and Finance

Note:

(a) This is an abbreviated operating statement. The full statement is shown in Budget Paper No. 4, Chapter 2, and provides additional information on economic flow measurements which, when added to the net result from transactions yields the net result.

Revenue

Total revenue is forecast to increase an average of 5.3 per cent per annum over the four years to 2012-13. Sales of goods and services, which account for an estimated 54.9 per cent of total PNFC revenue, are expected to increase by an average of 7.3 per cent per annum over the period. This is largely driven by strong growth in the water sector, which is expected to achieve average annual growth in sales of goods and services of 14.4 per cent over the four years to 2012-13. The revenue growth is largely underpinned by anticipated increases in the price of regulated water, as determined by the Essential Services Commission. The price rises allow the water sector to recoup the cost of the major infrastructure upgrades that will drought proof the State.

The other major source of revenue for the PNFC sector is grants income, which accounts for an estimated 37.7 per cent of total revenue in 2009-10. After increasing to \$2 852 million in 2009-10, grants income is projected to decline to \$2 376 million by 2011-12 before a slight increase in 2012-13. The increase in 2009-10 and decline in 2010-11 is largely due to changes in the Commonwealth funding agreement with Housing and Community Building (formerly Director of Housing).

Other sources of revenue are projected to remain relatively steady over the period.

Expenses

The average expected rate of growth in expenses over the four years to 2012-13 is 3.6 per cent. Other operating expenses largely consist of operating supplies and consumables in the water and transport sectors, and account for an estimated 51.3 per cent of total expenses in 2009-10. Other operating expenses are projected to increase across the forward estimates period to \$4 222 million by June 2013. The increase can be largely attributed to the Metropolitan Water sector, reflecting higher operational costs associated with new infrastructure. In addition, the item also includes a significant increase in the capital assets charge incurred by Victorian Rail Track, for which there is an offsetting revenue item within grants income.

Interest expense is forecast to increase to \$1 095 million by 2012-13. This represents an average annual growth rate of 19.8 per cent, and is underpinned by the expected increase in borrowings from \$8 303 million in June 2009 to \$16 800 million by June 2013.

Other property expenses consist of State Income Tax Equivalent expenses, and are expected to increase to \$173 million by 2012-13. This largely relates to the Metropolitan Water sector, and reflects improved trading results over the forward estimates period.

Net result from transactions

The PNFC sector is forecasting a net surplus from transactions of \$31 million in 2009-10. The sector has budgeted for improved operating surpluses for the remainder of the forward estimates period, largely attributed to increased revenues from the water sector, combined with low growth rates in major cost categories such as employee expenses and other operating expenses.

FINANCIAL PERFORMANCE OF THE NON-FINANCIAL PUBLIC SECTOR

The Non-Financial Public Sector (NFPS) comprises the general government sector and public non-financial corporation sectors (i.e. it excludes the public financial corporations sector). Table 4.2 below shows the summary operating statement for the NFPS sector, which combines and consolidates the results for the general government and PNFC sectors. Transactions between the general government and PNFC sectors are eliminated, including dividends payable by PNFCs.

Table 4.2: Non-financial public sector operating statement for the financial year ending 30 June^(a)

	(\$ million)			
	2009-10 Budget	2010-11 Estimate	2011-12 Estimate	2012-13 Estimate
Revenue				
Taxation revenue	13 070.6	13 766.9	14 204.9	14 777.5
Interest	455.2	445.5	453.3	456.3
Dividends and income tax equivalents and rate equivalents	117.7	272.6	324.2	314.3
Sales of goods and services	7 957.5	8 496.8	9 025.8	9 451.0
Grants	21 475.8	20 647.5	20 482.7	21 152.3
Other current revenue	2 120.2	2 065.3	1 961.7	1 961.6
Total revenue	45 197.1	45 694.6	46 452.7	48 113.0
Expenses				
Employee expenses	16 042.9	16 721.0	17 447.6	18 085.0
Superannuation interest expense	659.2	677.8	699.9	722.9
Other superannuation	1 668.7	1 733.0	1 762.6	1 843.8
Depreciation	2 701.8	2 895.9	3 106.2	3 229.4
Interest expense	1 379.7	1 808.0	2 099.3	2 198.7
Other operating expenses	16 342.0	16 195.1	16 212.8	16 460.5
Grants and other transfers	6 386.9	5 501.9	4 895.4	4 774.3
Other property expenses	0.0	(0.0)	0.0	0.0
Total expenses	45 181.2	45 532.6	46 223.9	47 314.3
Net result from transactions – Net operating balance	15.9	162.1	228.8	798.6
less Net acquisition of non-financial assets from transactions	8 138.6	6 869.9	4 960.1	1 786.5
Net Lending/(borrowing)	(8 122.7)	(6 707.8)	(4 731.3)	(987.8)

Source: Department of Treasury and Finance

Note:

(a) This is an abbreviated operating statement. The full statement is shown in Budget Paper No. 4, Chapter 2, and provides additional information on economic flow measurements which, when added to the net result from transactions yields the net result.

The net result from transactions is expected to show an operating surplus of \$16 million in 2009-10, before increasing over the remainder of the forward estimates period to an expected surplus of \$799 million by 2012-13.

Growth in revenue is expected to average 3.5 per cent over the four years to 2012-13. Both taxation and grants revenue, which accounts for an estimated 76.4 per cent of revenue in 2009-10 have been discussed in the previous chapter. Sales of goods and services are expected to grow by an average of 4.3 per cent over the period, and includes the impact of strong growth in sales by the water sector.

Growth in total expenses is expected to average 2.9 per cent over the next four years, reflecting effective expenditure management over the period. This is slightly below the expected rate of revenue growth, resulting in a steady improvement in the expected net result from transactions across the forward estimates period.

USE OF CASH RESOURCES BY THE NON-FINANCIAL PUBLIC SECTOR

Table 4.3 below provides a summary of cash generated through the operations of the NFPS, how that cash is applied to infrastructure investment, and the associated impact on net debt.

Table 4.3: Application of cash resources for the non-financial public sector

	(\$ million)			
	2009-10 Budget	2010-11 Estimate	2011-12 Estimate	2012-13 Estimate
Net result from transactions	15.9	162.1	228.8	798.6
Add back: Non-cash income and expenses (net) ^(a)	2 839.9	3 042.3	3 352.1	3 194.6
Net cash flow from operating activities	2 855.8	3 204.3	3 580.9	3 993.2
Less:				
Net investment in fixed assets				
Expenditure on approved projects	10 918.5	9 894.3	7 453.6	5 274.5
Proceeds from asset sales	(376.5)	(381.1)	(331.8)	(316.1)
Total net investment in fixed assets	10 542.0	9 513.3	7 121.9	4 958.5
Finance leases ^(b)	75.4	121.0	840.1	..
Other investment activities (net)	96.6	139.8	138.0	131.5
Decrease/(increase) in net debt	(7 858.3)	(6 569.8)	(4 519.0)	(1 096.7)

Source: Department of Treasury and Finance

Notes:

- (a) Includes depreciation and movements in the unfunded superannuation liability and liability for employee benefits.
- (b) The finance lease recognised in 2009-10 and 2010-11 is in relation to the Victorian Schools Public Private Partnership project. The finance lease recognised in 2011-12 is in relation to the redevelopment of the Royal Children's Hospital.

Investment in non-financial assets

Total net investment in infrastructure includes expenditure on new projects approved in the 2009-10 Budget, including the first funding announcements under the *Victorian Transport Plan*. It also includes projects such as the Royal Children's Hospital, the Wonthaggi water desalination plant and rural water infrastructure improvements in the Goulburn Murray Irrigation District.

Net investment in fixed assets is expected to be \$10.5 billion in 2009-10, and is estimated to total \$32.1 billion over the four years to 2012-13. This represents a significant increase when compared to \$20.4 billion for the four years to 2008-09, and reflects the Government's strategy of continuing to invest in essential infrastructure during a period of declining economic growth.

It is expected that 42.4 per cent of the new infrastructure will be funded by cash operating surpluses. The remainder will be funded by borrowings.

It should be noted however, over \$4.0 billion of expenditure currently shown in Table 4.3 for purchases of non-financial assets is likely to be undertaken as Partnerships Victoria projects and accordingly the cash flow forecasts will be revised when the projects are awarded, to take account of the different cash flow profile.

The Government has already announced significant infrastructure investments for the PNFC sector, including:

- the \$1 billion Northern Victoria Infrastructure Renewal Project (NVIRP) is implementing water distribution and delivery efficiency improvements by 2012-13, to deliver water savings of an average of 225GL per year to be shared equally by irrigators, environment and Melbourne. The Government is contributing \$600 million, Melbourne Water Corporation \$300 million and the Irrigators \$100 million;;
- the \$750 million Sugarloaf Interconnector which will link the Goulburn River to the Melbourne system and transfer a share of the water savings obtained through NVIRP to Melbourne from 2010. Melbourne Water Corporation will finance the delivery of this Project;
- \$610 million for the purchase of another twenty metropolitan trains and associated stabling and maintenance facilities; and
- \$754 million for the delivery of works to address congestion on the metropolitan train network, including electrification to Sunbury and rail extension to South Morang.

Procuring New Infrastructure

Once government determines that there are sufficient grounds and priority for development of a Business Case for a new investment, an analysis is undertaken as to the preferred method of delivery. Project funding methods include utilising cash reserves, operating surpluses or the use of long-term borrowings that match the expected life of the project. Projects can be procured either by traditional methods or via the *Partnerships Victoria* method of public-private partnerships (PPPs).

Partnerships Victoria is most useful in major and complex capital projects with opportunities for innovation, risk transfer, appropriate third-party usage of facilities and the integration of design, construction, and maintenance over the life of an asset, within a single project package. The approach allows for the delivery of key infrastructure projects using private sector expertise to benefit the public sector and the community.

There are currently 18 *Partnerships Victoria* projects in existence with a capital investment of approximately \$5.8 billion. Fifteen of these projects have reached commissioning and are now operational, and a further two projects are expected to reach commissioning in 2009-10.

A significant recent step for PPP policy was the formation of nationally harmonised guidance for the use of PPPs throughout Australia. The National PPP Policy and Guidelines were endorsed by the Council of Australian Governments in November 2008. The National Guidelines are broadly consistent with current Victorian practice, with additional Victorian-specific guidance provided in the *Partnerships Victoria* Requirements.

In PPP projects, the provision of private finance provides the necessary incentives to enable the effective transfer of appropriate risks to the private sector. A current issue arising out of the Global Financial Crisis which is affecting PPPs nationally (and indeed globally) is the shortage of liquidity in financial markets for larger commercial transactions (including PPPs).

Victoria is considering the potential implications of the liquidity shortage on PPP projects and is currently discussing this issue with other jurisdictions, together with Infrastructure Australia, through various PPP related forums.

Future Partnerships Victoria Projects

Four *Partnerships Victoria* projects with a combined capital value of over \$4 billion are currently under procurement. In each case, the project will only proceed as a PPP if this provides best value compared with what the same project could achieve under a more traditional procurement method. These projects are:

- Wonthaggi Desalination Project – The successful private sector proponent will be responsible for the design, construction, financing, operations and maintenance of the facility. Construction is scheduled to commence in 2009 with the first water due to be supplied by the end of 2011;
- BioSciences Research Centre – The State, through the Department of Primary Industries, in joint venture with La Trobe University (La Trobe), is investing in the development of the Biosciences Research Centre (BRC) located at La Trobe's Bundoora campus. In the 2007-08 Budget, the State committed \$180 million to fund capital costs and specialised equipment for the project. La Trobe has committed \$50 million and the site on which the BRC will be constructed. A private sector consortium will be responsible for the financing, design, construction, commissioning and maintenance of the new BRC. Contract execution is expected by the end of the current financial year. The BRC is expected to be completed by the fourth quarter of 2011 and fully operational by the end of the first quarter of 2012;
- Ararat Prison – In July 2008, it was announced that the new 350-bed medium-security Ararat Prison would be procured as a PPP, adjacent to the existing Ararat prison. The prison is a key part of the progressive upgrade of Victoria's correctional system and will provide upgraded correctional services to meet future projected prisoner growth. The private sector partner will design, construct, finance and maintain the facilities over the contract period, while core custodial services will be delivered by the State. Contract execution is expected to take place in the first quarter of 2010, with the prison expected to be completed in 2012; and

- Peninsula Link Project – Peninsula Link involves the delivery of approximately 25 kilometres of freeway standard road between the Frankston Freeway-EastLink Interchange at Carrum Downs and the Mornington Peninsula Freeway at Mount Martha. The successful private sector proponent will be responsible for the design, construction, financing, operations and maintenance of the freeway, for which it will receive regular Service Payments from the State subject to the ongoing achievement of specific service standards. Construction is scheduled to commence in December 2009 with the road opening to traffic in early 2013. A contribution to this project is being sought from the Commonwealth Government.

FINANCIAL POSITION OF THE NON-FINANCIAL PUBLIC SECTOR

Table 4.4 shows the summary balance sheet of the NFPS sector. Net assets are expected to increase to \$94.5 billion by 30 June 2013. The projected increase is underpinned by prudent balance sheet management, including the fact that a substantial proportion of infrastructure spending will be financed by operating cash flow surpluses.

Table 4.4: Financial position of the non-financial public sector

	(\$ billion)						
	1999	2008	2009	2010	2011	2012	2013
	Actual	Actual	Revised	Budget	Estimate	Estimate	Estimate
	AAS	GFS	GFS- GAAP	GFS- GAAP	GFS- GAAP	GFS- GAAP	GFS- GAAP
Assets							
Non-financial assets ^(a)	57.0	112.2	119.6	130.8	140.9	150.6	155.0
Financial assets ^(b)	7.2	14.2	11.9	11.6	11.8	12.0	12.6
Investments in other sector entities ^(c)	1.2	3.0	0.2	0.8	1.6	2.3	2.8
Total assets	65.4	129.4	131.7	143.2	154.4	164.8	170.5
Liabilities							
Superannuation	11.4	13.0	24.5	24.8	25.1	25.4	25.6
Borrowings ^(d)	9.9	13.9	19.2	26.7	33.2	37.8	39.2
Other liabilities	6.2	10.6	11.2	11.3	11.2	11.1	11.1
Total liabilities	27.5	37.5	54.9	62.7	69.5	74.3	76.0
Net assets	37.9	91.9	76.8	80.5	84.9	90.5	94.5

Source: Department of Treasury and Finance

Notes:

- Non-financial assets include land and buildings, plant and equipment, roads and earthworks, cultural collections and other non-current assets.
- Financial assets include cash assets, advances paid, investments, loans and placements, receivables, and investments accounted for using the equity method.
- Consists of investment in public financial corporations.
- Borrowings include deposits held and advances received.

Non-financial assets account for the bulk of total assets, and consist of land and buildings, plant and equipment, and other fixed assets. Non-financial assets are expected to increase to \$155.0 billion by June 2013, due to the substantial infrastructure investment over the period.

Other assets comprise financial assets, as well as investments in other sector entities. Investments in other sector entities consists of the net assets of the State's public financial corporations, which are expected to fall to \$0.2 billion by June 2009 as a result of the continuing impact of the Global Financial Crisis.

Borrowings (including advances received and deposits held) are expected to rise by \$20.1 billion, to \$39.2 billion over the four years to 2012-13. The increase assists the funding of the \$32.1 billion infrastructure program for the NFPS.

FINANCIAL SUSTAINABILITY

The growth in borrowings over the forward estimates period will result in a corresponding increase to both net debt and net financial liabilities. As shown in Table 4.5, net financial liabilities are expected to increase to \$63.3 billion, or 20.2 per cent of GSP by June 2013. This increase is largely driven by an increase in borrowings over the forward estimates period, as well as an estimated \$11.5 billion increase in the net superannuation liability during 2008-09. As discussed in Chapter 3, the superannuation changes largely relate to movements in the discount rate used to value the liability, as well as the continuing impact of the Global Financial Crisis on investment returns.

Table 4.5: Key financial indicators of the non-financial public sector

		(\$ million)					
	1999 <i>Actual</i> AAS	2008 <i>Actual</i> GFS	2009 <i>Revised</i> GFS- GAAP	2010 <i>Budget</i> GFS- GAAP	2011 <i>Estimate</i> GFS- GAAP	2012 <i>Estimate</i> GFS- GAAP	2013 <i>Estimate</i> GFS- GAAP
Net debt ^(a)	6 058.3	3 890.3	11 220.1	19 078.4	25 648.1	30 167.1	31 263.9
Net Financial Liabilities	20 833.8	23 500.1	42 979.6	51 072.0	57 706.3	62 369.4	63 344.8
		(per cent)					
Net debt to GSP ^(b)	3.9	1.5	4.2	7.0	9.1	10.1	10.0
Net interest to total revenue ^(c)	2.3	0.6	1.4	2.0	3.0	3.5	3.6
Net financial liabilities to GSP ^(b)	13.3	8.8	16.0	18.8	20.4	20.9	20.2
Net interest + superannuation interest expense to total revenue	4.6	1.4	2.9	3.5	4.5	5.1	5.1

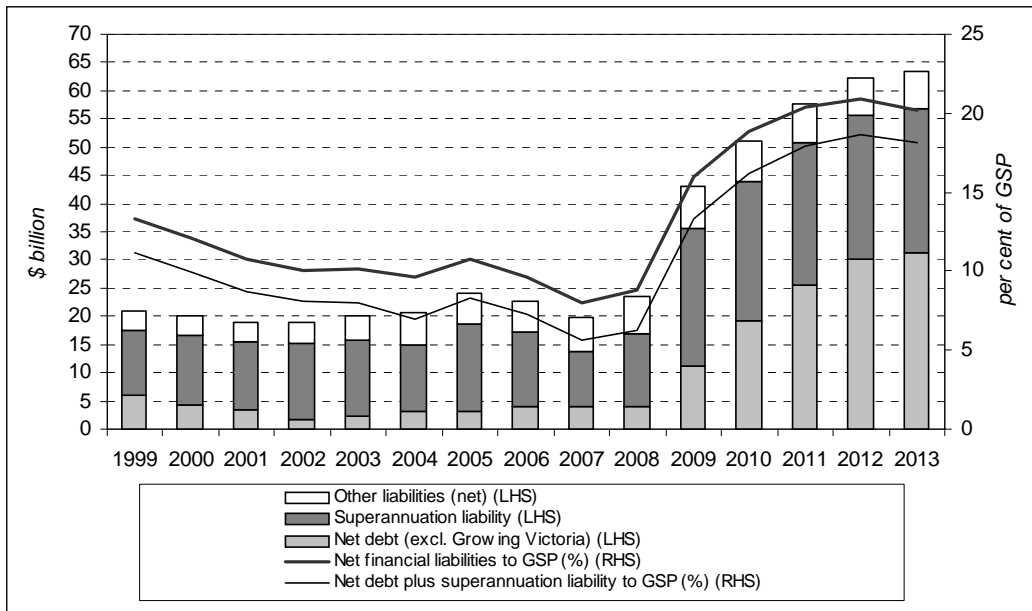
Source: Department of Treasury and Finance

Notes:

- (a) Net debt is the sum of deposits held, advances received and borrowings less the sum of cash deposits, advances paid, and investments, loans and placements.
- (b) Ratios to GSP may vary from publications year to year due to revisions to the ABS GSP data.
- (c) Net interest equals interest expense less interest revenue.

As shown in Chart 4.1, after significant increases in net debt and net financial liabilities in the short term, the increase in debt is expected to moderate from 2011-12. In 2012-13, cash operating surpluses are expected to meet over three quarters of net infrastructure investment. The Government is committed to maintaining fiscal discipline, and has undertaken a number of initiatives (including a more conservative wages policy for public service employees) to bring expenditure growth below revenue growth, thus boosting the operating surplus over time. It is through this strategy that the Government will maintain debt at prudent and sustainable levels over the longer term.

Chart 4.1: Non-financial public sector net financial liabilities



Source: Department of Treasury and Finance

Commonwealth Guarantee of State Borrowings

Victoria's commitment to its triple-A credit rating saw Victoria's cost of borrowing fall to the lowest of any Australian state over the past year. However, as a result of the Global Financial Crisis, it was becoming increasingly difficult for all Australian jurisdictions to raise long term funds, especially those that had either suffered a downgrade in their credit rating or were under the threat of one.

Consequently, the Commonwealth Government announced it was prepared to provide a guarantee over all debt issued by State and Territory Governments up to a maturity term consistent with its own debt profile, and with similar terms and conditions as those applying to the guarantee of bank borrowings. The practicalities of how the guarantee will work are still being considered, with legislation expected to be introduced to the Federal Parliament in May 2009. While Victoria is participating in these discussions, it remains committed to ensuring that any measures are temporary and can be sensibly unwound once a full return to open market operations is possible.

STATE FINANCIAL INDICATORS AND CREDIT RATINGS

Victoria receives credit ratings from two ratings agencies: Standard and Poor's (S&Ps) and Moody's Investor Services (Moody's). Both agencies examine a wide range of financial and non-financial indicators when assessing the credit worthiness of jurisdictions. The agencies have recently been releasing more information to markets on their methodologies, as well as updates on the credit ratings of all Australian jurisdictions.

In particular, S&Ps has described its assessment of key indicators that could trigger a change in a state's credit rating. S&Ps provided details of their approach in its March 2009 report *How stable is the credit quality of the Australian States*. The report endorsed Victoria's broad strategy of prudent fiscal management.

One of S&Ps key indicators is net debt (excluding advances paid) and the superannuation liability of the non-financial public sector as a proportion of operating revenue. In Victoria's case, S&Ps have indicated that the trigger point for a ratings downgrade from triple-A would be if this ratio were to exceed 130 per cent. It is important to note that this trigger point varies across Australian jurisdictions, with all other states having a lower trigger point than Victoria. Victoria's high trigger point is a reflection of the breadth of its economic base combined with its strong fiscal position and generally high quality infrastructure. In 2013, Victoria's ratio is forecast to reach 118.5 per cent, well short of the published S&Ps trigger point.

Moody's have provided similar endorsements of Victoria's financial management in reaffirming the State's triple-A credit rating in January 2009.

Victoria monitors the ratings agency indicators closely when developing its budgetary strategy to ensure its triple-A credit rating is maintained.