Rate Products Strategy

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Australia: State of the States

Strong Cyclical Improvement = Better Times Ahead

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- The **2010 State of the States** comments on and forecasts the States' economic, fiscal and debt outlook, infrastructure spending, borrowing programs, macro regulatory influences and given the recent Federal election (un)result, the upcoming VIC and NSW elections and the outlook for economic reform.

- **State GSP growth will improve across the years to FY14.** The notion of a 2-speed economy will re-emerge but will be characterised by the "haves" and the "have-mores" rather than the "haves" and the "have-nots". **Most of the States will move their budgets back into surplus ahead of the Federal Government's expected return to surplus in FY13.**

- **Infrastructure spending will accelerate out to FY12**. From then on, it will moderate as State Governments focus further on long-run financial objectives. **Semi Government bond issuance should increase to overtake Commonwealth bond issuance in FY12.** Demand for issuance will remain high, given global regulatory changes across the budgetary forward estimates.

- **State general government net debt as a ratio of output is lower than its Federal counterpart.** With the Federal Government enjoying an international reputation as a sovereign with lower net debt than its international peers, debt metrics of the States should also be held in the highest regard.

- **Trade recommendations:** In the front-end (3y maturity), sell Federal Government guaranteed semis at a spread of <25bps to CGS to buy State guaranteed semis, sell Federal Government guaranteed NSWTC.Apr19 at a spread of <=25bps to CGS to buy the State guaranteed NSWTC.May20. We recommend buying the NSWTC35i capital indexed bond at current real yields of 3.37%. Assuming successful QLD asset sales, we prefer State guaranteed QTC paper versus TCorp across the curve.

Figure 1. Summary Table of Key Forecasts for the States: FY11

State	GSP Growth % change	Operating Position $mn	Mining Royalties $mn	PTE Dividends $mn	Total State Net Debt % of GSP	Bond Issuance $bn	Infrastructure Spending $bn
NSW	3.00	773	1768	1705	9.9	47.6	16.6
VIC	3.25	872	46	505	6.4	21.1	6.6
QLD	3.75	-1745	3243	1460	12.1	74.6	17.1
WA	4.50	286	3271	1038	8.5	22.7	7.6
SA*	2.25	13	170	450	7.2	10.1	3.9
TAS	2.25	-65	36	149	6.9	3.3	1.0

*SA has yet to release its 2010-11 Budget. Data from 2009-10 Budget Update.

Source: State Budget Papers, Citi Investment Research and Analysis

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Key to Abbreviations Used In This Publication

Abbreviation	State
NSW	New South Wales
VIC	Victoria
QLD	Queensland
WA	Western Australia
SA	South Australia
TAS	Tasmania

Abbreviation	Semi-Government Borrowing Authority
TCorp	New South Wales Treasury Corporation
TCV	Treasury Corporation of Victoria
QTC	Queensland Treasury Corporation
WATC	Western Australian Treasury Corporation
SAFA	South Australian Government Financing Authority
TASCORP	Tasmanian Public Finance Corporation

Abbreviation	Other Terms
APRA	Australian Prudential Regulation Authority
BCBS	Basel Committee on Banking Supervision
GDP	Gross Domestic Product
GSP	Gross State Product
NFLR	Net Financial Liabilities to Revenue
LCR	Liquidity Coverage Ratio
PTE	Public Trading Enterprise
RBA	Reserve Bank of Australia

Source: Citi Investment Research and Analysis

Key Findings

- The cyclical improvement in economic activity and likelihood of continued acceleration in national output should translate into State Treasury forecasts for GSP growth being realised for the larger States across the budgetary estimates period to FY14. SA could slightly underperform relative to the official GSP forecast for FY12 and FY13.
- Economic growth across the States will be driven by dwelling investment, employment gains and private sector capital investment. The period of outsized public sector contributions to growth will come to an end. Commodity export volumes will increase, but import growth will reduce the contribution of net exports to GSP growth.
- WA and QLD should outperform the other States because of the resources boom mark II. The 2-speed pattern of economic growth will remerge but looking ahead is best characterised by the “haves” and the “have-mores”, rather than the “haves” and the “have-nots”.
- Downside risks to the outlook would come from slower than expected global economic growth, particularly if it was focused in Australia’s major trading partners. There could be some short to medium term growing pains as the risk of less than smooth handover from public and private investment growth has risen recently.
- Upside risks would emerge from stronger than expected commodity demand that would increase nominal growth in QLD and WA. However, the positive impact on the AUD could hurt the competitiveness on non-resource exports in a number of States. Higher than expected domestic interest rates further out in the budgetary estimates period would exert a downward influence on State GSP growth rates.
- The cyclical improvement in the economy and expectations of further gains has lifted revenue forecasts. The sources of State revenue are on a solid footing. Larger tax revenue collections and Federal Government grant money will be supported by an increase in dividends from public trading enterprises while NSW, QLD and WA should get an increase in royalty payments from miners and petroleum companies.
- While expenses have also increased, all States except QLD are expected to return to a budget surplus position by FY13. NSW, VIC and WA already estimate they are back in surplus to be followed by SA in FY11. This is ahead of the Federal Government’s timetable for a return to surplus in FY13.
- As a percentage of output, all of the States have a general government net debt position that is lower than the Federal Government across each of the forward estimate years to FY13. With the Federal Government enjoying an international reputation as a sovereign with lower net debt than its international peers, the States’ net debt positions should also be held in high regard.
- QLD should narrow the gap between its fiscal performance and that of the other States through its large asset sales program. The QLD Government estimates that as much as $15 billion could be achieved through targeted sales/leases. That said, there is no guarantee that the asset reform program will go ahead as currently planned.
- The GFC dented but did not stop the previous trend of higher infrastructure spending that was a catch-up from a period of previous underinvestment.

- Capital investment is expected to reaccelerate out to FY12 as the States return to their previous commitments. Investment expenditure growth beyond this date will ease as States focus back on long-run financial and budgetary goals.

- Semi Government authorities are forecast to expand their borrowing programs over the forward estimates. The increase reflects the commitment to fund infrastructure. The mid-point (projected) forecast is for total State issuance to reach $242 billion by the end of FY14.

- QTC and TCorp will likely continue to be the largest Semi Government issuers. For QTC, the proposed asset sales/lease program outlined in Budget 2010-11 has the potential to lower the borrowing needs of QTC over the forward estimates.

- With the Federal Election outcome uncertain, there is no guarantee that the proposed National Health and Hospital Network (NHHN) plan for control of the hospitals and health system at the Federal level will go ahead in its current form. The vertical shift in funding requirement from the Federal Government to the States should the NHHN not go ahead could be around $15 billion from FY15 to FY20. The potential cost will be offset by some GST revenues back to the States should this be the case.

- Citi believes that QTC and TCorp are unlikely to issue any more bonds under the Federal guarantee. Instead, they are likely to use this period to build up State guaranteed lines and consolidate federally guaranteed into State guaranteed lines.

- In the short-end, Citi recommends that investors sell Federal Government guaranteed semis at a spread of under 25bps to CGS to buy State guaranteed semis. In the long-end we would recommend a target of selling the Federal Government guaranteed NSWTC.Apr19 at a spread of 25bps or under to CGS to buy the State guaranteed NSWTC.May20.

- We maintain a preference to own QTC State guaranteed bonds versus TCorp across the curve. However, recently we have seen a sharp narrowing of the spread between State guaranteed QTC and NSWTC bonds. As such we would target re-entering spread narrowing positions (target +12 bps) on any widening of these spreads and would recommend investors buy QTC State guaranteed with a view to a ratings upgrade.

- We recommend buying the NSWTC35i capital indexed bond at current real yields of 3.37% and look for a move towards 3.0%.

- Changes to global and Australian banking regulations will increase the demand for sovereign government bonds. Focusing on the major Australian banks alone, there is likely to be an excess of demand for domestic sovereign paper. Outside of the major Australian banks, there are 67 ADIs that will be influenced in a substantial way from the regulatory changes.

- ADI's are already beginning to add to their stock of liquid assets. Semi Government borrowing authorities can take advantage of the structural increase in demand for their high quality paper by targeting primary issuance through their dealer panels at maturities that would best meet the regulatory demands of ADIs.

- Fixed term elections mean that VIC and NSW voters will go to the polls on 27 November 2010 and 26 March 2011 respectively. The VIC ALP Government should retain power with a reduced majority but the NSW ALP Government is likely to be removed from power by one of the largest swings against an incumbent Government in Australian political history.

- Developments in the aftermath of the Federal Election and the likelihood of a reduced majority for the ALP in VIC could have implications for policy reform agendas for government generally across at least the next parliamentary term. There is a risk that economic reform will take a back-seat to short-term political goals of State and Federal Governments more generally.

- Future strong economic performance and gains in living standards will require current State and Federal Governments to look through the political cycle and deliver solutions that will help promote economic growth and raise living standards long after Australia has stopped benefiting from the resources boom.

State Economic Outlook

Key Findings:

- The cyclical improvement in economic activity and likelihood of continued acceleration in national output should translate into State Treasury forecasts for GSP growth being realised for the larger States across the budgetary estimates period to FY14. SA could slightly underperform relative to the official GSP forecast for FY12 and FY13.

- Economic growth across the States will be driven by dwelling investment, employment gains and private sector capital investment. The period of outsized public sector contributions to growth will come to an end. Commodity export volumes will increase, but import growth will reduce the contribution of net exports to GSP growth.

- WA and QLD should outperform the other States because of the resources boom mark II. The 2-speed pattern of economic growth will remerge but looking ahead is best characterized by the “haves” and the “have-mores”, rather than the “haves” and the “have-nots”.

- Downside risks to the outlook would come from slower than expected global economic growth, particularly if it was focused in Australia’s major trading partners. There could be some short to medium term growing pains as the risk of less than smooth handover from public and private investment growth has risen recently.

- Upside risks would emerge from stronger than expected commodity demand that would increase nominal growth in QLD and WA. However, the positive impact on the AUD could hurt the competitiveness on non-resource exports in a number of States. Higher than expected domestic interest rates further out in the budgetary estimates period would exert a downward influence on State GSP growth rates.

FY10 Gross State Product Estimates Revised Upwards

The contrast between the FY10 Gross State Product (GSP) forecasts from one year ago in the 2009-10 State Budgets to those that were made this year in the 2010-11 State Budgets is large. All but one of the State Treasury departments was forecasting a contraction in annual economic output for FY10 last year, whereas the current forecasts are for all the States to grow (Figure 2). In hindsight, the earlier forecasts were overly pessimistic, being based on a substantial negative shock to the Australian economy from the GFC that did not eventuate.

Just as Federal and State fiscal stimulus, the RBA’s monetary policy easing cycle and trade links with regional economies that avoided recession shielded Australia from the worst of global downturn, it provided State economies with a healthier set of estimates for FY10. Importantly, it now provides a stronger starting point for the forecasts and projections.

Politically, this development will allow State Treasurers to promote their economic management skills to the public. This will be something that is crucial for the VIC and NSW Governments. Based on fixed term elections in these States, elections will need to be held in these States before the end of November 2010 and March 2011 respectively.

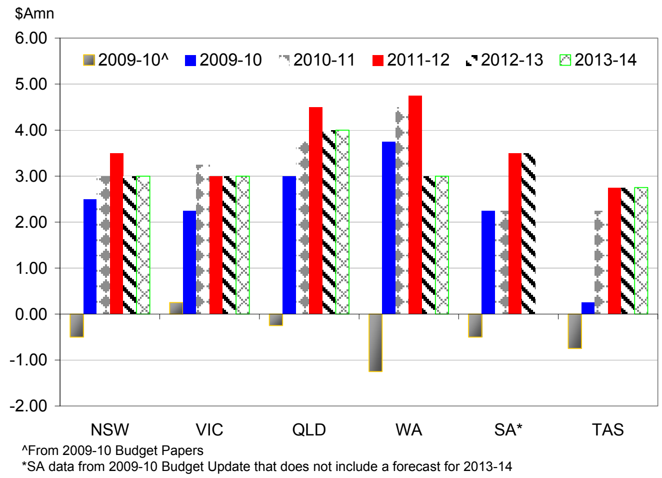
Figure 2. Gross State Product Table : Yearly Percentage Change

	1990-2009 *Annual Average*	2009-10 *09/10 Budget Estimate*	2009-10 *10/11 Budget Estimate*	2010-11 *Forecast*	2011-12 *Forecast*	2012-13 *Projection*	2013-14 *Projection*
NSW	2.5	-0.50	2.50	3.00	3.50	3.00	3.00
VIC	3.1	0.25	2.25	3.25	3.00	3.00	3.00
QLD	4.5	-0.25	3.00	3.75	4.50	4.00	4.00
WA	4.3	-1.25	3.75	4.50	4.75	3.00	3.00
SA*	2.4	-0.50	2.25	2.25	3.50	3.50	na
TAS	2.6	-0.75	0.25	2.25	2.75	2.75	2.75

*SA has yet to release its 2010-11 Budget. Data taken from 2009-10 Budget Update.

Source: State Budget Papers & Citi Investment Research and Analysis

Figure 3. Gross State Product Chart : Yearly Percentage Change



Source: State Budget Papers & Citi Investment Research and Analysis

The current FY10 GSP forecasts remain mostly below the annual average over the current economic cycle. Only NSW is forecast to return to its annual average growth rate in FY10, followed closely by SA (Figure 2). This is largely because NSW's long-run average growth rate was the second lowest of all the States, only ahead of SA.

Look For Further Improvement from FY11

Looking at each State across the forecast and projection period from FY11:

- The official forecast shows that NSW is expected to improve to an annual growth rate that is at least as strong as the pace of economic outlook recorded before the GFC, which was 2.8% for FY08. While Citi does not disagree with a return to this rate of growth, the potential for upside surprises beyond 3.0% is limited. The end of fiscal stimulus and low interest rates combined with high household debt levels implies some risk that dwelling investment and consumption growth will not drive overall economic growth.

- Out of the non-resource intensive States, VIC probably has the most conservative GSP forecasts relative to its long-run performance and should return to its long-run average growth rate comfortably. Despite the end of above average public sector support to output and the return of more "normal" monetary policy, VIC has the advantage of strong population growth that extends to regional centres and substantial economic momentum based on the most recent State Accounts data. Citi would not be surprised to see some marginal outperformance in at least one year of the forecast and projection time frame.

- SA's GSP forecast for FY11 is achievable but output growth could somewhat underperform compared to the forecast and projection beyond this date. Based on Citi's Gross Domestic Product (GDP) forecast for the Australian economy, SA is expecting to outperform national economic growth. While SA has some mineral resources, as a proportion of total output the SA economy is more reliant on manufacturing, agriculture and public administration than the national economy. As these industries are not benefitting from the positive terms of trade shock, SA's growth rate is unlikely to outpace the national growth rate.

- TAS's official GSP forecasts are lower than the other States, reflecting its less diverse economic base and sensitivity of its export sector to the AUD. The State is relatively reliant on public expenditure and agriculture but has enjoyed a modest increase in population in recent years that should help it approach the growth targets.

- Last but by no means least are WA and QLD. These States are the two most leveraged to the resources boom. Both are expected to grow at rates equal to their long run annual averages thanks to the structural nature of commodity demand in China and India and strong pipeline of large scale private investment work to be done in these States. There is a good chance that these States could once again exceed their long-run potential growth rates across at least one year of the forecast and projection time frame.

Drivers of State Economic Growth

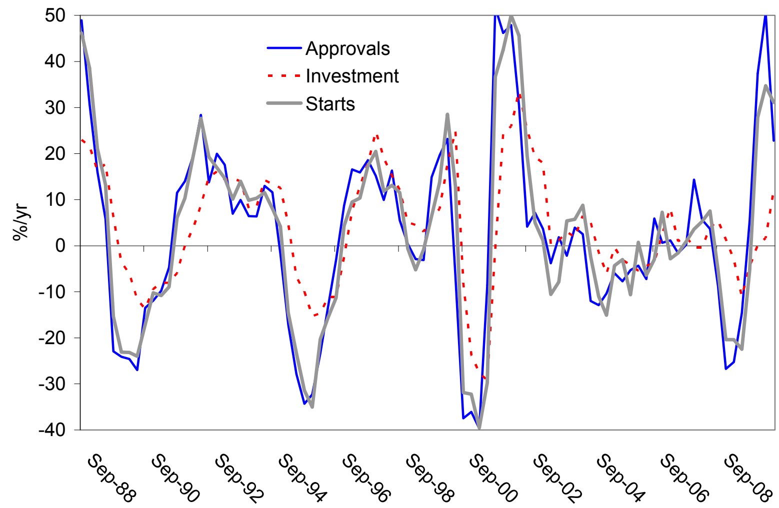
Over the next few years, the broad pattern of growth within the States is expected to be similar to the pattern expected nationally. Public sector expenditure growth will soften back to levels more consistent with long-run averages, to be replaced by private sector dwelling investment and private infrastructure investment. Private consumption growth will take time to return to a stronger rate but will be supported by employment and private sector wages growth.

Dwelling Investment

Strong population growth is expected to support dwelling investment in most of the mainland States. Dwelling investment should be aided as access to finance improves, allowing a recovery in medium to high density construction, while a general improvement in economic conditions supports renovation activity. Despite recent falls in approvals and housing finance thanks to interest rate increases and the unwinding of government incentives to potential first home buyers, there is a solid pipeline of work that is yet to be done. Economic data is showing a belated start to a pick up in housing investment and should boost growth in the second half of 2010 (Figure 4).

Australia has underinvested in residential dwellings relative to underlying demand, falling short by about 25,000 dwellings per annum. This undersupply is most evident in NSW around Sydney and in South East QLD. Reasons for this include land availability, the regulatory environment and up-front charging for physical infrastructure to new developments. The impediments to new supply are such that there is a risk that housing investment could underperform expectations in NSW.

Figure 4. Australian Housing Investment



Source: ABS & Citi Investment Research and Analysis

Employment

Employment growth is forecast to remain solid or accelerate in all of the States. This will maintain downward pressure on unemployment rates that are expected to be around full-employment across the budgetary forward estimates (Figure 5). The exception is SA, as these forecasts are from the previous Budget. Based on actual performance to date, there is likely to be downward revision to the SA unemployment forecasts and projections in the 2010-11 Budget.

Figure 5. Year-End Unemployment Rates

	2009-10 *Estimate*	*2009-10 Actual*	2010-11 *Forecast*	2011-12 *Forecast*	2012-13 *Projection*	2013-14 *Projection*
NSW	5.75	*5.3*	5.50	5.25	5.25	5.25
VIC	5.50	*5.4*	5.50	5.25	5.25	5.25
QLD	5.25	*5.3*	5.00	4.75	5.00	5.00
WA	5.25	*4.0*	5.00	4.75	4.75	4.50
SA*	8.25	*5.4*	8.50	7.50	6.50	na
TAS	5.50	*6.7*	5.50	5.25	5.25	5.25

*SA has yet to release its 2010-11 Budget. Data taken from 2009-10 Budget.

Source: State Budget Papers & Citi Investment Research and Analysis

All of the States except TAS finished FY10 with unemployment rates that were in-line with or below the official forecast. Excluding SA, the significant outperformer was WA, with an unemployment rate 1.25 percentage points below the official forecast (Figure 5). Actual differences between the States are likely to be based on how much exposure each State has to the mining boom mark II. QLD and WA are looking to lead the other States when it comes to employment growth, moving to the lowest unemployment rates of all the States in the future.

Private Sector Capital Expenditure

Business investment is also likely to grow the most in these two States. QLD is the only State that provides detailed economic forecasts across the expenditure components of GSP and the forecast is for a strong 9.5% increase in private business investment in FY11 and an even stronger gain of 17.75% in FY12. On a national basis, after adjusting the raw quarterly capital expenditure expectations data for historical reporting biases (i.e. applying 10 year average "realisation factors"), the current value of planned non-residential construction investment by companies is estimated to rise 44% in FY11 (vs. a rise of 38% in the previous survey) and equipment investment is estimated to rise 6½% (vs. a fall of 2½% in the previous survey).

Private sector projects are dominated by mining and energy with petroleum and gas projects account for around three quarters of committed mining and energy capex. The start of the Gorgon LNG project in WA boosted actual capex spending but has not yet been followed by more major announcements. ABARE estimate that there is around $A110bn worth of advanced mining and energy projects. Citi analysts currently expect four new gas projects to begin next year (Figure 6).

Figure 6. LNG projects likely to commence in 2011

Company	Total cost $m	Project
British Gas	18000	CSM project, Qld
Santos/Petronas	12000	CSM project, Qld
Shell	6000	LNG Prelude project, WA
Chevron & others	24000	Wheatstone LNG project , WA

Source: Citi Investment Research and Analysis

Outside of mining and energy, the best prospects for business investment are in offices and retailing.

The 2-Speed Economy = the "haves" and the "have-mores"

WA and QLD Growth to Re-Accelerate

The resource intensive economies of WA and QLD are forecast to have the fastest GSP growth of all the States by FY 12 before easing modestly (Figure 3). But this remains below their pre-GFC growth rates (5.1% and 4.7% respectively for FY08). Given their potential to extract the most gains from the minerals boom mark II, these States have the largest potential to improve on their growth prospects. This is particularly the case for WA. The GSP projections are more than two percentage points lower than the average yearly GSP growth rate over the minerals boom mark I.

WA and QLD are therefore likely to move ahead of the non-resource intensive States, thus re-visiting somewhat the 2-speed economy that existed prior to the GFC. This is not of itself a negative development. It merely reflects changes in relative prices for factors of production.

But Non-Resource Intensive States Won't Miss Out Entirely

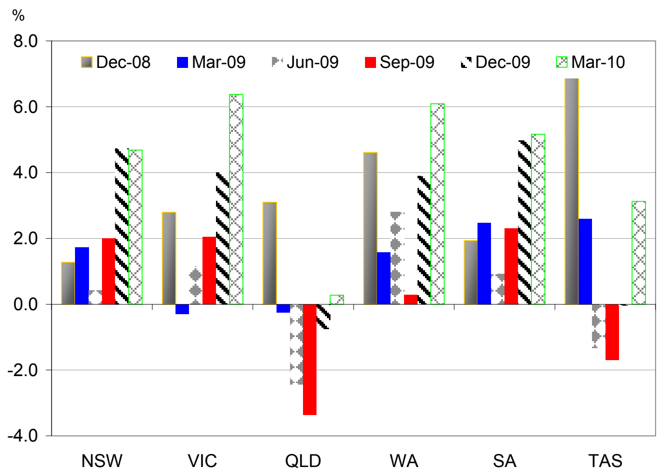
Increased activity in the minerals sector will increase demand in sectors of production and services that are used by the resources industry. These include but are not limited to financial, legal, marketing as well as middle and back-office services. These industries are more concentrated in the less resource intensive NSW and VIC. In other words, stronger resource intensive State activity will trickle-down into some of the other State economies.

Changes in relative factor prices for inputs to production in the resources sector will also see some excess capacity, whether it is labour or capital, move from the non-resource intensive States to QLD and WA. This is economic welfare improving for all concerned. It minimises idle capacity in the non-resource States and raises revenue to the sources of production that move to the resource States.

The Economic Recovery Started outside QLD and WA

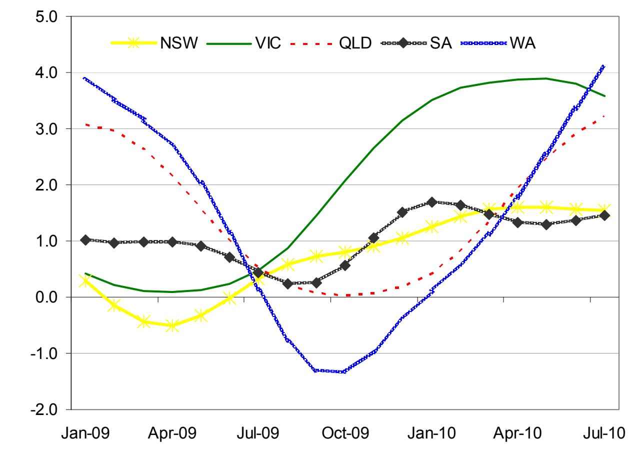
The recovery in 2009 was largely led by NSW, VIC and SA. In contrast, QLD and WA lagged in their recovery efforts. NSW and SA had stronger State Final Demand (SFD) growth than QLD throughout all four quarters of 2009, while VIC has stronger growth in three quarters. WA growth was below that of NSW, VIC and SA in two quarters (Figure 7). More frequent evidence of the relative underperformance of QLD and WA is provided by the labour force statistics. Employment growth weakened by more in these two States from July 2009. It was only in April 2010 that they started outperforming their non-resource counterparts again (Figure 8).

Figure 7. State Final demand: Yearly Percentage Change



Source: ABS & Citi Investment Research and Analysis

Figure 8. Yearly Employment Growth: Trend



Source: Citi Investment Research and Analysis

With VIC, NSW and SA experiencing less volatility in their major macroeconomic indicators during the GFC, the opportunity costs to activity and employment in these States were less than they otherwise could have been. The non-resource intensive States are therefore in a good starting position. As Citi broadly agrees with most of the economic forecasts put forward by the States, the 2-speed economy in the future is less likely to be characterised by the "haves" and the "have-nots", and more by the "haves" and "have-mores".

Main Risks to the States' Economic Forecasts

Potentially, there are a number of risks that could alter an economy's growth path from a central forecast. This is true of any jurisdiction, not just the States of Australia. However, to be credible and merit discussion, risks need to have more than a trivial chance of occurring. This is particularly the case for Australia that has weathered a number of global and regional economic and market shocks better than most industrialised economies.

Slower Global Growth

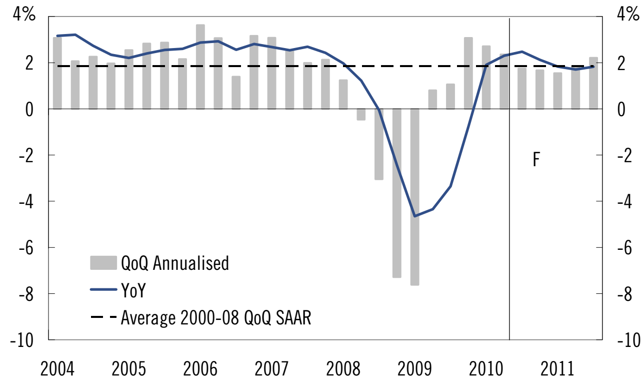
Slower than expected global economic growth, particularly slower than expected Asian economic growth would be a downside risk for a number of the States; most specifically if this was concentrated in major commodity demanding countries. This would reduce output growth in QLD and WA through lower commodity prices and export volumes. Additionally, slower global growth could reduce inbound tourism and manufactured exports, which would influence all of the States to a degree.

But Citi is not forecasting global economic growth to deteriorate further. We continue to expect a sustained but uneven global recovery, although the near term outlook could be quite choppy. We do not regard a double dip recession that takes major economies back into a period of sustained negative growth as likely. Industrialised country growth is forecast to return to around trend in the second half of this year (Figure 9). Importantly for Australia, major trading partner growth is forecast to remain healthy, even with a policy induced moderation in the pace of growth in China. Emerging market growth will continue to outpace industrialised country growth by a wide margin.

Stronger Commodity Demand

On the upside, should global growth and commodity demand be stronger than forecast, the resource intensive States would be expected to perform better. However, in this situation, some upward pressure on the AUD would potentially make import competing manufacturing businesses less cost competitive and at the same time make non-resource products less competitive in export markets against global substitutes. Other things being equal, the AUD appreciation would have a relatively greater impact on output in NSW, VIC, SA and TAS.

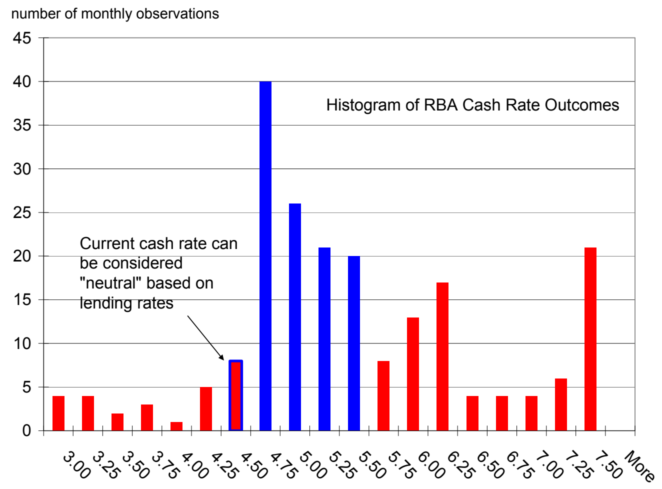
Figure 9. Industrial Country GDP Growth — Actual and Forecast, 2004-2011 Q3



Note: the forecast period is for Q2-2010 to Q3-2011 inclusive. Countries weighted by 2010 nominal GDP weights.

Sources: Datastream, Citi Investment Research and Analysis

Figure 10. Monthly RBA Cash Rate Outcomes Since the Inception of Inflation Targeting in 1993: Blue Bars Represent "Neutral" Band



Note: The central tendency of outcomes in blue can be considered broadly "neutral" over the history of inflation targeting.

Source: RBA, Citi Investment Research and Analysis

Higher Domestic Interest Rates

Domestically, demand that was stronger than expected and the threat of upside inflation as spare capacity is eroded would invite higher interest rates from the RBA. This would dampen real growth to a degree. The State that is most likely to be affected would be NSW. As the State with the largest average mortgage size and loan to property value, mortgagees in NSW are relatively more sensitive to interest rate movements per mortgagee than their counterparts in other States. Interest rates that move higher, in particular into restrictive territory, would probably dampen some discretionary consumption expenditure in NSW more so than elsewhere.

But Citi does not forecast the RBA to lift the cash rate target into restrictive territory. We expect the RBA to re-start monetary tightening in Q1 2011, but only announce another 100 bps of tightening over the course of the year, stopping at 5.50%. Based on current financial and credit conditions, this is arguably at the top of "neutral" territory (Figure 10).

Potential Short to Medium Term Growing Pains

A key driver of Australia's economic growth following the global financial crisis has been government investment spending. It contributed 2% pts of Australia's 2.7% GDP growth over the past 12 months led by spending on non-residential construction which doubled, reflecting the economic stimulus from the schools building program. The program is now peaking. Public sector investment is expected to be flat in FY11, with infrastructure spending offsetting the drop-off in the schools building program.

To drive a positive outlook for the economy with growth at around trend, most economic forecasts see a transition from government spending to private sector demand and in particular business investment, reflecting the high level of Australia's terms of trade.

But the risks to a neat handover in the growth drivers have risen recently. The signs of renewed slowdown in major economies, most notably in the US but including in China, are eroding risk appetite. These concerns have been amplified by doubts about what scope policy makers have to avoid a possible double dip in developed economies because of large budget deficits and debt, and with interest rates already at historically low levels. A moderation in business confidence domestically raises uncertainties about the outlook for business investment. The recent hung parliament and the uncertainty this creates in a number of policy areas including resource rent taxes does not help.

Fiscal and Debt Outlook

Key findings:

- The cyclical improvement in the economy and expectations of further gains has lifted revenue forecasts. The sources of State revenue are on a solid footing. Larger tax revenue collections and Federal Government grant money will be supported by an increase in dividends from public trading enterprises while NSW, QLD and WA should get an increase in royalty payments from miners and petroleum companies.

- While expenses have also increased, all States except QLD are expected to return to a budget surplus position by FY13. NSW, VIC and WA already estimate they are back in surplus to be followed by SA in FY11. This is ahead of the Federal Government's timetable for a return to surplus in FY13.

- As a percentage of output, all of the States have a general government net debt position that is lower than the Federal Government across each of the forward estimate years to FY13. With the Federal Government enjoying an international reputation as a sovereign with lower net debt than its international peers, the States' net debt positions should also be held in high regard.

- QLD will narrow the gap between its fiscal performance and that of the other States through its large asset sales program. The QLD Government estimates that as much as $15 billion could be achieved through targeted sales/leases.

Solid Fiscal Objectives Drive State Public Policy

All of the States have formally adopted budgetary or financial objectives to guide public sector resource management. Some are organised in broad qualitative terms while others have specific quantitative targets. All the States except NSW have as their objective the maintenance or achievement of an operating surplus. NSW's preference is to target a ceiling for net debt to GSP (Figure 11). Regardless of the exact wording, all of the States are focused on a derivation of the same theme of eliminating budget deficits and minimising net debt.

Figure 11. Fiscal/Financial Targets

NSW	Targeting the level of general government net debt at or below the 30 June 2005 level of 0.9% of GSP.
VIC	Maintaining a $100 million operating surplus per annum
QLD	Targeting a net operating surplus as soon as possible but no later than FY16
WA	Achieving an operating surplus for the general government sector
SA	Maintaining an operating surplus
TAS	Achieving a general government net operating surplus by 2014-15 on average over a rolling four year period

Source: State Government Budget Papers & Citi Investment Research and Analysis

This desire is a legacy of the high-debt levels of the 1980s in some of the States and the negative political impact this had on the incumbent governments of the time. In at least two States, the sitting government was voted out because of public concern about debt management. Nowadays, no State Government believes it cannot have some form of explicit fiscal/financial target as part of its overall budget strategy.

A formal fiscal strategy is also used as a way of trying to achieve or maintain a given credit rating. To more or less of a degree, all of the States have sought to make achieving or regaining a particular level of creditworthiness as assessed by the major credit ratings agencies a policy goal. There is also a marketing aspect attached to this goal. State Governments promote positive reports by rating agencies to justify the legitimacy of their broad fiscal objectives and priorities.

Stronger Revenues Improve Underlying Cash Balances

Just as the economic forecasts of the States benefitted from the broad improvement in the national economy, so has the outlook for the budget bottom line of state governments. The previous Budget estimate for the operating position as at the end of FY10 estimated that four of the six States would have deficits. The 2010-11 Budget estimate improved to just one State having a deficit in FY10 (Figure 12 and Figure 13). Furthermore, the improvement is expected to carry over into the forward estimates, placing every State except QLD in a surplus position by the end of FY14. This is a very solid turnaround. In part, this reflects the pre GFC fiscal positions of the States. This allowed them to help support their economies during the downturn without weakening balance sheets as much as in other OECD countries. For this reason, Australian governments were less exposed to the sovereign debt concerns that faced a number of other industrialised governments.

Figure 12. General Government Operating Position

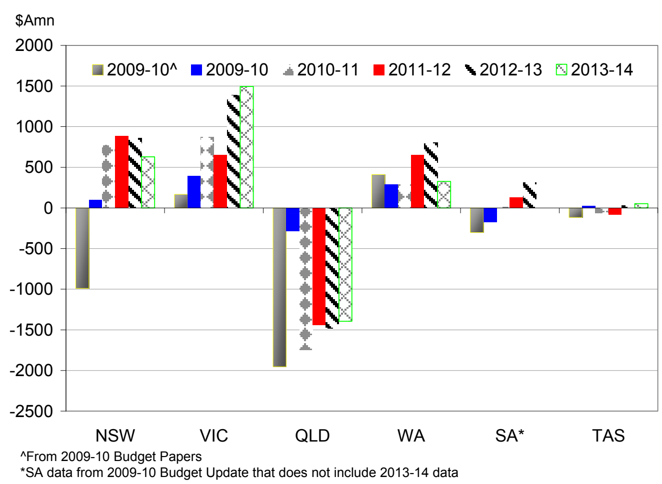
Operating Position: $A mn

	2009-10 *09/10 Budget Estimate*	2009-10 *10/11 Budget Estimate*	2010-11 *Budget*	2011-12 *Forward Estimate*	2012-13 *Forward Estimate*	2013-14 *Forward Estimate*
NSW	-990	101	773	885	863	628
VIC	165	395	872	650	1388	1493
QLD	-1954	-287	-1745	-1442	-1482	-1395
WA	409	290	286	652	807	325
SA*	-304	-174	13	127	316	na
TAS	-117	24	-65	-82	32	53

*SA has yet to release its 2010-11 Budget. Data from 2009-10 Budget Update.

Source: State Budget Papers & Citi Investment Research and Analysis

Figure 13. General Government Operating Position



Source: State Budget Papers & Citi Investment Research and Analysis

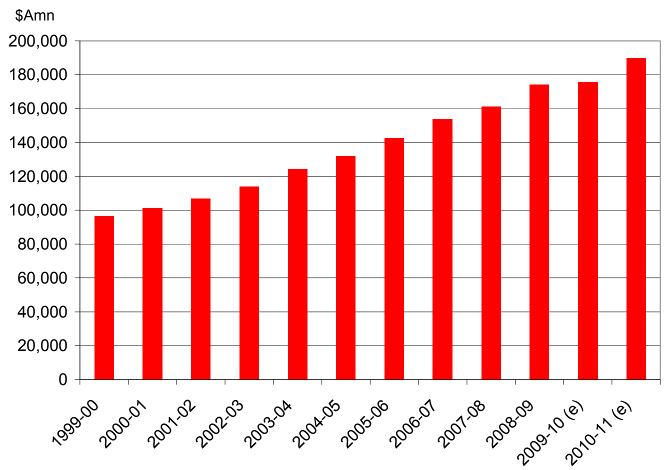
Total revenue is expected to be 8.0% higher in FY11. This is above the average yearly increase of 6.4% over the previous decade. This solid performance reflects the strong recovery from the GFC that slowed revenue growth to an expected 0.9% in FY10. Over a longer time series, revenue growth has been steady (Figure 14), a legacy of Australia’s long period of economic expansion.

State Taxation Revenue and Commonwealth Grants

The improvement in economic forecasts has boosted the outlook for State sourced revenue. With employment set to continue recovering, estimates of payroll tax have been lifted. As housing market activity grows so too will transfer duty on properties.

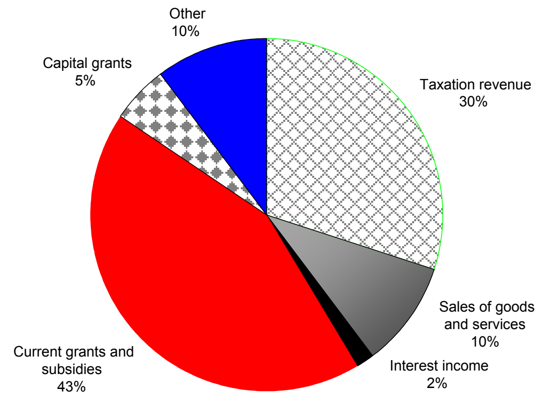
An increase in federally collected GST revenues from stronger nominal aggregate expenditure will spill over into more general purpose grant money being transferred from the Commonwealth to the States. As grant revenue and own sourced taxation revenues represent the largest two contributions to total revenues, it is not surprising that improvements in these categories would drive the overall revenue improvement (Figure 15).

Figure 14. Total State General Government Revenue Time Series: Actual and Expected



Source: ABS, State Budget Papers & Citi Investment Research and Analysis

Figure 15. FY 11 Expected State General Government Revenue Composition: Average of the States



Source: ABS, State Budget Papers & Citi Investment Research and Analysis

Dividends From Public Trading Enterprises (PTEs)

In addition to better expected grant and taxation income, State Governments have also been lifting their expectations for dividends from State public trading enterprises. These organisations typically run the utilities that supply electricity and water and pay annual dividends back to their respective State governments. NSW, QLD and WA are forecasting substantial increases in dividend income in the future (Figure 16).

There were broad increases in prices for electricity and water that started on 1 July 2010 that will add to the revenue stream from these PTEs. For example, electricity prices increased by 6% in TAS, 7% in NSW, 10% in WA and SA and 13% in QLD from 1 July 2010. Should State Governments elect to increase dividend payout ratios and/or PTEs increase efficiency, the dividends could be even higher.

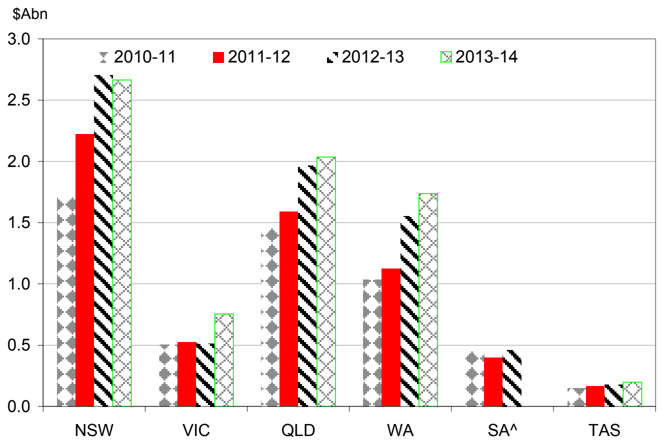
Mining Royalties

NSW, QLD and WA have an additional source of substantial revenue that will benefit from the return of higher commodity prices. Non-rural commodity prices in USD terms over the course of 2010 to July increased by 35%. The revenue opportunity this presents comes through royalty payments from mining and petroleum companies. For these States:

- WA forecasts a 48% increase in royalty income in FY11 to $3.3 billion. Total royalty revenue in WA is expected to represent 14% of total FY11 revenue, the third largest contributor after Commonwealth grants and own sourced taxation revenue.
- QLD is forecasting royalty income of $3.1 billion, a 71% increase from FY10.
- NSW will also share in some royalty payments from coal producers in the north of the State. Although not as large as the WA and QLD payments, NSW royalty income is forecast at just under $1.8 billion in FY11.
- SA receives some royalty income from mining interests, although they are small by comparison to the other States (Figure 17).

Across the forward estimates, mining royalties are expected to remain elevated (Figure 17) and come under no threat from the Federal Minerals Resources Rent Tax. This was constructed to allow States to continue charging royalties.

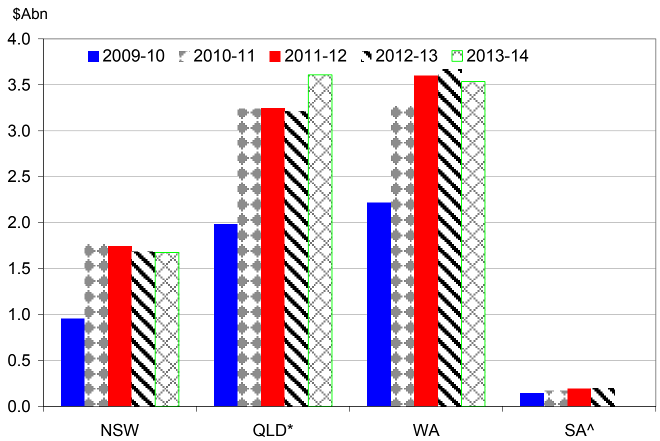
Figure 16. Dividend expectations from PTE's and Tax Equivalent Income



^SA has yet to release its 2010-11 Budget. Data from 2009-10 Budget

Source: State Budget Papers & Citi Investment Research and Analysis

Figure 17. Royalty Income Expected from Mining and Petroleum Sectors



*QLD includes land rents with royalties
^SA has yet to release its 2010-11 Budget. Data from 2009-10 Budget

Source: State Budget Papers & Citi Investment Research and Analysis

Higher Expenses Don't Threaten the Budget Position

On the other side of the ledger, expenses are expected to increase across the States. Some of the increase in total expenses is an attempt to catch-up on previously promised service delivery programs that were delayed when the GFC was expected to have a much larger negative influence on the Australian economy.

Expenses have been on a trending path higher for a number of years (Figure 18). Total expenses of the States are expected to increase by 6.3% in FY11. but this increase is below the expected total revenue increase for FY11 of 8.0%. The slight increase in total revenue relative to total expenses helps to reinforce the solid footing underneath State budgetary projections.

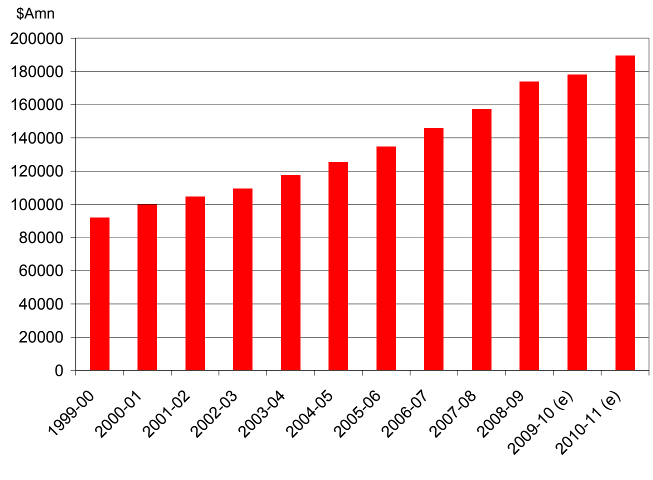
Essential Public Services

Governments are boosting funding to healthcare and other public services such as education and law enforcement. Some of the requirement for extra expenditure in these areas is coming from population growth and demographic change that is seeing more demand being placed on public services like hospitals.

Employee Expenses

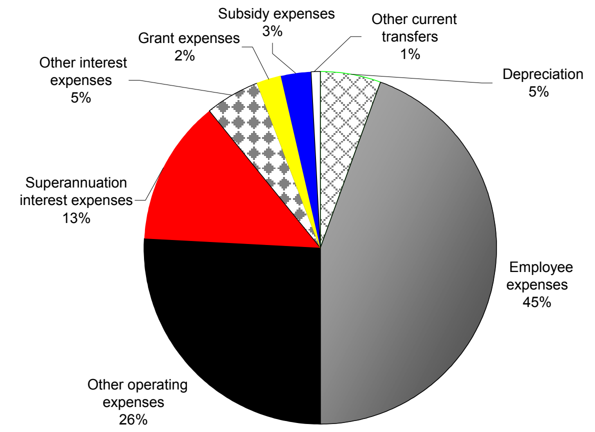
The largest expense item remains employees (Figure 19). This reflects higher staff numbers and salary growth across the public service. Salaries account for the majority of employee expenses with important service delivery areas of health and education topping the bill. Overall public service wage costs increased by 4.0% through the year to Q2 2010. Although this was a moderation from the growth rates over the previous eighteen month, it still outpaced private sector wage cost growth of 2.8%.

Figure 18. State General Government Expenses Time Series: Actual and Expected



Source: ABS, State Budget Papers & Citi Investment Research and Analysis

Figure 19. FY11 Expected State General Government Expenses Composition: Average of States



Source: ABS, State Budget Papers & Citi Investment Research and Analysis

State Government Net Debt

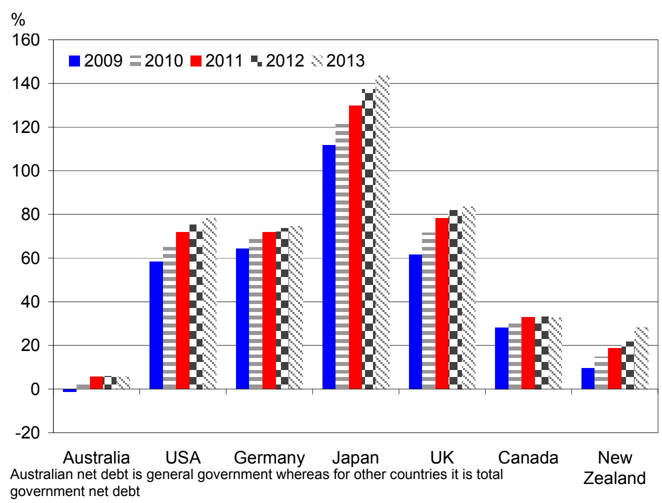
Much has been said by Citi about Australia's low general government net debt position, both on an outright basis and when compared to other OECD countries. For reference, Australia's net-debt position remains far below that of comparable industrialised countries when compared against a common denominator such as the level of nominal GDP (Figure 20). Little has been said about the how the States compare to their Federal counterpart.

Low State General Government Net Debt to GSP Ratio

General Government State net debt as a percentage of GDP averages 2.1% per year per State across the budgetary estimates period. Within this broad statistic there are some variations. QLD has negative general government net debt out to FY13 as its financial assets exceed its financial liabilities. All of the other States except TAS have similar net debt to GDP profiles that are very low.

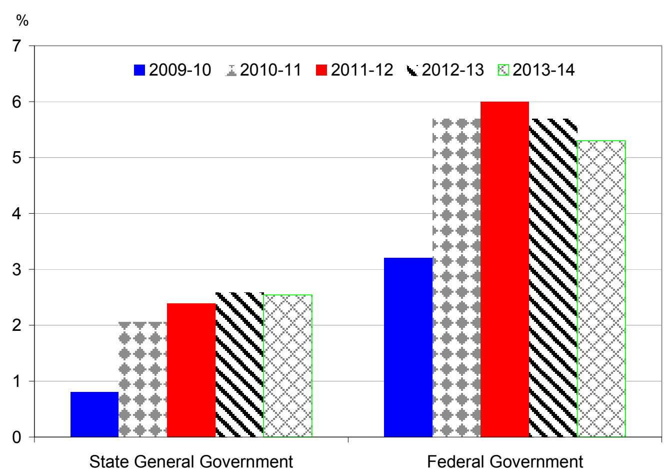
For these States, this reflects maintaining or returning to operating surpluses that will help to part fund infrastructure programs, meaning that less funding is required by way of borrowings. Despite these differences, the combined State net debt to output ratio is below that of the Federal Government's ratio across all the budgetary forecast and projection years (Figure 21). With the Federal Government enjoying an international reputation as a sovereign with lower net debt than its international peers, the States net debt positions should also be held in high regard.

Figure 20. National Government Net Debt to GDP Ratio: Global Comparison



Source: IMF, Federal Budget Papers & Citi Investment Research and Analysis

Figure 21. General Government Net Debt to Output Ratio: States vs Federal



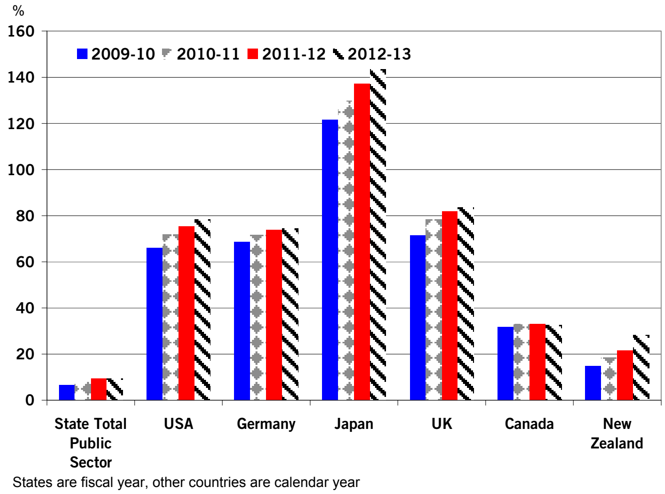
Source: ABS, State Budget Papers & Citi Investment Research and Analysis

Total Public Sector Net Debt to GSP Below the OECD

To properly account for public non-financial corporations and public financial corporations that are outside of the general government sector, total public sector net debt must be used. The Federal Government does not publish data on total public sector debt, so a direct comparison between total State and Federal Government net debt to output is not possible.

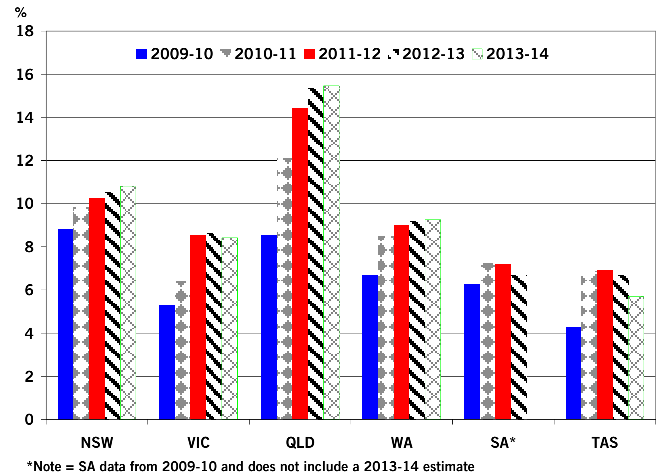
But a direct comparison can be made between the States and similar industrialised economies. On an international scale, the States have far lower net debt to output ratios than the major OECD countries and New Zealand (Figure 22).

Figure 22. Government Net Debt to Output Ratio: States vs Global



Source: Citi Investment Research and Analysis

Figure 23. Total State Government Net Debt to GSP Ratio



Source: Citi Investment Research and Analysis

Asset Sales in QLD Will Narrow the Fiscal Gap

A few of the States have an additional means of ensuring that net debt remains comparatively low. QLD is leading that way in this regard through targeted asset sales/long term leases to the private sector. This initiative was announced in June 2009 and was designed to encourage private sector participation in infrastructure provision.

Potential asset sale proceeds have not been factored into budget estimates. As the sales are completed, the proceeds will be incorporated into the forward estimates. The Government estimates that as much as $15 billion would be achieved through asset sales/leases of the following ongoing concerns (Figure 24). Net debt, net financial liabilities and borrowing requirements would be lower than is currently accounted for in the forward estimates, bringing these metrics back towards the expected outcomes of the other States (Figure 21). Citi is confident that the asset reform program will succeed in one form or another, but we do not ignore the political risks that have plagued other State Governments that have embarked upon asset sale/lease programs.

Figure 24. Planned QLD Asset Sales/Leases

Asset	Description
Forestry Plantations QLD	Agreed to sell to Hancock QLD Plantations for $603 million
Port of Brisbane Corporation	99 year lease for land and infrastructure expected to be finalised by the end of 2010
QR Limited	Proposed sale of coal, freight and service operations via public offer
Abbot Point Coal Terminal	99 year lease for land and infrastructure assets to commence in Q4 2010
QLD Motorways Limited	Sale via staged process to be completed in late 2011

Source: QLD 2010-11 Budget Papers & Citi Investment Research and Analysis

State Infrastructure Spending

Key findings:

- The GFC dented but did not stop the previous trend of higher infrastructure spending that was a catch-up from a period of previous underinvestment.
- Capital investment is expected to reaccelerate out to FY12 as the States return to their previous commitments. Investment expenditure growth beyond this date will ease as States focus back on long-run financial and budgetary goals.

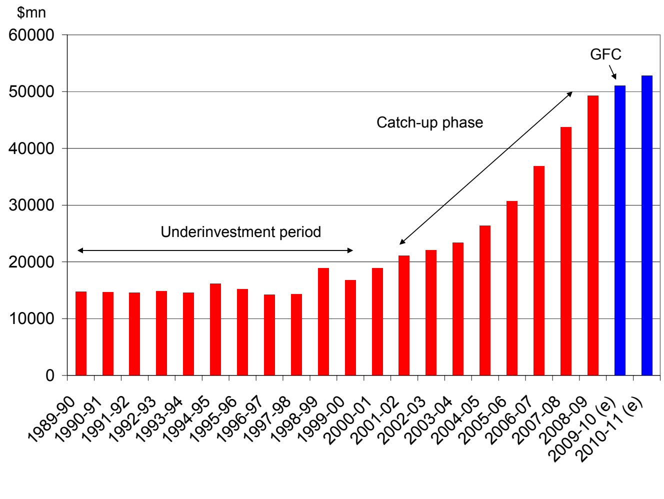
Infrastructure Spending Starts to Recover from the GFC

As mentioned above, some States have been increasing their net debt positions to fund much needed infrastructure priorities. Projects include but are not limited to the construction of roads, rail track, housing, electricity distribution, hospitals and schools.

The emphasis on extra spending on infrastructure is a catch-up from a period of underinvestment by past governments (Figure 25). Despite increases in population and greater demands on certain services, for example health care, nominal State spending remained largely constant throughout the 1990s.

In response, State Governments attempted to address this period of inadequate investment through an almost exponential increases in capital investment expenditure from early last decade through to 2008-09 (Figure 25). The interruption to the pace of investment was because of the GFC. At the time, this global event was expected to seriously affect State Government finances.

Figure 25. State and Local Government Capital Investment: Actual and Expected



Source: ABS & Citi Investment Research and Analysis

Figure 26. Infrastructure Spending: Total Government

	2009-10 $Abn*	2010-11 $Abn^	Percentage Change	2009/10 to 2012/13 $Abn#	2010/11 to 2013/14 $Abn^	Percentage Change
NSW	16.6	16.6	0.0	63.7	62.2	-2.3
VIC	7.2	6.6	-7.9	19.4	20.9	7.7
QLD	17.3	17.1	-1.2	55.9	49.2	-12.0
WA	7.2	7.6	5.6	26.5	24.9	-6.0
SA	2.2	3.9	77.3	10.3	11.4	10.7
TAS	0.6	1.0	79.8	2.1	2.3	10.8
TOTAL	51.0	52.8	3.5	177.8	170.8	-3.9

*estimated actual or revised in 2010-11 Budgets or where not available as estimated in 2009-10 Budgets

#as estimated in 2009-10 Budgets

^as estimated in 2010-11 Budgets or where not available carried over from 2009-10 Budget

Source: State Budget Papers & Citi Investment Research and Analysis

Investment Spending to Reaccelerate Out to FY12

State spending on infrastructure in FY11 is expected to be around $52 billion (Figure 26). The FY10 result of $51 billion was below the previous estimate made last year for planned expenditure total of $60 billion. The reduction reflected the then expected impact of the GFC on State finances. With the cyclical improvement in State finances since then, the FY11 estimate is 3.5% higher than the FY10 result. NSW and QLD are planning on spending the largest amounts on infrastructure in FY11 and across the budgetary estimate period. This reflects a pressing need to upgrade high cost physical infrastructure in these two States.

In total, the States are expected to spend $171 billion in the four years to FY14 (Figure 26). Although this figure is 3.9% below the expected four year expenditure to FY13, it is above any previous four year period.

Companies that are likely to benefit from the infrastructure expenditure growth include Boral, Adelaide Brighton and Leighton Holding. These companies supply materials for road, rail and bridge construction. Other companies that could benefit include Downer EDI, UGL Limited and Fletcher Building.

Beyond This Date Investment Expenditure Will Moderate

Based on current estimates from the States, investment growth is expected to ease from around FY12. This suggests that cumulative investment over the budgetary forward estimates will taper off. Part of this has to do with assets moving from public to private balance sheets as they are privatized. But mostly it reflects a return to more normal investment levels and the ongoing focus on long-run financial and budget goals.

Borrowing Programs, Risks and Market Dynamics

Key findings:

- Semi Government authorities are forecast to expand their borrowing programs over the forward estimates. The increase reflects the commitment to fund infrastructure. The mid-point (projected) forecast is for total State issuance to reach $242 billion by the end of FY14.

- QTC and TCorp will likely continue to be the largest Semi Government issuers. For QTC, the proposed asset sales/lease program outlined in Budget 2010-11 has the potential to significantly lower the borrowing needs over the forward estimates. That said, there is no guarantee that the asset reform program will go ahead in the current form.

- With the Federal Election outcome uncertain, there is no guarantee that the proposed National Health and Hospital Network plan for control of the hospitals and health system at the Federal level will go ahead in its current form. The vertical shift in funding requirement from the Federal Government to the States should the NHHN not go ahead could be around $15 billion from FY15 to FY20. The potential cost will be offset by some GST revenues back to the States should this be the case.

- Citi believes that QTC and TCorp are unlikely to issue any more bonds under the Federal guarantee. Instead, they are likely to use this period until 31st Dec 2010 to build up State guaranteed lines and consolidate federally guaranteed into State guaranteed lines.

- In the short-end (3yr maturity), Citi recommends that investors sell Federal Government guaranteed semis at a spread of under 25bps to CGS to buy State guaranteed semis. In the long-end we would recommend a target of selling the Federal Government guaranteed NSWTC.Apr19 at a spread of 25bps or under to CGS to buy the State guaranteed NSWTC.May20.

- We maintain a preference to own State guaranteed QTC bonds versus TCorp across the curve. However, recently we have seen a sharp narrowing of the spread between State guaranteed QTC and NSWTC bonds. As such we would target re-entering spread narrowing positions (target +12 bps) on any widening of these spreads and would recommend investors buy QTC State guaranteed bonds with a view to a ratings upgrade.

- We recommend buying the NSWTC35i capital indexed bond at current real yields of 3.37% and look for a move towards 3.0%.

Semi Government Borrowing Programs

Forecasting the borrowing requirements for Semi Government authorities requires acknowledging the following questions:

- To what degree do Semi government authorities choose to refinance existing maturities? They could choose to refinance none, some or all.

- What amount of pre-funding occurs in the base year that the forecasts are derived from? This depends upon market conditions and within year financing requirements.

- What amount of total issuance does each issuer believe constitutes a liquid portfolio that will support secondary market activity? This will depend upon feedback from the dealer panel and will vary based on market demand.
- What political drivers could influence a government's view on debt funding and therefore influence issuance patterns? Views on debt funding from State Treasurers and Treasury departments will influence total issuance and how much issuance is in any given maturity.
- To what extent will abnormal and extraordinary items like asset sales affect the need to issue debt to the market? Although less common than the influences, asset sales/leases can have a large influence on borrowing requirements.

In most of the cases the answers to these questions are not known in advance. To get around these limitations, Citi forecasts a low and high issuance profile within which we expect issuance to be across the budgetary forward estimates (Figure 27 to Figure 32). Based on the fiscal objective of minimising net debt levels and the cyclical improvement in revenues, we would suggest that the lower end of the forecast range may carry more political weight with State Treasurers.

TCorp

Citi estimates that in FY11 TCorp has a funding requirement of $10 billion of which $7.7 billion is to refinance maturing debt and $1.2 billion is (net) client funding including pre-funding. Citi expects the total stock of bonds on issue to be between $56 billion and $75 billion by FY14.

Figure 27. TCorp Net Debt and Issuance Estimates

	2009/10	2010/11	2011/12	2012/13	2013/14
Net Debt, Total State Sector ($bn)	36.1	42.6	47.0	51.0	55.1
% of GSP	*8.8*	*9.9*	*10.3*	*10.6*	*10.8*
Maturities	5.5	7.7	7.8	1.0	2.1
Gross Issuance	6.5	10.0	12.2	5.0	6.2
Net Issuance	1.0	1.2	4.4	4.0	4.1
Total Stock on Issue - Low	**42.0**	**43.2**	**47.6**	**51.6**	**55.7**
Total Stock on Issue - High	**42.0**	**52.0**	**64.2**	**69.2**	**75.4**

Source: Citi Investment Research and Analysis

QTC

QTC has a FY11 funding requirement of $18 billion of which $10.8 billion is to refinance maturing debt and $7.2 billion is for new funding, primarily capital works and asset procurement. We expect the total stock of bonds on issue to fall between $86 billion and $110 billion by FY14.

Figure 28. QTC Net Debt and Issuance Estimates

	2009/10	2010/11	2011/12	2012/13	2013/14
Net Debt, Total State Sector ($bn)	20.6	31.1	39.6	44.8	48.1
% of GSP	*8.5*	*12.1*	*14.4*	*15.3*	*15.5*
Maturities		10.8	4.7	0.0	8.2
Gross Issuance		18.0	13.2	5.2	11.5
Net Issuance		7.2	8.5	5.2	3.3
Total Stock on Issue - Low	**62.0**	**69.2**	**77.7**	**82.9**	**86.2**
Total Stock on Issue - High	**62.0**	**80.0**	**93.2**	**98.4**	**109.9**

Source: Citi Investment Research and Analysis

WATC

In FY11 WATC has a funding requirement of $8.9 billion of which $4.1 billion is to refinance maturing long-term debt and $4.8 billion is for new lending to clients. The amount of bonds on issue is expected to span between $25 billion and $37 billion by FY14.

Figure 29. WATC Net Debt and Issuance Estimates

	2009/10	2010/11	2011/12	2012/13	2013/14
Net Debt, Total State Sector ($bn)	11.4	15.4	17.5	18.9	20.1
% of GSP	*6.7*	*8.5*	*9.0*	*9.2*	*9.3*
Maturities		4.1	2.5	3.0	2.3
Gross Issuance	6.6	8.9	4.6	4.4	3.4
Net Issuance	6.6	4.8	2.1	1.4	1.2
Total Stock on Issue - Low	**15.8**	**20.6**	**22.7**	**24.1**	**25.2**
Total Stock on Issue - High	**15.8**	**24.7**	**29.3**	**33.6**	**37.1**

Source: Citi Investment Research and Analysis

TCV

In FY11 TCV has a funding requirement of $5.8 billion of which $2.6 billion is to refinance maturing debt and $3.3 billion is for new client funding. The total stock of bonds on issue could reach up to $34 billion by FY14.

Figure 30. TCV Net Debt and Issuance Estimates

	2009/10	2010/11	2011/12	2012/13	2013/14
Net Debt, Total State Sector ($bn)	16.1	20.6	28.9	30.9	31.7
% of GSP	*5.3*	*6.4*	*8.5*	*8.7*	*8.4*
Maturities		2.6	0.5	0.0	0.0
Gross Issuance	5.4	5.8	8.8	2.0	0.8
Net Issuance	5.4	3.3	8.3	2.0	0.8
Total Stock on Issue - Low	**16.6**	**19.9**	**28.2**	**30.2**	**31.0**
Total Stock on Issue - High	**16.6**	**22.4**	**31.2**	**33.2**	**34.0**

Source: Citi Investment Research and Analysis

SAFA

SAFA has a FY11 funding requirement of $3.6 billion of which $2.9 billion is to refinance maturing debt (although $1.5 billion is for P-note maturities). $1.3 billion is for new client funding and total issuance is expected to be just between $9.0 billion and $13.4 billion by FY14.

Figure 31. SAFA Net Debt and Issuance Estimates

	2009/10	2010/11	2011/12	2012/13	2013/14
Net Debt, Total State Sector ($bn)	2.1	2.8	3.2	3.1	2.9
% of GSP	*6.3*	*7.2*	*7.2*	*6.7*	*0.0*
Maturities	0.9	2.9	0.1	2.0	0.0
Gross Issuance		3.6	0.5	1.9	-0.2
Net Issuance		1.3	0.4	-0.1	-0.2
Total Stock on Issue - Low	**7.6**	**8.9**	**9.3**	**9.2**	**9.0**
Total Stock on Issue - High	**7.6**	**11.2**	**11.7**	**13.6**	**13.4**

Source: Citi Investment Research and Analysis

TASCORP

TASCORP will be the smallest issuer in terms of Semi Government bond issuing authorities. Funding is just $1.1 billion in FY11, consisting of rolling over existing maturities. Total issuance is expected to rise to as much as $4.7 billion FY14.

Figure 32. TASCORP Net Debt and Issuance Estimates

	2009/10	2010/11	2011/12	2012/13	2013/14
Net Debt ($bn)	1.0	1.7	1.8	1.8	1.6
% of GSP	*4.3*	*6.9*	*6.9*	*6.7*	*5.7*
Maturities		1.1	0.0	0.9	0.0
Gross Issuance		1.1	0.1	0.9	-0.2
Net Issuance		0.0	0.1	0.0	-0.2
Total Stock on Issue - Low	**2.8**	**2.8**	**2.9**	**2.9**	**2.7**
Total Stock on Issue - High	**2.8**	**3.9**	**4.0**	**4.9**	**4.7**

Source: Citi Investment Research and Analysis

Risks to the Forecasts

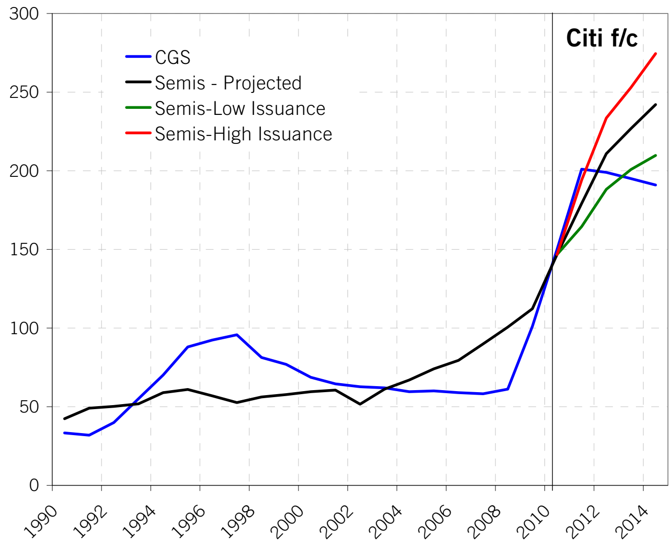
At the end of FY10 there were approximately $147 billion of Semi Government bonds outstanding (Figure 33). Increased demand for public services, infrastructure requirements and funding for capital investment in public trading enterprises (PTEs) are driving the increase in funding over the forward estimates.

Citi's analysis shows that QTC and TCorp will likely continue to be the largest Semi Government issuers (Figure 34). Should the proposed asset sales/leases by QLD be successful it is likely that bond issuance from QTC over the forward estimates will be lower than currently projected.

In the 2010-11 budget, only the $603 million sale of Forestry Plantations Queensland was factored into the budget estimates. However, with the majority of the asses sales proposed in Q4 2010, the 2011-12 State budget is likely to be the next opportunity for the QLD Government to begin including asset sales/lease proceeds into the forward estimates.

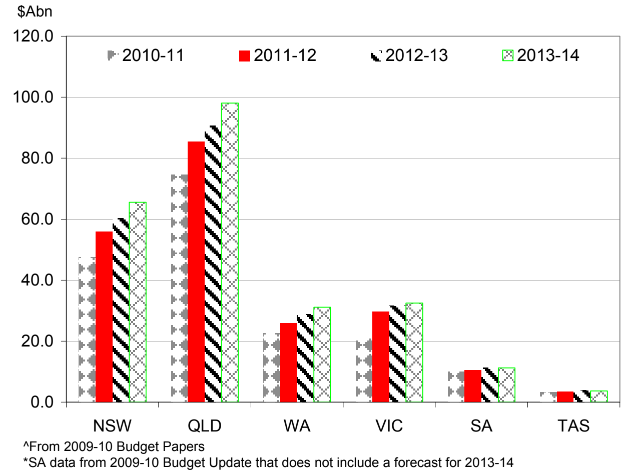
Asset sales/leases could deliver QLD as much $15 billion in proceeds and avoid $10 billion capital investment in these assets over the next five years. Whilst the exact amount of reduction in the net funding requirement is highly dependant on the price received for the asset sales, delivery of the expected gains would push issuance to the low forecast. That said, other State Governments have tried asset reform programs. Whilst some have been successful they have shown that the path to reform can be politically costly. Given the Federal Election stand-off, there is no guarantee that politicians in QLD will be as eager to divest State owned assets as currently proposed.

Figure 33. CGS and Semis Issuance Actual & Forecast $A billion



Source: AOFM, State Government Borrowing Authorities & Citi Investment Research and Analysis

Figure 34. Semi-Government Bond Projections



Source: State Budget Papers & Citi Investment Research and Analysis

A risk to issuance across all the States comes from the eventual outcome of the Federal election. The current ALP Government's National Health and Hospital Network (NHHN) plan will be responsible for absorbing the majority of cost growth in the health and hospital system. Under the COAG agreement, the Commonwealth Government will fund 60% of the efficient price of public hospital services. Under the coalition, this figure would only be 40%. Funding is sourced from the National Healthcare Specific Purpose Payment, State GST payments and an additional top up funding from the Australian Government.

With the election outcome uncertain, there is no guarantee that the proposed NHHN plan for control of the hospitals and health system at the Federal level will go ahead in its current form. The area of funding that could get affected is the additional top-up funding that would otherwise have come from the Federal Government. States could be required to fund the shortfall. The vertical shift in funding requirements should the NHHN not go ahead could be around $15 billion from 2014-15 to 2019-20. The potential cost will be offset by some GST revenues back to the States should this be the case.

Market Dynamics

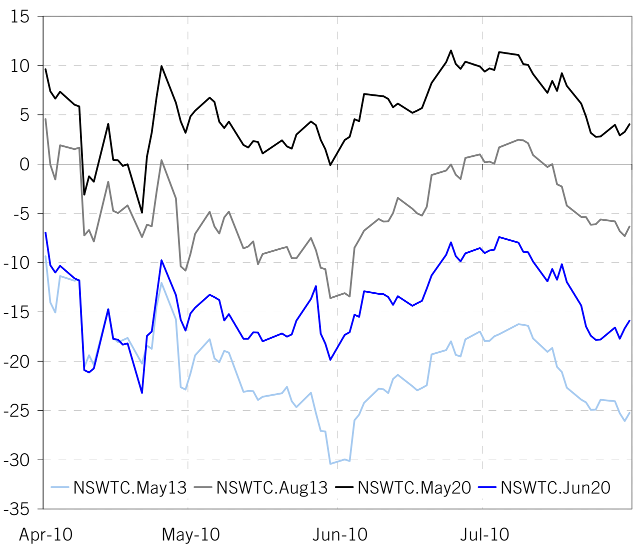
Semi Government bonds, which generally trade as a spread product to Commonwealth Government bonds or swaps, usually follow moves in global credit conditions (i.e. increased risk aversion and wider swap spreads sees wider semi spreads). As such, during the period surrounding the Lehman Brothers collapse, semi spreads widened quite significantly prompting the Australian Federal Government to issue an optional temporary guarantee on State Government debt for a fee for each State authority. This was to ensure that the States could continue to borrow in financial markets to fund ongoing critical capital investments. The guarantee helped to bolster investor sentiment, thereby narrowing semi-spreads quite significantly and reducing the cost of funding.

However, not all Semi Government authorities had guaranteed their bonds, and for those that had, not every outstanding bond line was guaranteed. The change effectively introduced a new 'class' of Semi Government bonds that were 'Federal Government Guaranteed'. In a sense, the market trades on two different curves – semis that are 'Federal Government guaranteed' and those that are 'State Government guaranteed'.

Earlier this year the Federal Government announced that it would be withdrawing the temporary guarantee for semis. States have until 31 Dec 2010 to guarantee new lines.

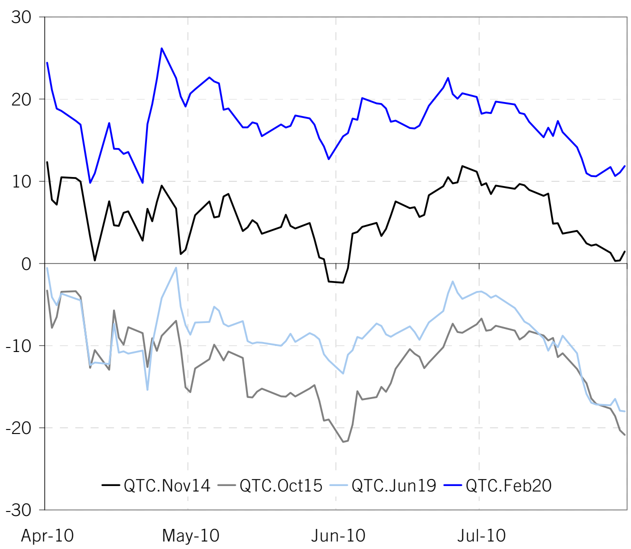
Citi believes that QTC and NSWTC are unlikely to issue any more bonds under the Federal guarantee. Instead, they are likely to use this period to build up State guaranteed lines and consolidate Federal guaranteed into State guaranteed lines. With a scarcity value on Federal guaranteed Semi Government issuance, they have been in high demand as indicated by their spread to other issuance (Figure 35 and Figure 36).

Figure 35. NSWTC Non-guaranteed vs. Guaranteed Bonds as Asset Swap Spread:



Source: Bloomberg & Citi Investment Research and Analysis

Figure 36. QTC Non-guaranteed vs. Guaranteed Bonds as Asset Swap Spread



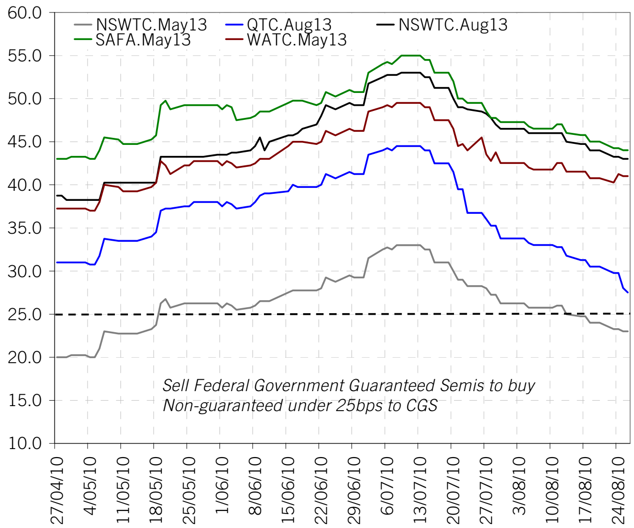
Source: Bloomberg & Citi Investment Research and Analysis

Outlook for Semi Government Bonds

Citi's market view for Semi Government bonds over the coming months is based on the following key ideas:

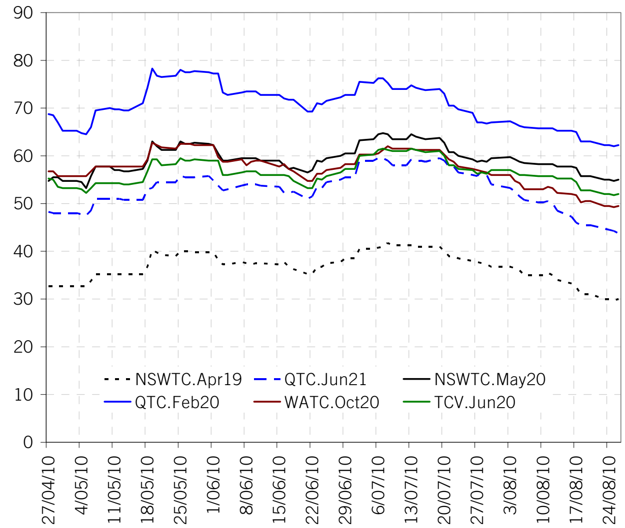
- **The consolidation of the Federal Government guaranteed and State Government guaranteed lines.** TCorp and QTC have already begun issuing State guaranteed bond lines at maturities where Federal Government guaranteed bonds exist. The switches will likely be offered to investors who will pick up yield in doing so. However this pick up is likely to remain under 15bps and 20bps for TCorp and QTC paper respectively (i.e. the cost of the guarantee for issuing existing stock). We also note that both QTC and NSWTC are likely to be significantly ahead of their funding schedules.

Figure 37. Selected Semis (spread to CGS)



Source: Bloomberg & Citi Investment Research and Analysis

Figure 38. Selected Semis (spread to CGS)



Source: Citi Investment Research and Analysis

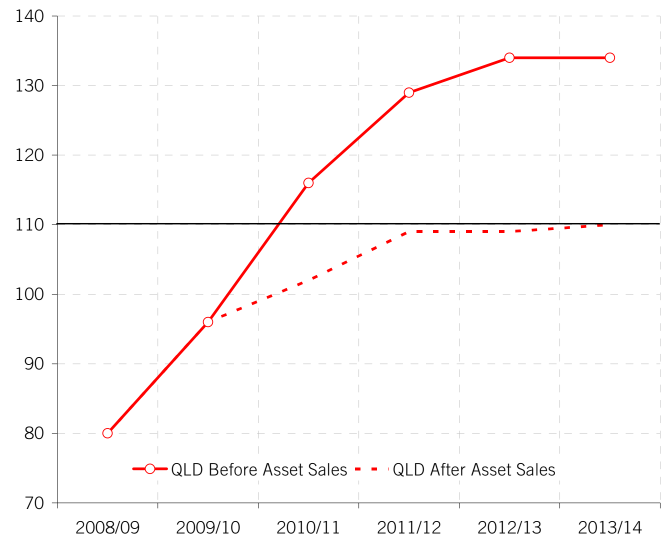
*In the short-end of the semi curve we would recommend investors sell Federal Government guaranteed semis at a spread of under 25bps to CGS to buy State guaranteed semis (*Figure 37*).*

*In the long-end we would recommend a target of selling the Federal Government guaranteed NSWTC.Apr19 at a spread of 25bps or under to CGS to buy the State guaranteed NSWTC.May20 (*Figure 38*).*

- **Queensland's credit rating.** The proposed asset sales program outlined in Budget 2010-11 has the potential to significantly lower the borrowing needs of QTC over the forward estimates. The most commonly used metric that credit rating agencies will use to gauge the success of the asset sales on the balance sheet is the reduction in the Net Financial Liabilities to Revenue (NFLR) Ratio.

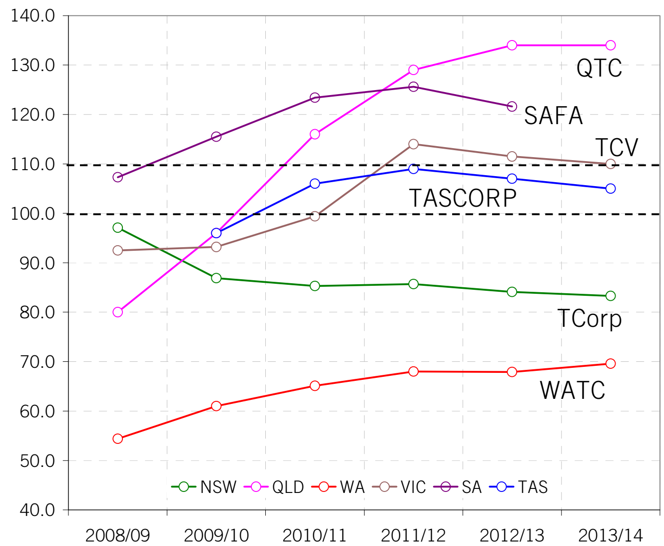
  Ratings agencies have indicated that the 100-110% range is one of the criteria required for a reassessment of the State's credit rating, along with a demonstration of a solid operating surplus (Figure 39 and Figure 40).

Figure 39. QLD NFLR (%) Before and After Proposed Asset Sales



Source: QLD Budget 2010-11 & Citi Investment Research and Analysis

Figure 40. NFLR (%) Comparison Across Different States

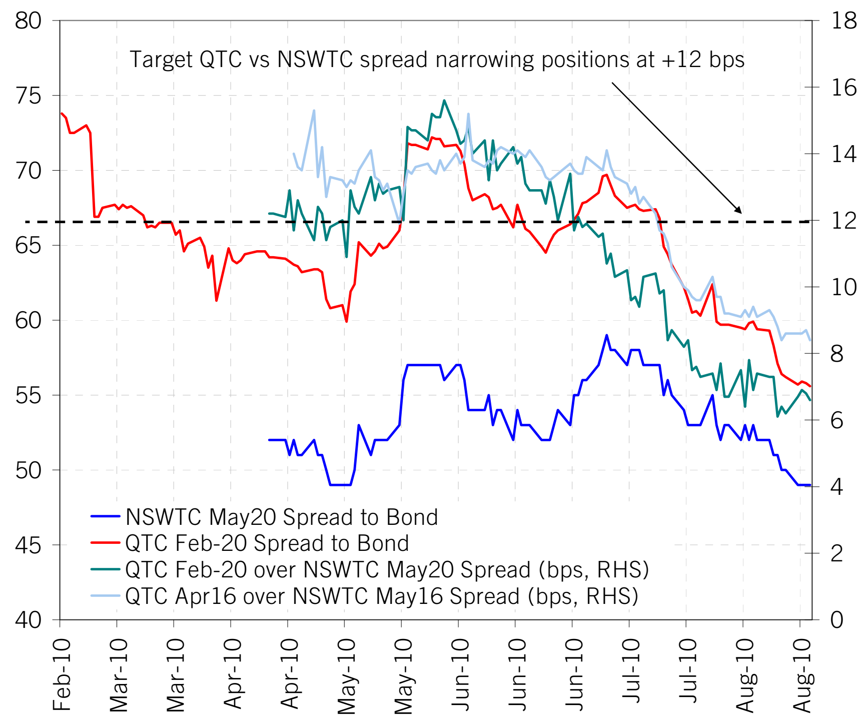


Source: Various State Budget Papers & Citi Investment Research and Analysis

The asset sales are expected to reduce the net financial liabilities on the State's balance sheet, and thus the NFLR after revenue foregone. Consequently this is expected to reduce the net debt and therefore, the net funding requirement.

The bulk of asset sales are likely to occur in Q4 2010, so the Budget for FY12 will be the next opportunity for Queensland to factor the reduction in borrowing requirements into their forward estimates. However, Citi believes it is quite likely that ratings agencies will react (should the asset sales be successful) favourably before the year end.

Figure 41. QTC Non-guaranteed Spreads Over NSWTC



Source: Bloomberg & Citi Investment Research and Analysis

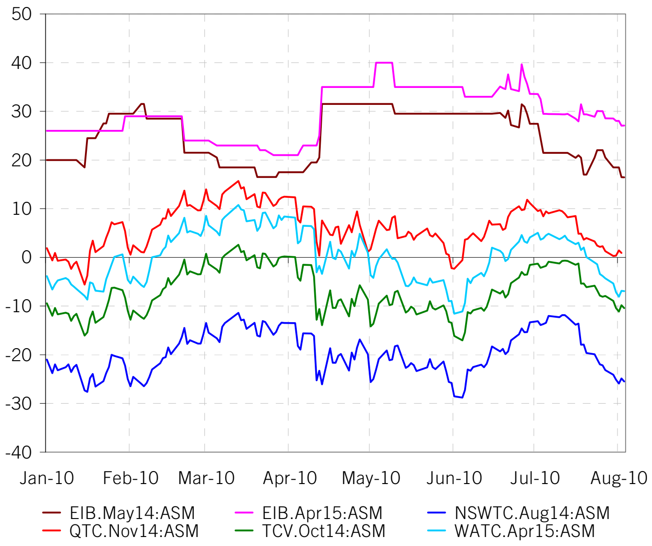
A favourable outcome on Queensland's asset sales will be beneficial for semi-spreads in general.

*We maintain a preference to own State guaranteed QTC versus TCorp across the curve. However, recently we have seen a sharp narrowing of the spread between State guaranteed QTC and NSWTC bonds (*Figure 41*).*

As such we would target re-entering spread narrowing positions (target +12 bps) on any widening of these spreads and would recommend investors buy QTC State guaranteed bonds with a view to a ratings upgrade.

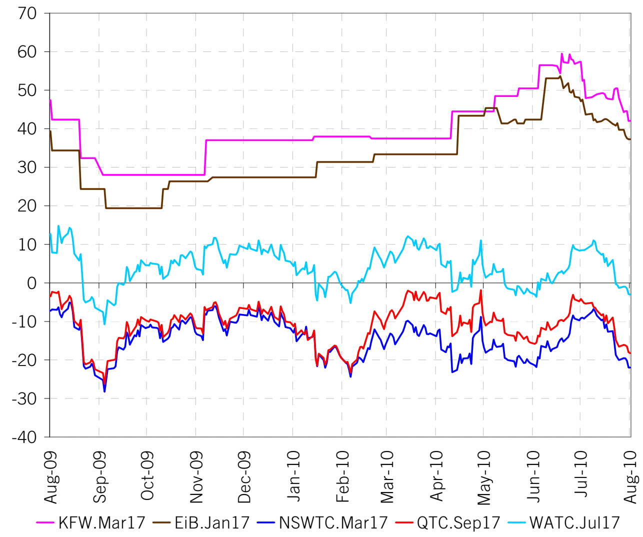
- **Semis overall look expensive versus similar rated Supranational agencies (SAS) or Federal Government Guaranteed Bank Debt.** The recent tightening of semi-spreads makes semis appear relatively expensive against similar rated SAS paper. For investors looking for yield while maintaining exposure to a similar rated entity, SAS paper appears relatively cheap on an asset swap margin basis (Figure 42 & Figure 43).

Figure 42. Selected Semis and SAS Asset Swap Margins



Source: Bloomberg & Citi Investment Research and Analysis

Figure 43. Selected Semis and SAS Asset Swap Margins



Source: Bloomberg & Citi Investment Research and Analysis

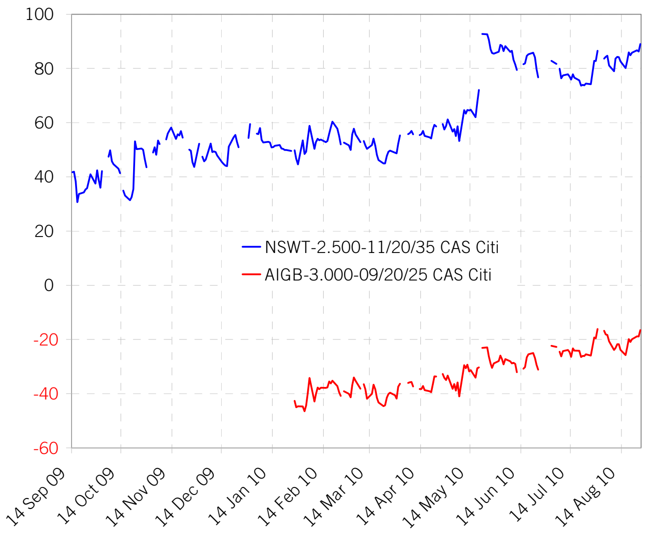
- **Buy NSWTC35i capital indexed bond.** We believe the break-even inflation rate on the NSWTC35i inflation linked bond is too low given Australia's recent inflation performance and the break-even rates on comparable securities.

  For example, the break-even inflation rate from the CGS Sep-25i bond (versus the CGS Jul-22 nominal) is around 2.5%, compared to the 2.0% break-even rate from the NSWTC35i (Figure 45).

  We expect headline inflation to be 3.0% or above in 2011. We do not believe that such a difference is warranted despite the NSWTC35i having a longer maturity than comparable issues.

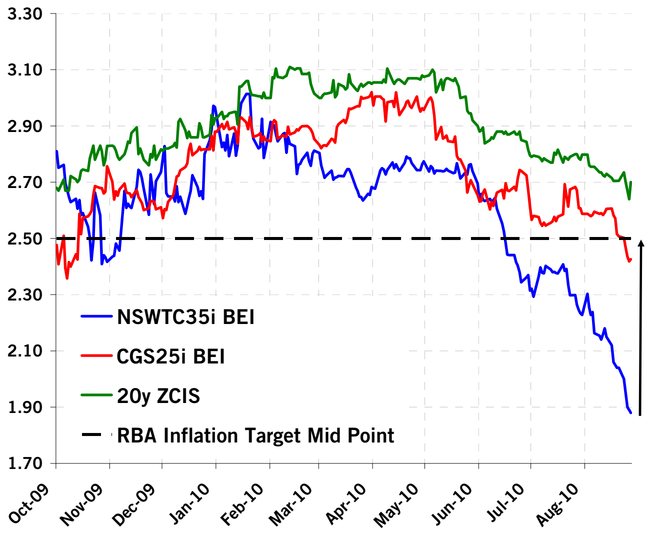
  We recommend buying the NSWTC35i capital indexed bond at current real yields of 3.37% and look for a move towards 3.0%.

Figure 44. CAS History of NSWTC35i and CGS25i



Source: Citi Investment Research and Analysis

Figure 45. Selected Break-even Inflation Rates



Source: Citi Investment Research and Analysis

Regulatory and Political Issues

Key findings:

- Changes to global and Australian banking regulations will increase the demand for sovereign government bonds. Focusing on the major Australian banks alone, there is likely to be an excess of demand for domestic sovereign paper. Outside of the major Australian banks, there are 67 ADIs that will be influenced in a substantial way from the regulatory changes.

- ADI's are already beginning to add to their stock of liquid assets. Semi Government borrowing authorities can take advantage of the structural increase in demand for their high quality paper by targeting primary issuance through their dealer panels at maturities that would best meet the regulatory demands of ADIs.

- Fixed term elections mean that VIC and NSW voters will go to the polls on 27 November 2010 and 26 March 2011 respectively. The VIC ALP Government should retain power with a reduced majority but the NSW ALP Government is likely to be removed from power by one of the largest swings against an incumbent Government in Australian political history.

- Developments in the aftermath of the Federal Election and the likelihood of a reduced majority for the ALP in VIC could have implications for policy reform agendas for government generally across at least the next parliamentary term. There is a risk that economic reform will take a back-seat to short-term political goals of State and Federal Governments more generally.

- Future strong economic performance and gains in living standards will require current State and Federal Governments to look through the political cycle and deliver solutions that will help promote economic growth and raise living standards long after Australia has stopped benefiting from the resources boom.

Bank Regulations Add to Demand for Semi-Government Bonds

Changes to the global regulatory structure for authorised deposit taking institutions (ADIs) have the potential to create an opportunity for Semi Government borrowing authorities. This is despite the fact that these issuers are not directly affected by the regulatory changes being considered by the Basel Committee on Banking Supervision (BCBS) or the Australian Prudential Regulatory Authority (APRA). The changes that have relevance for the States are:

- **BCBS.** One part of the global regulatory change is the proposed new liquidity rules that require to banks comply with a liquidity coverage ratio (LCR). To comply, banks need to hold sufficient liquid assets to meet cash outflows over a thirty day period. Stressed scenarios are used to calculate the outflows. The aim is to discourage risky liquidity profiles and ensure that banks have funding to survive for thirty days under severe circumstances. Eligible Level 1 liquid assets include sovereign government bonds with 100% weighting. This is because under a stress scenario there is the assumption that these financial market instruments will be able to be readily sold and converted to cash. The favorable treatment given to sovereign debt under the LCR makes them attractive for ADIs.

- **APS 210.** Until recently, this Australian Prudential Standard provided limited guidance to what constituted a liquid asset for stress testing purposes. In parallel with the working of the BCBS, APRA is tightening the definition of what constitutes a liquid asset. They need to be high quality, easily sold or used as collateral in the market. Based on this definition and to avoid cross currency basis risk, the most highly prized and liquid form of assets available to domestic ADIs is Australian sovereign bonds.

Citi banking analysts calculate that the regulatory changes will increase the holding requirements from the major banks. Focusing on the major Australian banks alone, the demand for domestic sovereign bonds is likely to lead to excess demand before the end of the budgetary estimates period (Figure 46).

The demand/supply balance in Figure 46 is likely to be conservative. It only includes regulatory created demand from the major banks. It does not include regulatory demand from the remaining Australian ADIs, foreign ADIs, supranational organisations or trading demand and flows from the desks of banks, hedge funds and brokers. Outside of the major Australian banks, there are 67 ADIs that will be influenced in a substantial way from the regulatory changes and a further 107 that could also be affected to a degree. The demand/supply analysis also contains the implicit assumption that neither the AOFM nor the Semi Government borrowing authorities will hold each others bonds. To date, the AOFM has been a holder of Semi Government paper.

Figure 46. Demand vs Supply - Major Banks Demand for Sovereign Australian Bonds: $Abn

	2009/10	2010/11	2011/12	2012/13	2013/14
Federal Government Bond Issuance Forecast*	137	178	189	185	181
Projected State Government Bond Issuance Forecasts*	147	179	211	227	242
Total Domestic Sovereign Bonds on Issue	284	358	400	412	423
minus bonds owned offshore^	193	243	272	280	288
AU Sovereign Bonds Available for Domestic ADIs	91	114	128	132	135
Forecast Portfolio Holdings by Major Australian Banks~	70	86	106	131	162
Surplus/Deficit of Sovereign Bonds	**21**	**28**	**22**	**1**	**-27**

*Citi forecasts
^calculated using non-resident holdings data for Commonwealth Government Securities
~Forecasts provided by Citi banking analysts assuming FY12 implementation of LCR with a 6 year transition period

Source: Citi Investment Research and Analysis

An Opportunity for Semi-Government Authorities

There is not enough high grade Federal and State Government bonds to satisfy regulatory demand, let alone the combination of regulatory and normal market demand. This is why the BCBS will review in September the arrangements for jurisdictions like Australia that do not have sufficient Level 1 liquid assets. Changes are likely to be made that will help with the demand/supply imbalance and Citi is optimistic that a solution will eventually be proposed. But with around 75% of our forecast for issuance in both Commonwealth and Semi Government bonds already held by investors we envisage a tight fit between demand and supply in the future.

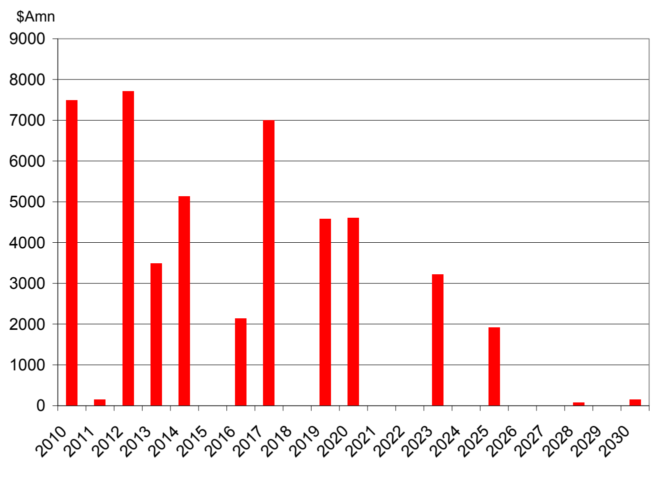
ADIs are purchasing more sovereign bonds in anticipation of the implementation of the regulatory changes. In response, Semi Government authorities can take advantage of the structural increase in demand for their high quality paper by targeting primary issuance through their dealer panels at maturities that would best meet the regulatory demands of ADIs.

Based on current expectations about the implementation timing of the regulatory regime, maturity buckets in strong demand are likely to be those from FY13 to FY 17. While we cannot rule out longer maturities, an environment of higher interest rates more generally as the Australian economy moves back to trend and above trend growth in the next few years is likely to favour bonds of shorter duration. In addition to greater time to maturity increasing duration, bonds of maturity greater than FY17 tend to have higher coupon rates, which is also associated with higher duration.

Most Semi Government issuers have gaps in their yield curves or relatively less issuance across certain maturity buckets (Figure 47 to Figure 52). Should they wish to increase liquidity in certain bond lines, most of the Semi Government borrowing authorities could do so knowing that there would be solid demand for issuance. BY issuing into maturity buckets in high demand Semi Government authorities could raise more proceeds from primary auctions, ie, a lower initial running yield.

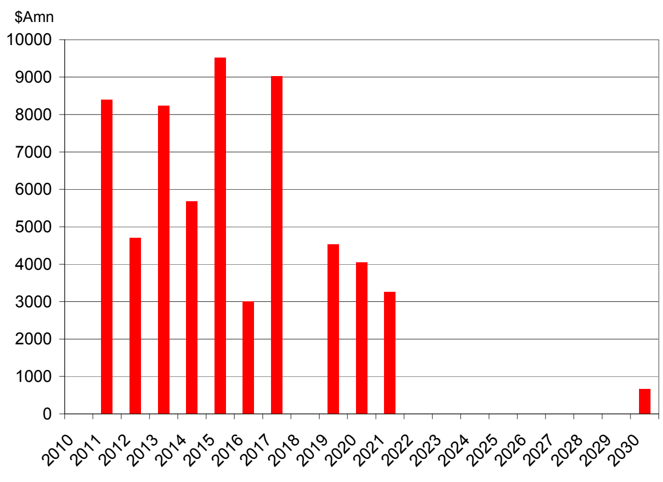
At this point in time, QTC is the issuer that has the most complete yield curve over the estimated initial period of regulatory derived demand for bonds. That said, based on their issuance requirements, TCorp and QTC probably have the most to gain from aiming the issuance profile towards buckets of high demand, followed by WATC and TCV. SAFA and TASCORP have the largest gaps and smallest line, but this reflects their lower absolute funding requirement.

Figure 47. TCorp Bond Issuance Maturity Buckets to 2030



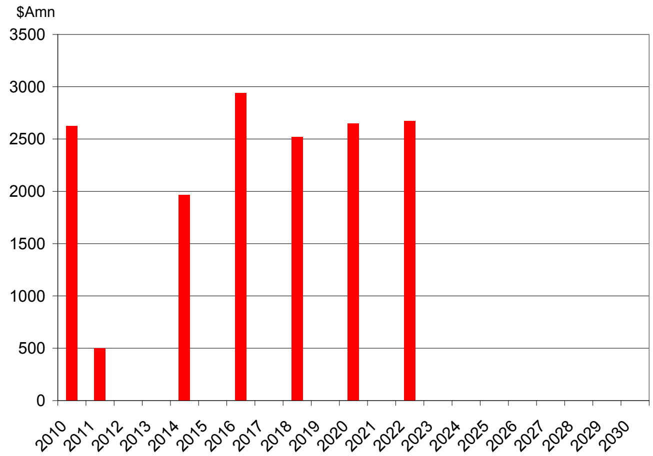
Source: Bloomberg & Citi Investment Research and Analysis

Figure 48. QTC Bond Issuance Maturity Buckets to 2030



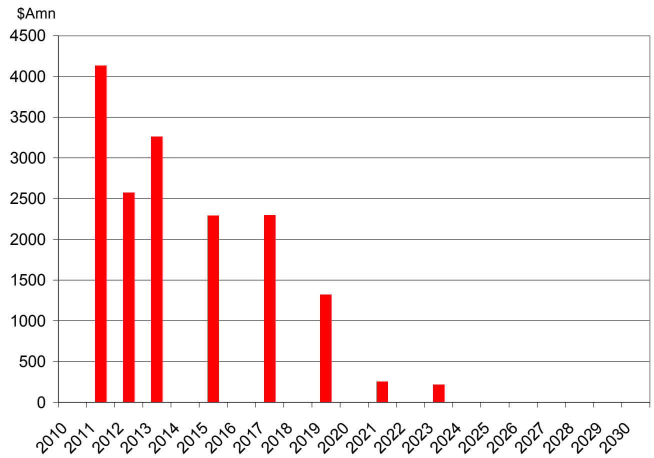
Source: Bloomberg & Citi Investment Research and Analysis

Figure 49. TCV Bond Issuance Maturity Buckets to 2030



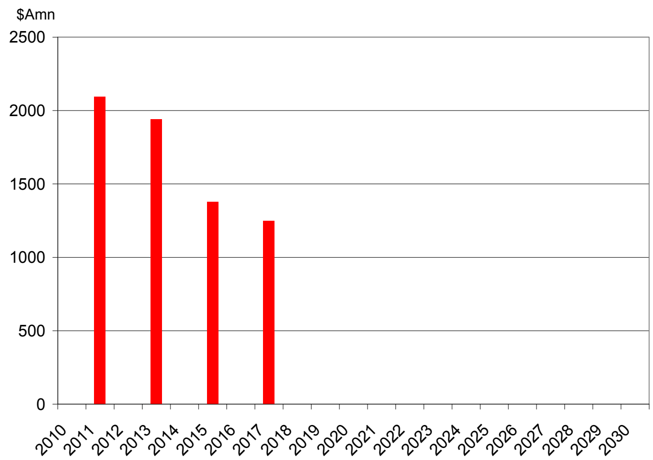
Source: Bloomberg & Citi Investment Research and Analysis

Figure 50. WATC Bond Issuance Maturity Buckets to 2030



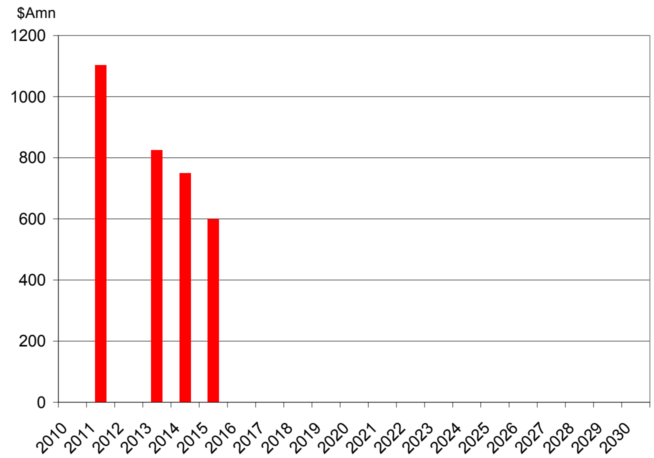
Source: Bloomberg & Citi Investment Research and Analysis

Figure 51. SAFA Bond Issuance Maturity Buckets to 2030



Source: Bloomberg & Citi Investment Research and Analysis

Figure 52. TASCORP Bond Issuance Maturity Buckets to 2030



Source: Bloomberg & Citi Investment Research and Analysis

Upcoming State Elections

VIC next to the polls

VIC voters will go to an election on 27 November 2010 and decide whether to retain the John Brumby Labor Government or to elect a Liberal/National Coalition Government led by Ted Baillieu. The Labor Party has been in Government since 1999 when then leader Steve Bracks swept aside the Kennett Liberal/National Coalition. The current composition of the VIC Legislative Assembly is the ALP 55 seats, Coalition 32 seats and 1 independent. The upper house, known as the Legislative Council has 40 members with the balance of power held by the Greens.

The most recent Newspoll placed the two party preferred voting intentions at 51% for Labor and 49% for the Liberal/Nationals. This is the closest the two party preferred vote has been since the November 2006 election. As for the preferred Premier, Mr Brumby remains the favourite at 51%, with Mr Baillieu at 24% and 25% undecided.

Despite the narrowing in the two party preferred gap to just 2 percentage points, the Liberal/National Coalition would require a Statewide swing of 6.5%. Given that the swing to the Coalition in the 2010 Federal Election was 2.1%, a change of government is unlikely. The likely outcome is a Labor Government for the next four years with a reduced majority. The Coalition will probably gain some seats but the Greens could obtain some seats in Victoria's Legislative Assembly.

Followed by NSW

After defeating the Liberal/National Coalition in March 2007 to retain Government, the Labor Government is likely to be removed from power when NSW voters go to the polls on 26 March 2011. The latest Newspoll has the two party preferred vote for Labor at just 39%, compared to the Liberal/National Coalition on 61%. Both the Premier Ms Keneally and the opposition leader Mr O'Farrell rate at 39% on the preferred Premier poll. Ms Keneally's personal satisfaction rating among voters had fallen 8 percentage points from the previous Newspoll, to be behind Mr O'Farrell for the first time.

The swing required by the Coalition to win government is 7.6%. This is achievable as in a by-election held in the electoral district of Penrith in June there was a swing of over 25% to the Liberal candidate over the sitting Labor member. This was the biggest swing against an incumbent government in NSW history.

The current composition of the NSW Legislative Assembly is the ALP 49 members, Coalition 38 and 6 independents. The Legislative Council has 42 members with the balance of power held by the Greens and independents.

Broader Implications of Election Results

Developments in the aftermath of the Federal Election and the likelihood of a reduced majority for the ALP in VIC could have implications for policy reform agendas for government generally across at least the next parliamentary term. If governments have slim majorities or rely on independents to form minority governments, there is a risk that long-term forward looking economic reform policies will be ignored as governments look at short-term political goals.

A recent example is *Australia's future tax system* report that was chaired by Treasury Secretary Ken Henry. This far reaching report contained numerous recommendations for substantial change to the tax system in a number of areas. The Federal Government's response was disappointing given that there was substantial potential to reignite an economic reform agenda that had largely languished following the substantial efforts of the Hawke/Keating Governments of the 1980s and 1990s.

While Australia's growth legacy over the current business cycle has benefited from previous micro and macroeconomic reforms, future strong economic performance and gains in living standards will require current State and Federal Governments to look through the political cycle and deliver solutions that will deal with funding and supplying essential government services for current and future generations and reduce impediments to private sector activity. Doing so will likely help promote economic growth and raise living standards long after Australia has stopped benefiting from the resources boom. Not doing so will likely squander the current gains the "Lucky Country" enjoys from the urbanization of our nearest major trading partners and burden future generations with a low growth, low productivity future.

Recent Australian/NZ Reports

- State of the States, 31 August 2010
- Transitioning to Higher Ground, 27 August 2010
- Letter From Canberra, 2 August 2010
- Profit Reporting Season and the Operating Environment, 23 July 2010
- Australian Economic Leaders, 7 July 2010
- Macro Risks to Share Market Earnings, 30 June
- Letter From Canberra, 24 June 2100
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- Australian Commonwealth Budget FY11, 11 May 2010
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- Australian Monetary Policy: Inflation get Worried, 31 March 2010
- Australian Economic and Share Market Earnings, 30 March 2010
- Non-Residential Construction Update, 2 February 2010
- Australian Macro Themes for the New Decade, 9 December 2009
- Non-Residential Construction: The Next Phase of the Boom, 31 August 2009
- Aussie Economic Forecasts Upgraded, 6 August 2009

Appendix A-1

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