

Research Update:

Australian Capital Territory 'AAA/A-1+' Ratings Affirmed; Outlook Negative

September 10, 2020

Overview

- ACT's tax and grant revenues are taking a hit from the COVID-19 recession; it is also rolling out a large stimulus program and higher infrastructure spending that will drive up debt.
- We expect ACT's economy, which is closely linked to the public sector, to outperform its domestic peers in the recovery phase. As such, its fiscal metrics, including its operating balance, should improve during the next two to three years.
- We are affirming our 'AAA/A-1+' ratings on ACT.
- The outlook on the long-term ratings is negative.

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Rating Action

On Sept. 10, 2020, S&P Global Ratings affirmed its 'AAA/A-1+' long- and short-term issuer credit ratings on Australian Capital Territory. The outlook on the long-term ratings is negative.

Outlook

The negative outlook reflects our view that there is at least a one-in-three chance that ACT's fiscal and economic recovery will underperform our forecasts. It also reflects that on the Australian sovereign (see "Australia Outlook Revised To Negative As COVID-19 Outbreak Weakens Fiscal Outcomes; 'AAA/A-1+' Ratings Affirmed," published April 8, 2020).

Downside scenario

We could lower our long-term ratings on ACT during the next two years if we believe its recovery from the COVID-19 recession is likely to be delayed beyond our current expectations. This could be evidenced by budgetary performance, including the operating and after-capital-account balance, remaining persistently weak.

Given our view that no state or territory in Australia can sustain stronger credit characteristics

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than the sovereign in a stress scenario, we would also lower our ratings on ACT if we were to take similar action on the sovereign.

Upside scenario

We could revise our outlook on ACT to stable during the next two years if we were to take similar action on Australia, and if ACT's budgetary performance recovers broadly in line with our forecasts, resulting in a stabilizing or declining debt burden.

Rationale

The COVID-19 outbreak has dealt Australia a severe economic and fiscal shock. The Australian economy has plunged into recession for the first time in almost 30 years, though we expect a strong recovery from 2021 onward (see "Credit Conditions Asia-Pacific: China First To Recover," published June 30, 2020). We have updated and extended our forecasts for ACT through fiscal year 2023 (i.e., the year ending June 30, 2023) following the publication of the territory's August 2020 economic and fiscal update.

ACT's budgetary performance will temporarily weaken because tax and grant revenues will be materially lower than we previously expected, and as expenses rise. The ACT government is delivering various health and economic support initiatives, and has enlarged its forward infrastructure program as a stimulus measure. Together, these developments will result in transitory operating deficits and wider after-capital-account deficits, and a rising debt burden. We don't believe that weak fiscal performance is structural and expect fiscal outcomes to improve during the next two to three years.

Supporting ACT's rating, and counteracting the impermanent budgetary shock, are its robust financial management; very high-income economy, which relies on the public sector; and exceptional level of liquidity. Our rating is also underpinned by Australia's excellent institutional framework.

We don't consider that any state or territory in Australia has the ability to maintain stronger credit characteristics than the sovereign in a stress scenario (see "Rating Non-U.S. Local And Regional Governments Higher Than The Sovereign," published Dec. 15, 2014). This is because of the revenue raising and expenditure imbalances between the states and territories and the Commonwealth. In Australia, taxation powers are concentrated at the Commonwealth level, while the states and territories are responsible for the delivery of key public services such as health and education. This renders the states and territories somewhat financially reliant on grants from the Commonwealth.

Revenue writedowns and fiscal stimulus in response to COVID-19 recession will lead to rising debt burden; liquidity remains exceptional

We expect ACT's fiscal metrics to weaken materially in fiscal 2021, before recovering after, because of revenue writedowns and economic support measures offered by the government in response to the COVID-19 recession. The largest hit to revenue will come from lower goods-and-services tax (GST) grants, because weak Australia-wide consumption and consumer confidence results in a smaller national GST pool. ACT receives about 39% of its cash operating revenues as transfers from the Commonwealth government. Most of these transfers are general-purpose GST grants distributed to the states and territories under Australia's system of

horizontal fiscal equalization.

Own-source taxation revenues will also wane, with smaller receipts expected from payroll tax, general rates, land tax, and conveyance duties. In addition, since March 2020 the territory government has provided several hundred million dollars of support to the local populace through various "economic survival and recovery" measures. These include rates rebates; not increasing average rates and freezing increases in a range of other fees and charges; a Jobs for Canberrans fund; accelerating minor capital works; and expanding investment in healthcare and social housing.

As the economy recuperates, we forecast that ACT's operating balance will revert to surplus in fiscal 2023, after temporary deficits peaking at 12% of operating revenues in fiscal 2021. Likewise, we expect ACT's after-capital-account deficits will also narrow after peaking at about 21% of total revenues in fiscal 2021. The territory government has increased its planned infrastructure pipeline in areas like public transport, hospitals, and education. Delivering this enlarged pipeline will be a challenge. This is because of existing capacity constraints in the engineering and construction industry, as well as the fact that we expect other Australian states to simultaneously endeavor to ramp up their own infrastructure programs. ACT underspent on capital works, relative to last year's budget, by 34% in fiscal 2020. This underspending was exacerbated by widespread restrictions on movement during earlier lockdowns to contain the spread of COVID-19. Our forecasts assume that ACT will deliver about 80% of its budgeted capital program during the next three years.

We note that ACT was the first Australian jurisdiction, on Aug. 27, to publish a comprehensive four-year fiscal update. ACT posted an operating deficit of about 3% in fiscal 2020, according to interim accounts. It is likely that other Australian states will report comparable downward budgetary revisions in the coming months, as they are affected by similar tax and GST grant dynamics. Our financial analysis is based on ACT's "total territory" sector, which includes both general government and public trading enterprises like the Suburban Land Agency and Icon Water.

Unlike the Australian states, ACT is both a self-governing territory and a local government, and it levies general property rates. It is therefore less reliant than its domestic peers on conveyancing duties, which tend to be sensitive to transaction volumes in the property market. ACT has an additional revenue source in the form of land releases by the Suburban Land Agency and City Renewal Authority, which raise somewhere around A\$360 million to A\$550 million per annum.

We forecast that total tax-supported debt, as a proportion of operating revenues, will climb to about 154% by the end of fiscal 2023, up from 93% at the end of fiscal 2019. Included in our measure of tax-supported debt are lease liabilities associated with public-private partnerships for two major projects: the ACT Law Courts Facilities and Light Rail Stage 1. New accounting standards introduced in 2019 mean there is no longer a distinction in Australia between operating leases and finance leases. Most of the territory's debt is market-financed, in the form of Australian dollar fixed-rate medium-term bonds and inflation-linked bonds. ACT also has a small volume of historic loans from the Commonwealth government.

The territory's liquidity remains exceptional. We estimate that ACT had about A\$1.85 billion in unrestricted cash in its Territory Banking Account as of July 1, 2020. There are no bullet maturities due in the coming 12 months; the next is a A\$550 million bond maturing in April 2022. ACT also has A\$200 million of short-term commercial paper outstanding. We conservatively calculate that total free cash is sufficient to cover about 145% of the next 12 months' debt service. We have not included ACT's superannuation (i.e., defined-benefit pension) or insurance assets in our assessment of its liquidity, because these assets are set aside for meeting long-term liabilities.

In addition to its high level of internal liquidity, ACT has strong access to external liquidity.

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Australian states and territories utilize well-developed domestic bond markets for the majority of their funding. The capital markets in Australia are deep and liquid, and we expect them to remain so, despite the temporary dislocations of March 2020 that affected virtually all credit markets worldwide. We note that the Reserve Bank of Australia (RBA), Australia's central bank, made secondary purchases of state and territory government bonds over March 2020 to May 2020, helping to enhance market functioning. We believe the RBA would restart these purchases if markets become strained. We also believe the Commonwealth government would provide support, if needed in a severe stress scenario, as it did in 2009-2010, when it offered to provide a guarantee over state and territory government borrowing.

ACT's contingent liabilities are low compared with its peers, and do not weigh on our assessment of its credit metrics. In 2014, the ACT government announced the implementation of a voluntary buyback scheme for all homes affected by loose-fill asbestos insulation. Under the scheme, the government is acquiring and demolishing about a thousand affected homes and remediating the blocks of land, which are then resold on the open market to defray overall costs. The demolition program is almost complete, and 883 remediated blocks have been resold. The estimated net cash cost of the scheme is around A\$279 million.

ACT's economy will outperform its peers; Australia's excellent institutional settings support our ratings

The ACT government forecasts that gross state product (GSP) will contract by about 1.5% in fiscal 2021. The national economy is in recession; national GDP fell 7.0% quarter on quarter in the June 2020 quarter, following a small decline of 0.3% quarter on quarter in the March 2020 quarter. While these figures are historically large, Australia is outperforming most other advanced economies. Most Australian states and territories have been successful in containing COVID-19. ACT has zero active cases, and recorded just 113 cumulative cases in total. Restaurants, universities, sporting centers, and other venues have reopened, though there are still some restrictions on indoor occupancy and seating capacity. Australia's international borders are closed and extensive interstate travel restrictions remain in place, causing damage to the education and tourism sectors.

ACT has a very high-income economy, reflecting its location as home of the Commonwealth government and the Australian Public Service. The territory's GSP per capita is about US\$71,600, substantially above the national average of about US\$56,300, based on data at June 30, 2019. We expect economic prospects to remain solid. ACT has, by far, Australia's strongest labor market, with an unemployment rate of 4.6% in July 2020, which is three percentage points below the national figure of 7.5%. Its economy has been a perennial outperformer domestically. The local economy could stand to benefit from any further loosening by the Commonwealth, which tends to support public sector jobs as well as related professional services.

Fiscal and monetary policy in Australia is now extremely accommodative; the federal government is delivering large stimulus and wage subsidy programs, while the RBA has lowered its policy rate to 0.25% and introduced a government bond purchase program among other unconventional measures. The territory's economy is somewhat reliant on the public sector, which accounts for around 30% of gross value added. Its population was 427,400 as of December 2019.

Supporting the territory's strong financial management is the institutional framework within which all Australian states and territories operate. We consider this framework to be one of the strongest and most predictable for subnational governments globally. It promotes a robust management culture and high levels of disclosure and transparency. The ACT government is midway through a 20-year program of reforming its tax system by phasing out narrowly based

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transaction taxes, such as conveyancing duties, in favor of a broad-based land tax. These difficult reforms are helping ACT's budgetary performance to be less volatile through the COVID-19 crisis than would otherwise be the case. The benefit should grow as inefficient conveyance duties are fully phased out. While ACT has an unfunded superannuation liability, it has a credible plan to extinguish this liability over time through ongoing appropriations and investment earnings in its superannuation provision account.

In ordinary years, the ACT government produces annual budgets that include detailed projections for three years beyond the budgeted fiscal year, as well as midyear updates and audited final financial outcomes within four months of period-end. It prepares accounts on an accrual basis, with public trading enterprises consolidated in these accounts. This year, Australia's states and territories made a coordinated decision to postpone their usual budgets to the fourth quarter of 2020 or later. As noted above, though, ACT is the first jurisdiction to release a comprehensive fiscal update. Since attaining self-government in 1989, ACT has had a unicameral parliament with fixed, four-year terms. The next territory election is scheduled for Oct. 17, 2020.

Key Statistics

Table 1

Key Statistics

(mil. A\$)	--Year ended June 30--				
	2019	2020e	2021bc	2022bc	2023bc
Selected indicators					
Operating revenues	6,392	6,125	5,913	6,385	7,070
Operating expenditures	5,856	6,297	6,612	6,594	6,785
Operating balance	536	(172)	(699)	(210)	285
Operating balance (% of operating revenues)	8.4	(2.8)	(11.8)	(3.3)	4.0
Capital revenues	276	132	321	314	268
Capital expenditures	863	768	904	1,096	993
Balance after capital accounts	(50)	(808)	(1,282)	(991)	(440)
Balance after capital accounts (% of total revenues)	(0.7)	(12.9)	(20.6)	(14.8)	(6.0)
Debt repaid	437	966	67	617	1,171
Gross borrowings	1,001	2,572	915	2,266	1,212
Balance after borrowings	514	798	(434)	658	(399)
Tax-supported debt (outstanding at year-end)	5,925	8,209	9,166	10,843	10,908
Tax-supported debt (% of consolidated operating revenues)	92.7	134.0	155.0	169.8	154.3
Interest (% of operating revenues)	2.6	3.6	3.6	3.9	3.6
National GDP per capita (single units)	76,833	75,046	73,749	78,107	80,138

The data and ratios above result in part from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. The main sources are the financial statements and budgets, as provided by the issuer. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. N/A--Not applicable. N.A.--Not available. N.M.--Not meaningful.

Ratings Score Snapshot

Table 2

Ratings Score Snapshot

Key Rating Factors

Institutional framework	1
Economy	1
Financial management	1
Budgetary performance	3
Liquidity	1
Debt burden	4
Standalone credit profile	aaa
Issuer credit rating	AAA

S&P Global Ratings bases its ratings on non-U.S. local and regional governments (LRGs) on the six main rating factors in this table. In the "Methodology For Rating Local And Regional Governments Outside Of The U.S.," published on July 15, 2019, we explain the steps we follow to derive the global scale foreign currency rating on each LRG. The institutional framework is assessed on a six-point scale: 1 is the strongest and 6 the weakest score. Our assessments of economy, financial management, budgetary performance, liquidity, and debt burden are on a five-point scale, with 1 being the strongest score and 5 the weakest.

Key Sovereign Statistics

Sovereign Risk Indicators. An interactive version is available at <http://www.spratings.com/sri>.

Related Criteria

- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Governments | International Public Finance: Methodology: Rating Non-U.S. Local And Regional Governments Higher Than The Sovereign, Dec. 15, 2014
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Checks And Imbalances: Delayed Australian State Government Budgets Will Embrace More COVID-19 Stimulus, Sept. 7, 2020
- Comparative Statistics: Asia-Pacific Local And Regional Government Risk Indicators, July 29, 2020
- Credit Conditions Asia-Pacific: China First To Recover, June 30, 2020
- COVID-19: Fiscal Response Will Lift Local And Regional Government Borrowing To Record High, June 9, 2020

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- Ratings History List: Asia-Pacific Local And Regional Government Ratings Since 1975, May 29, 2020
- Australia Outlook Revised To Negative As COVID-19 Outbreak Weakens Fiscal Outcomes; 'AAA/A-1+' Ratings Affirmed, April 8, 2020
- COVID-19: Emerging Market Local Governments And Non-Profit Public-Sector Entities Face Rising Financial Strains, April 6, 2020
- Default, Transition, and Recovery: 2018 Annual International Public Finance Default And Rating Transition Study, Aug. 19, 2019
- Institutional Framework Assessments For International Local And Regional Governments, July 4, 2019
- Public Finance System Overview: Australian States And Territories' Institutional Framework One Of The Strongest In The World, Nov. 11, 2018

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

Ratings List

Ratings Affirmed

Australian Capital Territory (Government of)

Issuer Credit Rating AAA/Negative/A-1+

Australian Capital Territory (Government of)

Senior Unsecured AAA

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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