

Tasmanian State Budget

2007-08

After the big spending in last year's Budget the focus returns to meeting fiscal strategy targets

8 June 2007

Michael Aird's second Budget speech and the accompanying Treasury analysis strike exactly the right tone in identifying **increasing productivity** as 'the cornerstone of economic growth', the need to 'improve education outcomes' as 'the greatest challenge we face as a State to our ongoing productivity and economic performance', and the crucial role of infrastructure in 'driv[ing] our productivity'. These are precisely the themes that ANZ has been emphasizing in our commentaries on the Tasmanian economy for more than a decade.

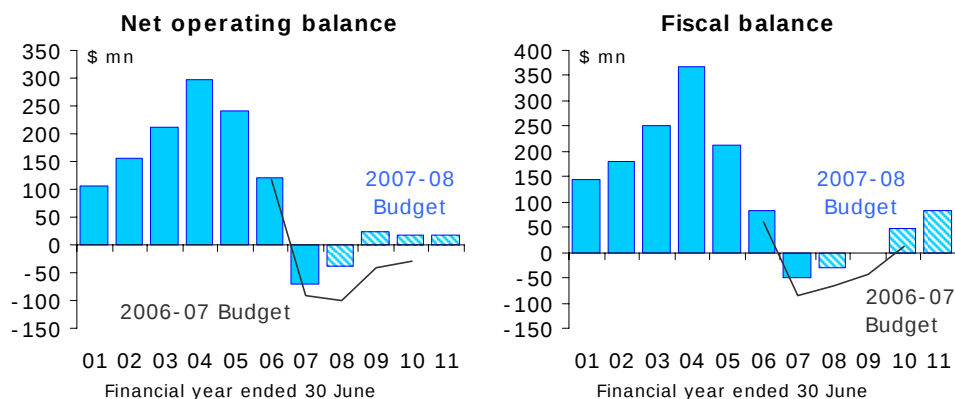
However the Budget itself is notable for its **conservative** approach to these challenges. Most of the gains accruing from revisions to projections of revenues and expenses and from a forecast acceleration in economic growth are applied to the attainment of the Government's **Fiscal Strategy objectives** (such as achieving a fiscal surplus, on average, over rolling four-year periods, and extinguishing the State's net unfunded superannuation liability); while most of the initiatives in the Budget are funded by offsetting revenue or expenditure measures.

Another notable feature of the Budget is the substantial improvement in the quality of the **Budget Papers** themselves. Nearly all of the suggestions made in ANZ's commentary on last year's Budget have been taken up in this one. As a result, Tasmania is now second only to Western Australia in terms of the quality and comprehensiveness of the information presented in its Budget Papers. In particular, Tasmania's Budget Papers are more informative than those of the Commonwealth Government.

Author:

Saul Eslake
Chief Economist
+61 3 9273 6251
saul.eslake@anz.com

The Budget's 'bottom lines'



Note: the 'net operating balance' is the excess of revenue (excluding asset sales) over expenses (including depreciation but excluding capital expenditures). The 'fiscal balance' is the net operating balance plus net additions to the capital stock.

Modest revenue and spending measures

The Budget contains a small number of revenue initiatives:

- a 21% cut in the **tax on light vehicles** from 1 October (with a full year cost of \$9½ mn pa) and a two-thirds reduction in the **duty on transfer of heavy vehicle registrations** (full-year cost of about \$5mn pa) – funded by the abolition of the 2¢ per litre **subsidy on petrol and diesel fuel** currently paid to oil companies (eventually saving \$17mn pa)
- introduction of a new \$20 annual **road safety levy** for five years from 1 December, raising \$8½ mn pa to be spent on road safety initiatives;
- introduction of an (insurable) Ambulance Service Fee;

- phasing out from 1 January 2008 of **payroll tax concessions** for IT employees and apprentices, saving around \$5½mn pa which will be re-directed towards other programs of assistance to SMEs and for apprenticeships and trainees;
- **Special Dividends** of \$30mn over three years from the Motor Accidents Insurance Board (which has enjoyed exceptionally strong investment returns in recent years) and \$12mn over four years from TOTE Tasmania.

On the expenditure side the initiatives are also fairly small:

- \$5mn per annum for planning associated with the proposed **new Royal Hobart Hospital**;
- \$13mn over four years for the Government's arrangement with the **Hawthorn Football Club**;
- \$12.3mn as Tasmania's contribution to action to protect **Macquarie Island**;
- \$4.6mn over four years for further work on **water and sewerage** reform; and
- an additional \$1½mn per annum for **arts grants**¹.

Although the Budget includes, according to the Treasurer's Speech, 'an exciting new strategy to take Tasmania's **education** sector forward to a more productive future' (and this analyst warmly applauds the initiatives announced by Education Minister David Bartlett designed to increase school retention rates beyond Year 10), it does not provide for new recurrent expenditure initiatives in the education portfolio.

Education does feature prominently in the capital works side of the Budget, however, with \$30mn over the next four years for improvements to school buildings, for the proposed Learning and Information Network Centre and for the new Kingston High School.

The Budget also provides for the **sale of Hobart Airport** (bringing Tasmania into line with other States where the capital city airports are all owned by the private sector), the Printing Authority of Tasmania and the Southern Regional Cemetery Trust. The Budget estimates do not include any provision for the sale proceeds (although the Treasurer has since suggested that Hobart Airport should sell for more than \$40mn).

Thus the 'policy decisions' taken since last year's Budget or announced in this Budget are largely mutually offsetting in terms of their impact on the 'bottom line'. For 2007-08, the net impact of revenue and operating expense decisions is to increase the operating deficit by \$10mn; while for 2008-09 and 2009-10 the net impact is to improve the operating balance by \$6mn and \$7mn respectively.

The total impact of 'policy decisions' on the net operating balance over the next three years is actually to *improve* it by \$3mn; while the cumulative impact of capital expenditure decisions on the fiscal balance over the next three years is to reduce it by \$38mn.

Priority given to the fiscal strategy

Instead, although the Treasurer's Budget Speech doesn't trumpet it, the principal consequence of this Budget is to bring the Government much closer to meeting the Fiscal Strategy targets laid down in last year's Budget.

Among the key elements of that strategy are:

- the **net operating balance** to be in surplus on average over rolling four-year periods;
- the **fiscal balance** to be in surplus over rolling four-year periods;
- the general government sector to remain **net debt** free;
- the net **unfunded superannuation liability** to be extinguished by 2033; and
- Tasmania's '**tax severity ratio**' to be maintained below the all-States average.

On last year's Budget projections, neither of the first two targets would have been met beyond the 2007-08 fiscal year. Indeed, last year's Budget projected operating deficits in every year between 2006-07 and 2009-10, and fiscal deficits each year through 2008-09 (see the charts on page 1).

That was largely because last year's Budget lifted non-interest operating expenses by some \$125mn (or around 5¼% pa) and capital outlays by nearly \$60mn per annum in order to 'deliver' on the promises made by the Lennon Government during the 2006 election campaign. Last year's Budget Papers foreshadowed that the Government would 'need to take action ... to ensure that the net operating surplus and fiscal surplus targets are met'.

And this is what the 2007-08 Budget essentially seeks to do. It envisages the operating balance returning to surplus by 2008-09, with all of the fiscal strategy objectives being satisfied except for very small operating and fiscal deficits being incurred, on average, over the four years ended 2009-10.

This outcome stems from the fact that, in net terms, the Government has directed all of the favourable impact (compared with what was expected in last year's Budget) of increased grants from the Commonwealth, increased stamp duty collections and higher mineral royalties² to flow through to the bottom line, rather than being absorbed by policy decisions.

This can be seen from the table on page 3, which is drawn from the 'Policy and Parameter Statement' included for the first time in Budget Paper No 1. What the table shows is that 'parameter variations' since last year's Budget have improved the net operating balance by a total of \$168mn over the three years 2007-08 through 2009-10; and that the net impact of the policy decisions in the Budget was to improve the operating balance by a further \$3mn over these three years.

¹ Which, in another capacity (as Chair of the Tasmanian Arts Advisory Board), I particularly welcome.

² These favourable 'parameter variations' more than offset the adverse effect of revenue from Betfair being revised downwards by a total of \$86mn over the three years to 2009-10).

Impact of 'policy decisions' and 'parameter variations on the net operating balance

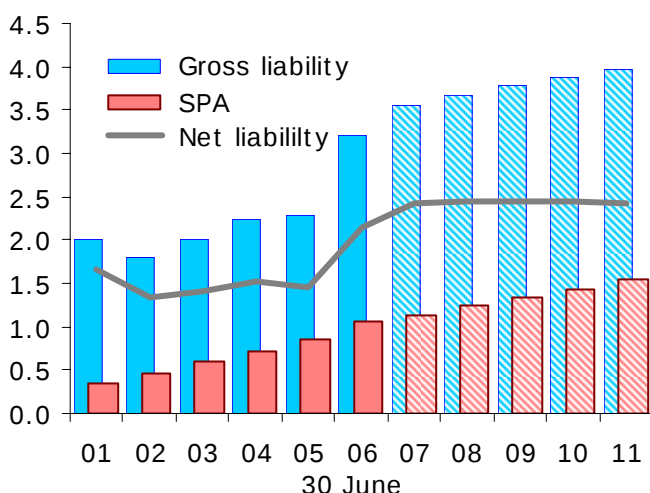
	\$ millions			
	2007-08	2008-09	2009-10	Total
Net operating balance in 2006-07 Budget	-101	-43	-29	-173
Plus 'parameter variations'				
Revenues	174	205	172	551
Expenses	-103	-146	-134	-383
Total	71	59	38	168
Plus 'policy variations'				
Revenues	7	8	7	22
Expenses	-17	-2	0	-19
Total	-10	6	7	3
Net operating balance in 2007-08 Budget	-40	22	16	-2

Note: 'Parameter variations' are changes to the Budget and Forward estimates due to the economic environment, the agency operating environment or the timing of a transaction. A 'policy variation' is the result of a specific decision by the Government related to a new policy or a change in the Government's existing policy position. A negative (positive) number in this table indicates that the variation detracts from (improves) the net operating balance.

Consistent with the improvement in the accrual measures of the 'bottom line', the 2007-08 Budget projects **cash surpluses** some \$43mn (or 50%) larger on average than foreshadowed in last year's Budget. As a result, the general government sector's net debt position is expected to improve to -\$746mn (that is, financial assets exceeding gross debt by \$746mn) by 30 June 2010, \$211mn more than foreseen in last year's Budget, and to reach -\$946mn by the end of the forward estimates period on 30 June 2011.

The bulk of these cash surpluses will be directed towards the **Superannuation Provision Account** (which is, in effect, a State version of the Commonwealth's Future Fund). By June 2011 this Account is projected to have net assets of over \$1.5bn, an increase of some \$0.4bn from its expected 30 June 2007 level.

Unfunded superannuation liabilities



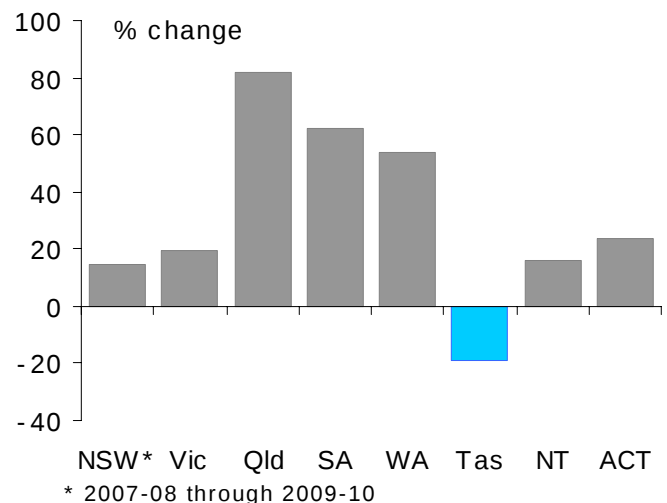
Tasmania's Budget differs from other States

With only New South Wales yet to bring down its 2007-08 Budget, it is apparent that Tasmania is following a somewhat different fiscal strategy from most other States and Territories.

Apart from Western Australia (where State government revenues have been dramatically boosted by the resources boom), Tasmania is the only State expecting to run fiscal surpluses during the second half of the four-year forward estimates period (ie in 2009-10 and 2010-11). Along with the two Territories (which have also enjoyed significant revenue gains in recent years), Tasmania and WA are the only jurisdictions expecting to run 'general government' cash surpluses over the entire forward estimates period.

Every other State is anticipating a significant ramping up in the level of **capital expenditures** over the next four years – of between 14% in New South Wales (based on its 2006-07 Mid-Year Review projections) and 82% in Queensland – compared with 2005-06 levels; and is willing to undertake additional borrowings (except in WA and the Territories where they aren't necessary) in order to fund them. By contrast, the level of general government capital spending in Tasmania over the next four financial years is expected to be 19% lower (on average) than in 2005-06.

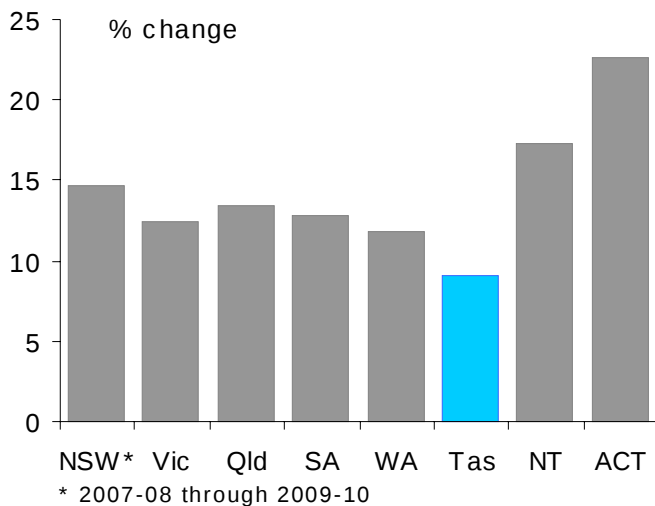
Average general government 'purchases of non-financial assets' (capital expenditures) 2007-08 to 2010-11 compared with 2005-06



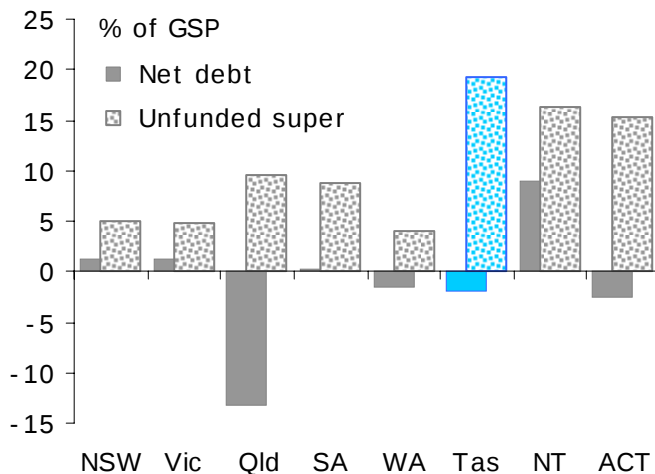
Tasmania's inability (or reluctance) to embark upon a more aggressive capital expenditure program reflects two relatively greater constraints on its budgetary flexibility compared with that open to other States:

- Tasmania's **revenue base** is growing less rapidly than that of other States, large because of its smaller exposure to the commodities boom; and
- Tasmania has a bigger **unfunded superannuation liability** than any other State (which requires it to run cash surpluses to offset those liabilities rather than using them to finance capital expenditures).

Average general government receipts 2007-08 to 2010-11 compared with 2005-06



General government net debt and unfunded superannuation liabilities, 30 June 2007



The speed with which Tasmania is electing to offset its unfunded superannuation liability by running cash surpluses and applying them to the Superannuation Provision Account is to some extent a matter of choice. However the Government has already chosen (in last year's Budget) to push out the date at which the liabilities are to be fully funded from 2018 to 2033.

Tasmania's economy expected to pick up

'State economic activity' is forecast to grow by 3½% in 2007-08, a noticeable pick up from the 2½% now expected for 2006-07. 2006-07 growth was originally forecast to have been 3½% in last year's Budget and revised down to 2¾% in February's Mid-Year Review.

Consistent with the enhanced transparency of this year's Budget Papers, Treasury has for the first time provided some insight into the compilation of its measure of 'State economic activity', its proxy for the Statistics Bureau's measure of gross State product (GSP), which it considers 'not reliable for a small economy such as Tasmania'. It is derived from the forecast for employment growth and average hours worked, plus an assumption about productivity growth.

Thus for 2006-07, with a forecast for employment growth of ½% (which after the upward revisions to employment growth in recent months released on the morning of the Budget will almost certainly exceed ¾%), and an increase of about 1½% in average hours worked, 2½% growth in economic activity implies productivity growth of ½%. This represents a substantial decline from the 2%-plus annual growth rate of productivity in 2004-05 and 2005-06, but is consistent with national data for the first three quarters of 2006-07.

The 2007-08 forecast assumes that growth in State economic activity will be boosted by ½ pc point by the commencement of construction work on Gunns Ltd's proposed **pulp mill** in the second half of the year. The forecast also assumes that work on the Alinta power station at Bell Bay and the Musselroe Bay eco-tourism project gets under way during the year. A sharp downturn in business investment following the completion of major energy projects has been one of the major reasons for the slowdown in overall economic growth in Tasmania since the end of 2005.

Employment is expected to grow by 2¼% in 2007-08, of which ¼ pc point is attributed to the commencement of construction work on the pulp mill. Some of these jobs are expected to go to workers drawn from the mainland or overseas, lifting the forecast for population growth by 0.1 pc pt to 0.7% in 2007-08. Even with an anticipated ½ pc pt increase in the labour force participation rate, this would be sufficient to cut the **unemployment rate** to an average 5½% in 2007-08, ½ pc pt lower than that expected for 2006-07.

Hobart's **inflation** rate is forecast to average 2½% in 2007-08, in line with the national average.

Statistics released last week on State final demand and employment suggest that Tasmania's economy may be now be picking up from last year's pronounced slowdown. Against that background, Treasury's forecasts for 2007-08 appear reasonable.

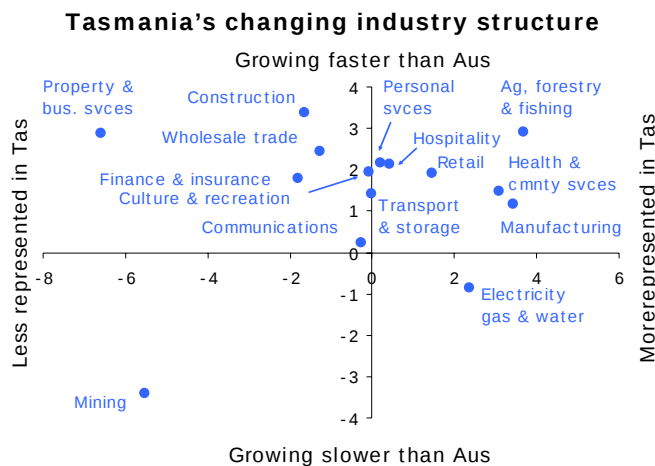
With the sharp fall in unemployment in May (to 4.4%), and downward revisions to the figures for earlier months, the average unemployment rate for 2006-07 is now more likely to be around 5¾%. Hence if employment grows as forecast, the unemployment rate could average close to 5% in 2007-08.

Among the **risks** which Treasury identifies to the outlook are the usual global factors (the US economy, global imbalances and higher oil prices), any further large increases in interest rates (although Treasury thinks that is unlikely) and the possibility that construction work on the pulp mill does not commence in the second half of the year.

A further risk not mentioned by Treasury is the possibility of slower population growth. The most recent population statistics indicate that Tasmania is again losing people to the mainland for the first time in four years – at an average rate of 8 people per week during 2006, compared with net interstate arrivals averaging 58 people per week during 2003. This has halved Tasmania's population growth rate from a most recent peak of 1.2% in 2004 to 0.6% during 2006.

Treasury's analysis of recent performance of the Tasmanian economy rightly emphasizes the importance of lifting Tasmanian productivity given the State's above-average exposure to demographic change, and the difficulty of attracting investment and skilled labour to low-productivity regions in increasingly competitive global and national markets.

The analysis also includes an interesting chart (reproduced below) showing that sectors which at the national level have enjoyed high growth rate but which are relatively under-represented in Tasmania – such as property and business services, or finance and insurance – have been growing in importance in Tasmania in recent years (as indicated by their position in the upper left quadrant). Some of the industries which are more important to Tasmania's economy than the national economy have also been enjoying faster growth than their respective national averages – such as agriculture and manufacturing (in the upper right-hand quadrant).



Note: the horizontal axis shows the difference in sectoral growth rates between Tasmania and Australia as a whole over the period 2000-01 to 2005-06, while the vertical axis shows the difference between sector shares of gross value added in Tasmania and Australia as a whole in 2005-06. *Source:* 2007-08 Budget Paper No 1, Chart 2.13.

On the other hand, the mining sector – which accounts for a smaller proportion of Tasmania's economy than for Australia as a whole – is growing at a much slower rate than its national counterpart (hence its position in the lower left-hand quadrant). As noted earlier, this has implications for the revenue side of Tasmania's budget compared with those of other States.

Much improved Budget Papers

This year's State Budget Papers have rectified most of the inadequacies noted in ANZ commentaries on previous State Budgets. In particular:

- as noted earlier, the Budget Papers now include a **'Policy and Parameter Statement'** showing separately the impact on the Budget of 'policy decisions' taken by the Government and of changes in economic and other assumptions since the previous Budget (so-called 'parameter variations'). This provides much more detailed information on the reasons for changes in the shape of the Budget than is provided, for example, in the Commonwealth Budget Papers;

- the Budget Papers provide financial statements for the **public non-financial corporations sector** and for the **non-financial public sector as a whole** for the **full four-year forward estimates period**, instead of (as previously) just for the forthcoming financial year (as the Commonwealth and Victorian Budget Papers still do);
- the economic outlook section of the Budget Papers now provides **projections of key economic and demographic indicators** for the **full four-year forward estimates period** rather than just for forthcoming financial year. And, as noted above, Treasury has now provided an explanation of how its measure of 'State economic activity' is compiled. Although (as is the case in other States and for the Commonwealth) the projections for the out-years do not carry the same status as the forecast for the year ahead, they give an indication of the assumptions on which the forward estimates have been based.

These improvements represent a significant advance in the usefulness and extent of disclosure in Tasmania's Budget Papers, for which the Treasurer and Treasury deserve commendation. The discussion on pp. 2-3 of this report, and in particular the table at the beginning of p. 3, would not have been possible without the 'Policy and Parameter Statement' set out in Chapter 4 of Budget Paper No 1.

Tasmania's Budget Papers are now arguably second only to Western Australia's in terms of the extent and quality of the information provided therein. To match Western Australia, Tasmania's Budget Papers would need to include:

- forward estimates for the public financial sector (which WA is the only jurisdiction to provide);
- projections of the major sources of State taxation and grants from the Commonwealth, and of operating expenses and purchases of non-financial assets (capital outlays) by purpose (ie, education, health etc.) over the full four-year forward estimates period rather than just for the forthcoming financial year; and
- an indication of the sensitivity of key components of the Budget (such as taxation revenue or expenses) to changes in economic parameters such as employment growth or inflation.

These are reforms which merit attention in next year's Budget.

Some 'big decisions' have to be taken soon

This is a very conservative Budget, especially when compared with the Budgets brought down by other State and Territory Governments over the past few weeks. That is not intended as a criticism, but as a statement of fact. As explained earlier, the conservatism of this Budget is the inevitable outcome of the big spending in last year's Budget, the limited impact on Tasmania's revenues of the resources boom, and the need to deal with Tasmania's above-averaged unfunded superannuation liability.

Yet Tasmania needs to incur some significant expenditures over the next few years if it is to continue to narrow the 'productivity gap' with the mainland and to attract investment in an increasingly competitive national and global environment. In particular:

- the Government is committed to building a new Royal Hobart Hospital, at a capital cost likely to exceed \$800mn;
- reform of Tasmania's water, sewerage and irrigation systems is likely to require investment of up to \$825mn, according to the Treasurer;
- the Southern Transport Investment Program (including the Brighton Transport Hub) has a \$280mn price-tag – of which less than half is likely to be picked up by the Commonwealth; and
- the Government will need to put real money behind David Bartlett's education reforms. Lifting Tasmania's retention rate from Year 10 to Year 12 by 11 percentage points (the gap between Tasmania and the national average in 2006) will not come cheaply.

Tasmania needs to find a way of 'breaking out' of its current fiscal strait-jacket without putting the sustainability of its public finances (hard-won over the past decade) at risk.

The most obvious way of achieving this is through **major asset sales**. This Budget makes a start in that direction, with the proposed sale of Hobart Airport, the Printing Authority and the Southern Regional Cemetery Trust.

However these are 'tiddlers' compared with the Government's total equity in public financial and non-financial corporations, and (through the Department of Economic Development) in private sector businesses, which the Budget Papers estimate to be \$3.1bn as at the end of this month, rising to \$3.67bn by 30 June 2011. Most of this equity is in the Government's energy businesses (Hydro Tasmania, Aurora and Transend), Forestry Tasmania, the Motor Accidents Insurance Board and TT Line.

The Labour Government came to office in 1998 on a platform which prominently included a pledge not to privatize the then Hydro-Electric Commission. When the HEC was subsequently disaggregated into three separate businesses, the enabling legislation included a provision stipulating that none of them could be sold without prior approval at a referendum.

While it is almost impossible to envisage the present Government selling the iconic Hydro assets, there is no compelling reason why it should not sell part or all of its stake in the 'downstream' businesses Transend and Aurora, which on conservative valuations could realize at least \$400mn and \$500mn respectively.

Last November the Queensland Labor Government sold its Energex retail business (as Sun Retail and Sun Gas) for \$1.3bn, \$300mn more than expected, a month after selling its Allgas distribution business for \$535mn. The sky has not fallen in over south-east Queensland as a result.

And despite previous promises to the contrary, it is possible that the New South Wales Labor Government will contemplate the sale of at least part of its wholly-owned electricity businesses during its current term of office.

There is no reason why the Tasmanian Government should not be prepared to follow the same course.

The Budget estimates also indicate that the Government directly owns land and other fixed assets to the value of nearly \$8.7bn. Much of this is required for Government use (including offices, schools, hospitals and community facilities) or could not feasibly be sold (including national parks and conservation areas). But it is hard to believe that there isn't at least some land currently owned by the Government which could not be sold without compromising other legitimate objectives.

The proceeds of major asset sales should either be applied to reducing Tasmania's unfunded super-annuation liabilities (thereby reducing the need to run such large cash surpluses), or used directly to fund major capital works commitments.

The Government could also consider options for private sector participation in infrastructure provision. Although this may not be suitable for the Royal Hobart Hospital or schools, private sector involvement in the provision of transport and (less commonly) water infrastructure has been successfully pursued in other States.

The Government may also need to examine options for raising additional revenue. According to Commonwealth Grants Commission estimates Tasmania has the second-lightest State taxation burden in Australia (after Queensland), raising about 3% less per head of population than it would if its tax regime were of the same severity as the average of all States and Territories (after allowing for Tasmania's below-average revenue-raising capacity).

However Queensland's very low revenue-raising effort (almost 15% below the all-State average) is looking increasingly unsustainable, especially as Queensland moves towards becoming a 'donor State' under the GST revenue-sharing arrangements. Queensland's State taxes are likely to rise in coming years, which means that Tasmania could afford to contemplate some modest increases in State taxes, if necessary, without surrendering its relatively advantageous competitive position relative to other States.

In South Australia, for example, residential water consumers (other than eligible pensioners) now pay an annual levy of around \$32 (and non-residential users \$142) indexed to Adelaide CPI movements, which funds improvements in the long-term security and quality of that State's water supply. A similar measure could be used to fund part of the costs of improvements in Tasmania's water supply infrastructure.

An unwillingness to contemplate imaginative options will inevitably mean that future Tasmanian Budgets will look like this one, and the major challenges facing the State will remain unresolved.

Research

Economics@ANZ

Saul Eslake

Chief Economist
+61 3 9273 6251
saul.eslake@anz.com

Fiona Allen

Business Manager
+61 3 9273 6224
fiona.allen@anz.com

Tony Pearson

Head of Australian
Economics
+61 3 9273 5083
tony.pearson@anz.com

Mark Rodrigues

Senior Economist -
Industry
+61 3 9273 6252
mark.rodrigues@anz.com

Riki Polygenis

Senior Economist (Acting) –
Australia
+61 3 9273 4060
riki.polygenis@anz.com

Wain Yuen

Economist – Industry
+61 3 9273 6295
wain.yuen@anz.com

Amber Rabinov

Economist - Australia
+61 3 9273 4853
amber.rabinov@anz.com

Amy Auster

Head of International
Economics
+61 3 9273 5417
amy.auster@anz.com

Katie Dean

Senior Economist,
International
+61 3 9273 5466
katie.dean@anz.com

Jasmine Robinson

Senior Economist -
International
+61 3 9273 6289
jasmine.robinson@anz.com

Dr Alex Joiner

Economist –
International
+61 3 9273 6123
alex.joiner@anz.com

Paul Braddick

Head of Financial System
Analysis
+61 3 9273 5987
paul.braddick@anz.com

Ange Montalti

Senior Economist -
Financial System Analysis
+61 3 9273 6288
ange.montalti@anz.com

Warren Hogan

Head of Financial Markets
Economics
+61 2 9227 1562
warren.hogan@anz.com

Cherelle Murphy

Economist
- Markets
+61 3 9273 1995
cherelle.murphy@anz.com

ANZ Markets Research

Warren Hogan

Head of Markets
Research
+61 2 9227 1562
warren.hogan@anz.com

Sally Auld

Senior Interest Rate
Strategist
+61 2 9227 1809
sally.auld@anz.com

Tony Morriss

Senior Currency Strategist
+61 9226 6757
anthony.morriss@anz.com

Patricia Gacis

Fixed Income Analyst
+61 2 9227 1272
patricia.gacis@anz.com

David Croy

Strategist (London)
+44-20 7378 2070
david.croy@anz.com

Sarah Percy-Dove

Head of Credit Research
+61 2 9227 1142
sarah.percy-dove@anz.com

John Manning

Senior Credit Analyst
+61 2 9227 1493
john.manning@anz.com

Bradley Bugg

Senior Credit Analyst
+61 2 9227 1693
bradley.bugg@anz.com

Research & Information Services

Mary Yaxley

Head of Research &
Information Services
+61 3 9273 6265
mary.yaxley@anz.com

Marilla Rough

Senior Information
Officer
+61 3 9273 6263
marilla.rough@anz.com

Manesha Jayasuriya

Information Officer
+61 3 9273 4121
manesha.jayasuriya@anz.com

ANZ National New Zealand

Cameron Bagrie

Chief Economist (NZ)
+64 4 802 2212
bagriec@anz.com

Khoon Goh

Senior Economist
+64 4 802 2357
gohk@anz.com

Phillip Borkin

Economist
+64 4 802 2199
borkinp@anz.com

Sean Comber

Economist
+64 4 802 2286
combers@anz.com

Steve Edwards

Economist
+64 4 802 2217
edwards1@anz.com

Kevin Wilson

Rural Analyst
+64 4 802 2361
wilsonk1@anz.com

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Australia and New Zealand Banking Group Limited ABN 11005 357 522
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Telephone +61 3 9273 6224 Fax +61 3 9273 5711

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Australia and New Zealand Banking Group Limited
ABN 11 005 357 522
40 Bank Street, Canary Wharf, London, E14 5EJ, United Kingdom
Telephone +44 20 3229 2121 Fax +44 20 7378 2378

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Tel: +1 212 801 9160 Fax: +1 212 801 9163

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ANZ National Bank Limited
Level 7, 1-9 Victoria Street, Wellington, New Zealand
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